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CYPRUS

April 2014

THIRD REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR

The following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 28, 2014, following discussions that ended on February 11, 2014, with the officials of Cyprus on economic developments and policies underpinning the IMF Extended Arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on March 13, 2014.
- A **Staff Supplement** of March 24 updating information on recent developments.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Cyprus.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Cyprus*
Memorandum of Economic and Financial Policies by the authorities of Cyprus*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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International Monetary Fund
Washington, D.C.

CYPRUS

March 13, 2014

THIRD REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

Extended Arrangement: On May 15, 2013, the Executive Board approved a three-year Extended Arrangement under the Extended Fund Facility in the amount of SDR 891 million (563 percent of quota; about €1 billion). Three purchases of amounts equivalent to SDR 74.25 million (about €86 million) each have been made so far, and another purchase of the same amount is proposed to be released upon completion of the third review. The European Stability Mechanism has released €4.6 billion of €9 billion committed, with a disbursement of €150 million expected in early April.

Recent Economic Developments: While deep, the 2013 recession was not as severe as anticipated. The adjustment is occurring through both quantities and prices, and signs of stabilization are emerging in the banking sector. However, the outlook remains challenging, with rising unemployment, falling credit, and increasing non-performing loans. In this context, growth projections remain unchanged, with a deep contraction expected in 2014 and a modest and credit-less recovery taking hold in mid-2015.

Policy Implementation: The program remains on track. Fiscal targets were met with considerable margins, the coop sector was recapitalized, and additional relaxations of payment restrictions are being implemented. Delays in the implementation of structural reforms have recently been overcome. Looking forward, policies will need to focus on dealing with the high level of non-performing loans, further normalizing payment flows, maintaining fiscal prudence, and stepping up the implementation of the ambitious fiscal structural reform agenda. Risks to program implementation remain significant, including due to remaining financial sector vulnerabilities and diminished political support following the breakup of the governing coalition.

Approved By
Philip Gerson and Mark Flanagan

Discussions were held in Nicosia during January 29 - February 11. The mission met with the Minister of Finance, the Governor of the Central Bank of Cyprus, other Cabinet Ministers, members of Parliament, leaders of the main political parties, union representatives, and other representatives of the private sector. Staff worked in conjunction with representatives from the European Commission and the European Central Bank. The IMF team comprised Delia Velculescu (head), Luis Cortavarría, Chady El Khouri, Alejandro Hajdenberg, Yinqiu Lu, Jeta Menkulasi, Uffe Mikkelsen, Jiri Podpiera, Preya Sharma, Alejandro Simone, and Oliver Wuensch. Vincenzo Guzzo and Maria Heracleous (IMF resident representative office) assisted the mission. Mr. Kanaris (OED) attended some of the meetings.

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BACKGROUND

1. **The program remains on track.** All end-December and continuous performance criteria (PCs) were met, in some cases with significant margins. Compliance with structural conditionality, however, was mixed (Table 13). On one hand, the structural benchmark (SB) on fulfilling the preconditions for injection of state aid in the cooperative sector was met, and the sector was recapitalized. The authorities also met the SB on strengthening AML-related supervision of banks. On the other hand, remaining SBs were not met on time. Structural and program requirements related to legislation on budget systems and privatization were eventually fulfilled as prior actions for the completion of the third review. The authorities also committed to implement as a prior action structural requirements to combat tax evasion. They requested more time to entrust the voting rights of legacy Laiki's equity stake in Bank of Cyprus (BoC) to an independent entity.

2. **Political support for the program is, however, weakening.** Following almost 40 years of division of the island between the Greek and Turkish Cypriots, the two sides have recently restarted negotiations toward a common solution. While this could bring important long-term benefits, in the short run, it led to a breakup of the governing coalition, with the DIKO party having left the government. This could complicate the government's ability to advance its reform agenda, especially in key areas such as privatization and insolvency legislation, where labor unions and other vested interests have been intensifying their opposition. The Central Bank Governor announced his resignation on March 10; a new Governor has been appointed and will assume duties on April 11.

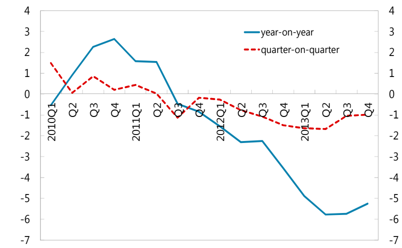
3. **European policies and initiatives are broadly supportive of Cyprus's situation**. The ECB's accommodative monetary policy stance and collateral policies are helpful, although Cyprus could benefit from further ECB action to reduce fragmentation of the financial system and relax bank collateral requirements, and deflation remains a risk. Furthermore, the upcoming introduction of the Single Resolution and Supervisory Mechanisms (SRM, SSM) in the Euro-area will help to strengthen supervision of Cypriot banks and coops. Additional efforts toward European backstops, such as ESM direct recapitalization, could further help to reduce remaining concerns regarding the strength of Cypriot banks should negative risks materialize.

RECENT ECONOMIC DEVELOPMENTS

4. **The economy is adjusting through both quantities and prices**. The decline in nominal GDP during the first three quarters of 2013 was close to the program forecast (around 7 percent). The data continue to signal a smaller-than-expected adjustment of quantities but a larger-than-forecasted adjustment of prices:

- ***Staff estimates the 2013 growth outturn in the range of -6 percent, significantly better than the projected -7.7 percent*** (Figure 1). The flash outturn signals that the result could be even better, perhaps -5.3 percent.[1] However, the flash estimate remains subject to measurement uncertainty, and published data could be further revised even months and years after publication. In the fourth quarter, output appears to have fallen by about 1 percent q-o-q and 5.3 percent y-o-y, continuing the trend of slowing rates of decline since the trough reached in the second quarter. Recent indicators on retail and cement sales suggest that the fall in private consumption and investment in the fourth quarter has been moderating compared to the third quarter. Monthly trade data also point to a lower decline in imports and to a modest contraction of exports, likely resulting in a smaller contribution of net exports to growth in the last quarter. On the supply side, tourism receipts continued to outperform expectations, and construction activity, while still depressed, may have bottomed out in the third quarter. Economic sentiment indicators improved for a tenth consecutive month in February, driven by consumption, construction, and industry.

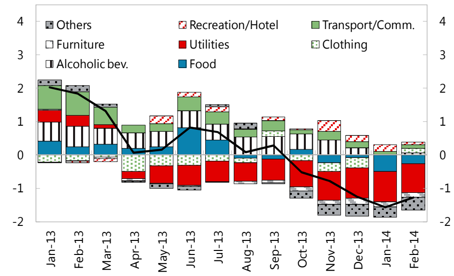
GDP Growth
(Percent)



Source: Cystat.

- ***HICP inflation averaged 0.4 percent in 2013, against a projected 0.8 percent.*** Inflation has been on a downward trend in 2013 and turned negative in October, reaching -1.3 percent in February. Core inflation stood at -0.7 percent in January. Utility prices have contributed to the declining trend, driven by lower global fuel prices and administratively imposed cuts in electricity prices. But, in the context of weak domestic demand, other prices have also been falling. The GDP deflator in the first three quarters registered a decline of about 1.5 percent, mostly due to compensation cuts in the public sector and falling prices of capital goods.

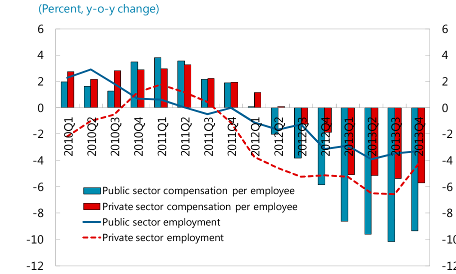
Contributions to HICP
(Percentage points)



Sources: Eurostat; and IMF staff estimates.

5. **In the labor market, lower wages are helping to cushion the fall in employment** (Figure 2). Economy-wide compensation per employee fell by 6.1 percent y-o-y in 2013, largely driven by cuts in the public sector (by an estimated 9.4 percent), while in the private sector, the decline was estimated at 5.3 percent. The statistics may underestimate the wage adjustment—given the implementation of some of the public sector wage reductions as witholding taxes—and do not include more recently agreed private sector wage cuts, including in the cooperative credit sector. Total employment declined by 5.2 percent during the same period (compared to a projected decline of 6.3 percent for the year). As a result—with the labor force relatively stable—the unemployment rate reached 17.2 percent in December, better than expected, while youth unemployment stood at 40.2 percent, among the highest in the eurozone.

Labor Market
(Percent, y-o-y change)

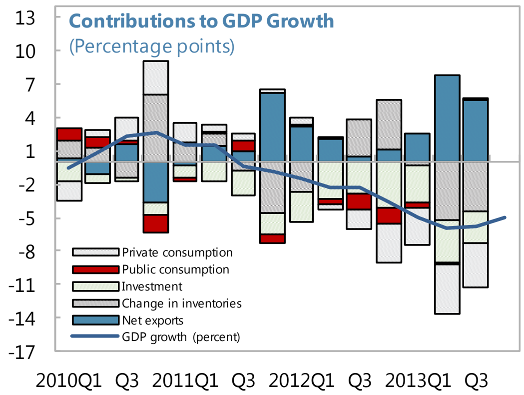


Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

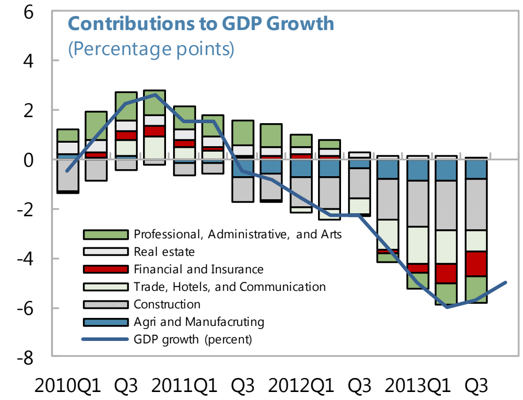
[1] Final national accounts data will become available on March 11.

Figure 1. Cyprus: Recent Economic Developments

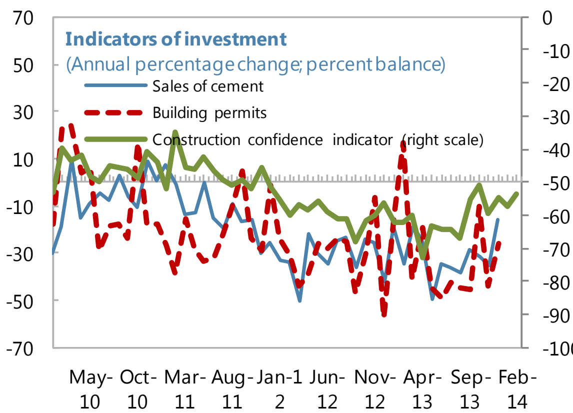
In 2013, domestic demand remained weak, while the contribution from net exports was positive, given a contraction in imports.



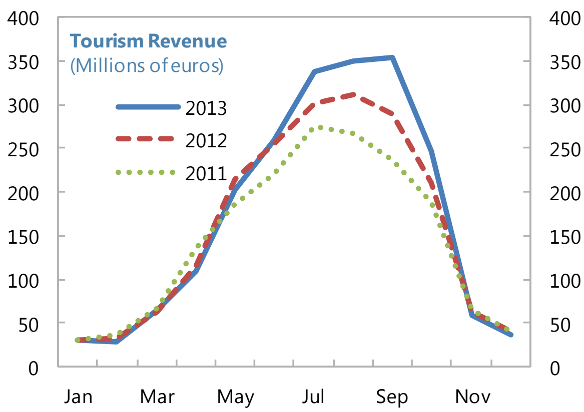
Output declined across the board, with construction and manufacturing particularly affected.



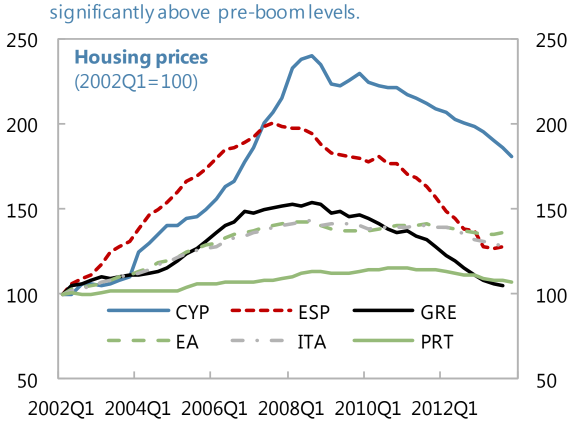
The decline in sales of cement and building permits moderated recently.



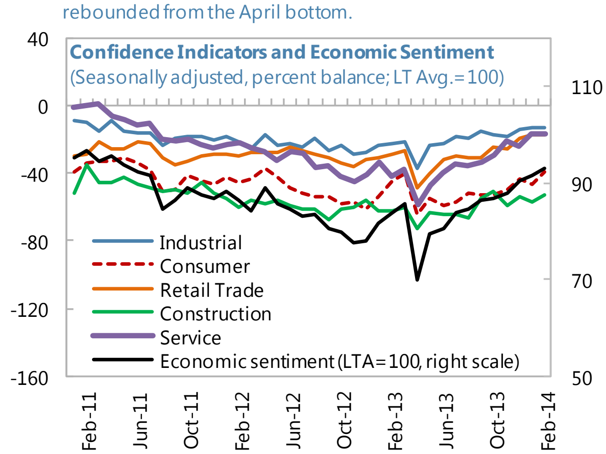
Tourism has been resilient.



Housing prices have declined from their peak, but remain significantly above pre-boom levels.



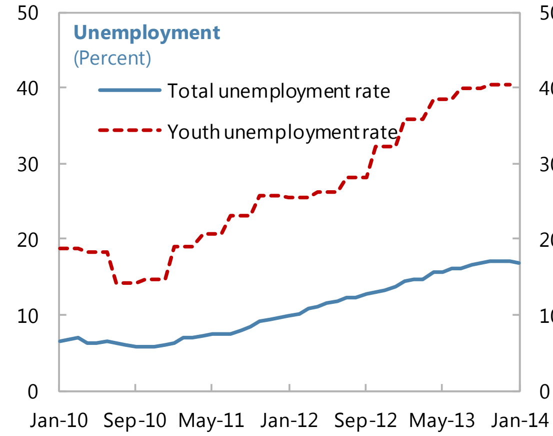
Confidence indicators and economic sentiment have rebounded from the April bottom.



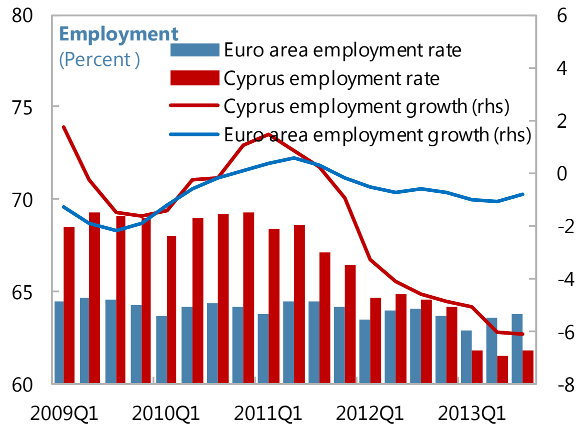
Sources: Central Bank of Cyprus; Cystat; ECB; Eurostat; and IMF staff estimates.

Figure 2. Cyprus: Labor Market

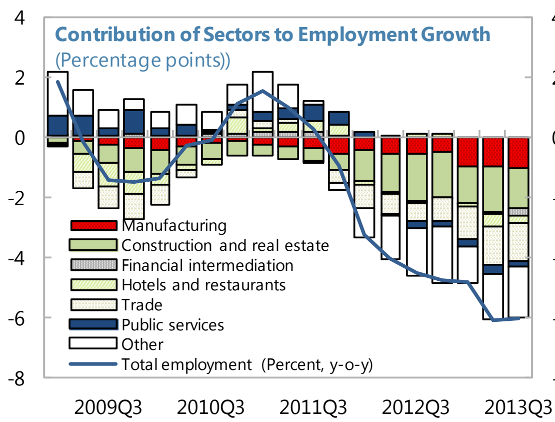
Unemployment, particularly for youth has increased, although the trend flattened recently.



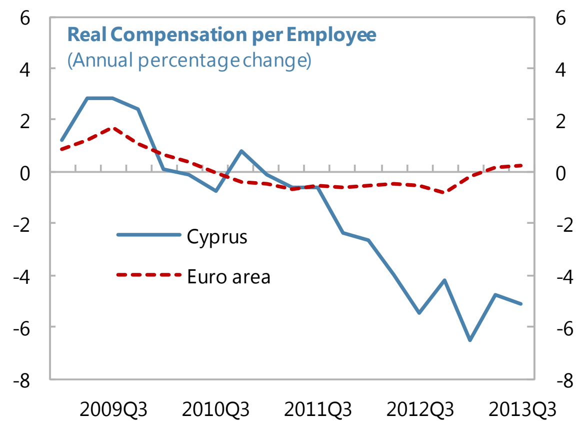
Employment has fallen rapidly.



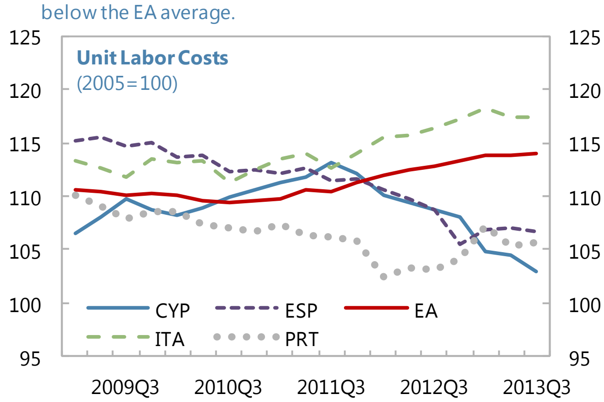
The decline in employment is broad based.



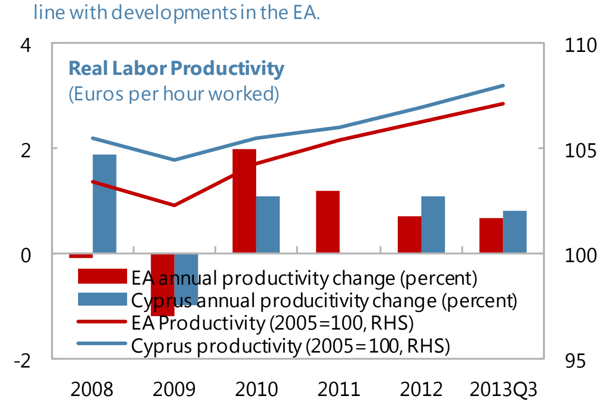
Compensation is also adjusting.



As a result, unit labor costs have declined, falling well below the EA average.

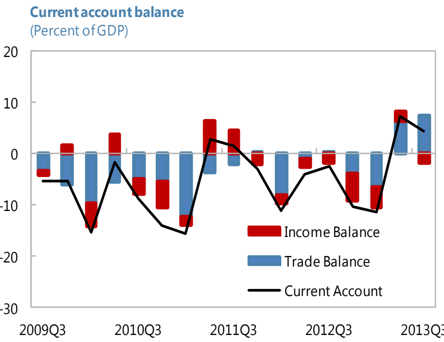


In recent years, labor productivity has moved broadly in line with developments in the EA.



Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

6. **The current account reached a small surplus in the first three quarters of 2013, on the back of strong import compression** (Figure 3). The surplus of 0.3 percent of GDP compares to a deficit of 5.7 percent of GDP during the same period in 2012. Imports plummeted by 15.7 percent y-o-y, reflecting the contraction in domestic demand, while exports declined by about 4.4 percent y-o-y, with rising exports of goods and tourism only partially offsetting the decline in other service exports. In the third quarter, while the trade balance continued to improve, the current account surplus declined as a result of negative income flows related to lower returns on investment assets abroad. Indicators for the fourth quarter suggest that the decline in imports moderated and exports contracted marginally relative to the third quarter.



Sources: Central Bank of Cyprus and IMF staff estimates.

7. **The 2013 fiscal deficit was significantly lower than programmed**. The general government primary deficit (cash basis) reached 1.7 percent of GDP, compared to a projected adjusted target of 3.2 percent of GDP. Revenues were higher than expected by 0.5 percent of GDP, on account of higher social contributions due to a lower-than-anticipated decline in overall employment and to one-off transfers from the EU budget. Primary spending was lower than targeted by about 1 percent of GDP, reflecting a smaller wage bill as a result of higher redundancies in the public sector (about 1,600 relative to a target of 1,000), additional across-the-board cuts in spending on goods and services, and lower execution of capital expenditures, which more than offset modest overruns in the payment of social transfers and other current spending. In January, the primary balance reached a surplus of about 1 percent of GDP, 0.6 percent of GDP better than programmed, due to continued better-than-expected tax revenues and social contributions.

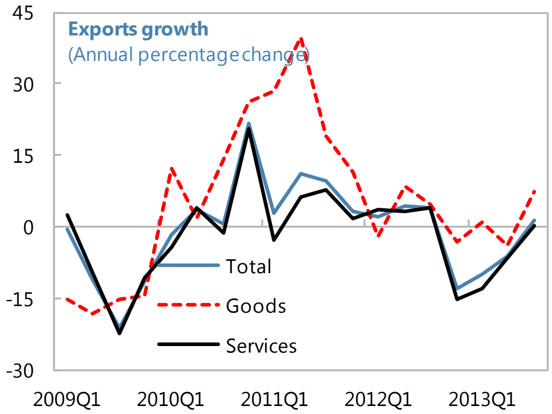
General Government, January-December 2013 1/2/

	(Millions of Euros)		(Percent of GDP)	
	Program 3/	Prelim.	Program 3/	Prelim.
Revenue	**6,770**	**6,848**	**41.2**	**41.7**
Taxes on production and imports	2,420	2,402	14.7	14.6
Current taxes on income and wealth, etc	1,919	1,921	11.7	11.7
Social contributions	1,433	1,482	8.7	9.0
Other revenue	998	1,044	6.1	6.4
Expenditure	**7,824**	**7619**	**47.6**	**46.4**
Current expenditure	7,276	7170	44.3	43.6
Goods and Services	857	775	5.2	4.7
Wages and Salaries	2,630	2567	16.0	15.6
Social transfers	2,573	2595	15.7	15.8
Interest	536	499	3.3	3.0
Subsidies	95	95	0.6	0.6
Other current expenditure	586	639	3.6	3.9
Capital Expenditure	547	450	3.3	2.7
General Government balance	**-1,054**	**-771**	**-6.4**	**-4.7**
General Government primary balance	**-518**	**-272**	**-3.2**	**-1.7**
General Government primary spending	**7288**	**7121**	**44.3**	**43.3**

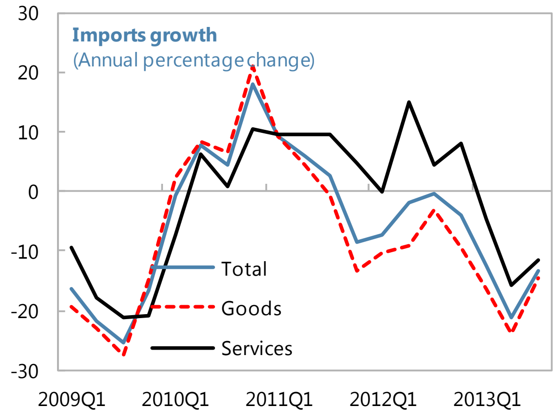
Sources: Ministry of Finance; and IMF staff estimates.
1/ ESA95 classification, cash data.
2/ For consistency with the original program forecast, sign-in bonuses for gas exploration licenses are included in other revenues and not as a negative capital expenditure as treated by Eurostat.
3/ Adjusted Second review program projections. The primary spending target was adjusted upwards by 83 million reflecting additional compensation payments to pension funds (Other current expenditure) as per the TMU. The primary deficit target was correspondingly adjusted downwards by the same amount.

Figure 3. Cyprus: External Indicators

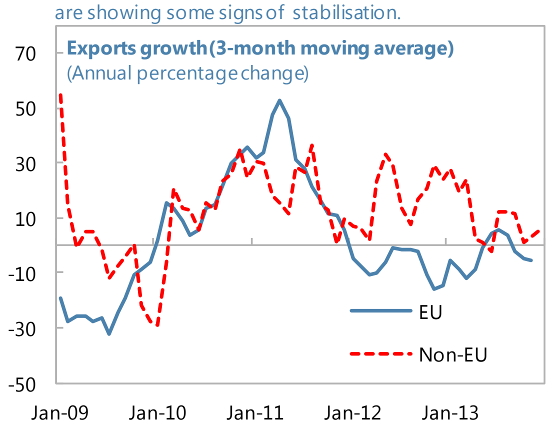
Service exports picked up due to the tourism sector, while growth in goods exports was helped by one-off factors.



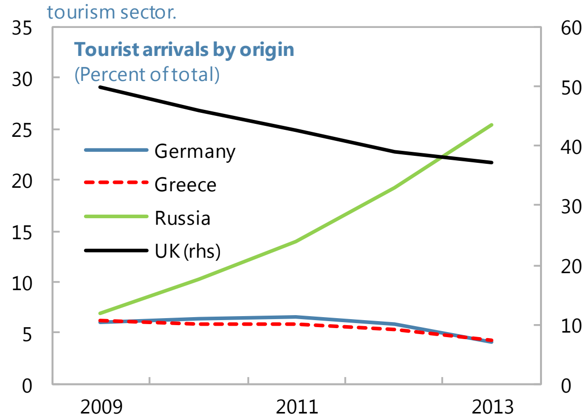
The pace of import contraction has recently moderated.



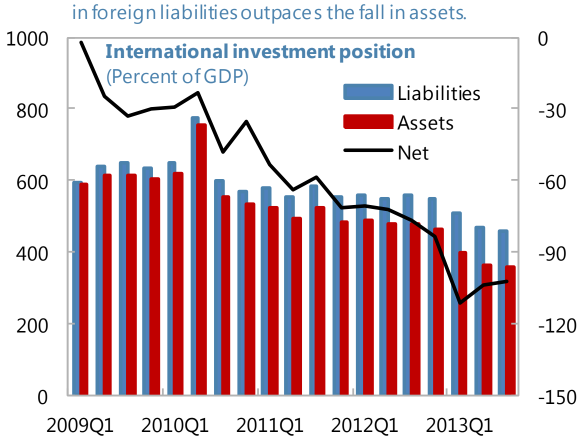
Exports of goods to non-EU has slowed, while EU exports are showing some signs of stabilisation.



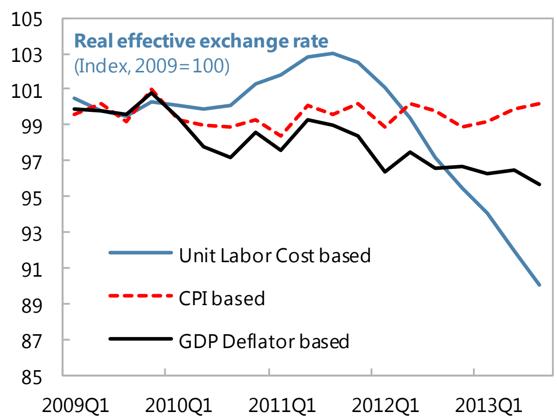
Growing arrivals from Russia are supporting growth in the tourism sector.



The net international position has improved as the fall in foreign liabilities outpaces the fall in assets.



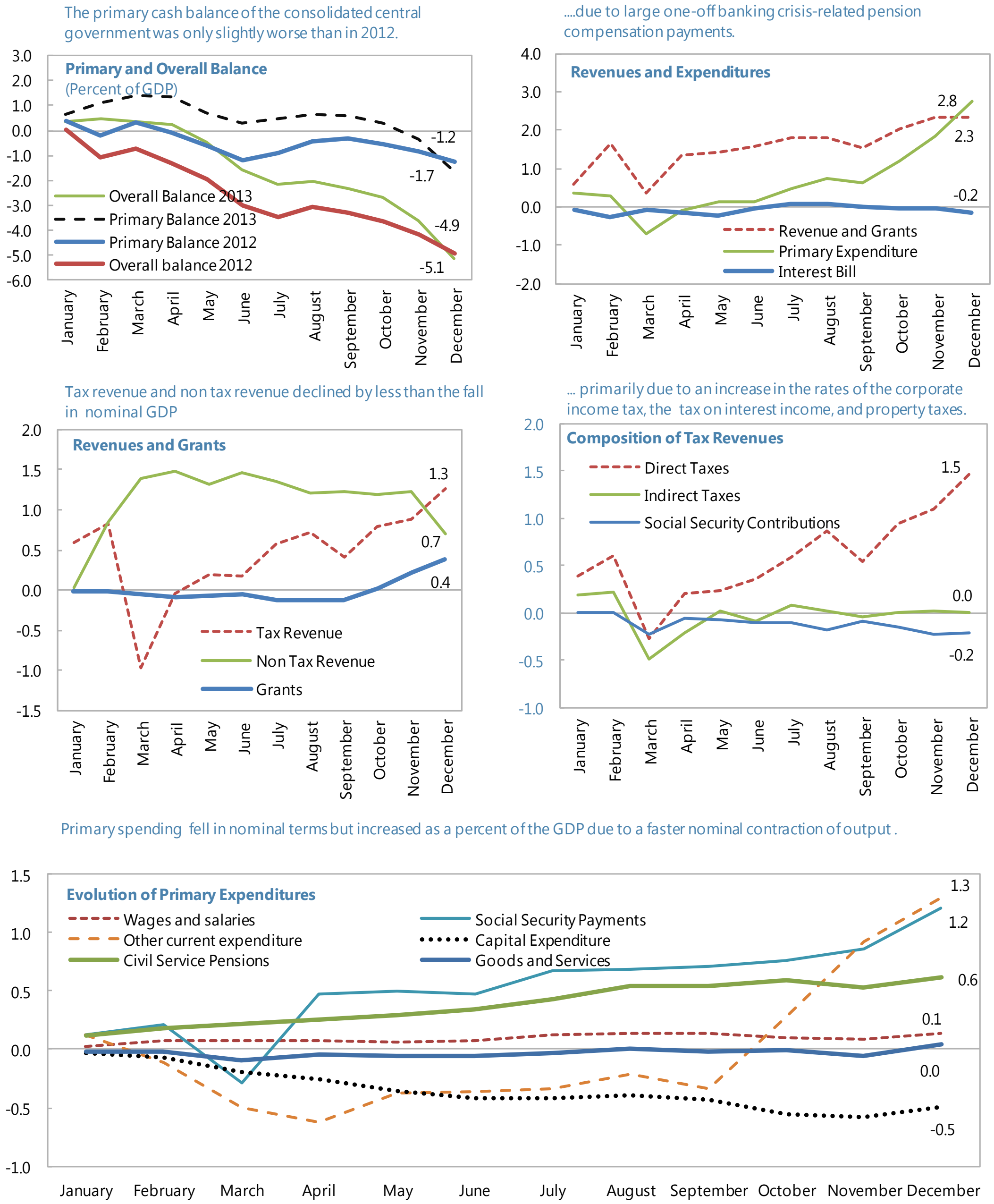
External price competitiveness continues to improve.



Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

Figure 4. Cyprus: Recent Fiscal Developments 1/

(Cumulative percent of GDP difference relative to previous year, unless otherwise specified)

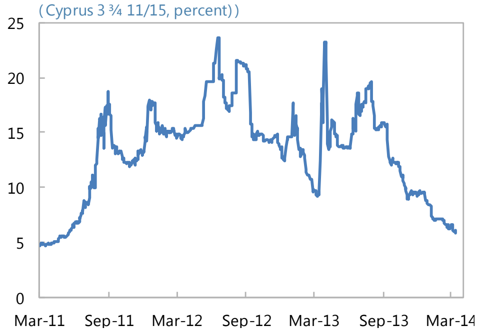


Sources: Ministry of Finance; and IMF staff estimates.

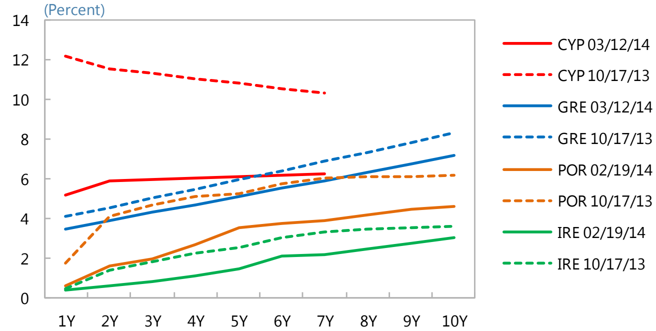
1/Based on cash data and the national classification, which unlike ESA do not cover local governments and semi-government entities.

8. **Capital market conditions have improved**. Government bond yields have fallen from close to 20 percent in July 2013 to about 6 percent in March 2014, reaching levels seen in May 2011, when Cyprus lost market access. This reflects the good performance under the program, better-than-expected domestic macroeconomic outcomes and, to some extent, improving conditions in other European peripheral countries (where yields have fallen by about 30-120 bp during the same period). Furthermore, while still above that of peers, Cyprus's sovereign yield curve has recently dis-inverted, suggesting that markets have scaled down the near term probability of default. Cyprus's sovereign credit rating was upgraded by S&P in November 2013 to B- and remains broadly in line with Greece's, but below that of Portugal and Ireland.

Government Bond Yield
(Cyprus 3 ¾ 11/15, percent))



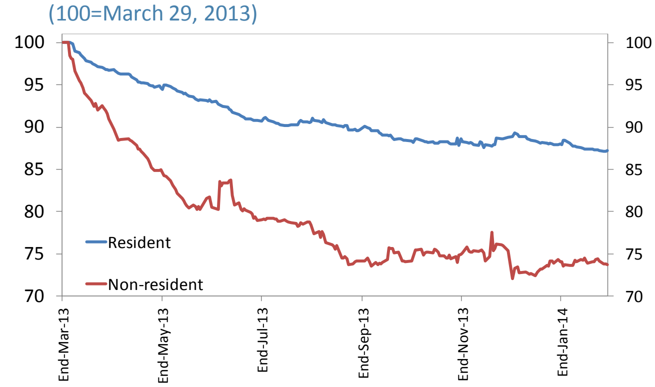
Sovereign Yield Curves
(Percent)



Source: Bloomberg.

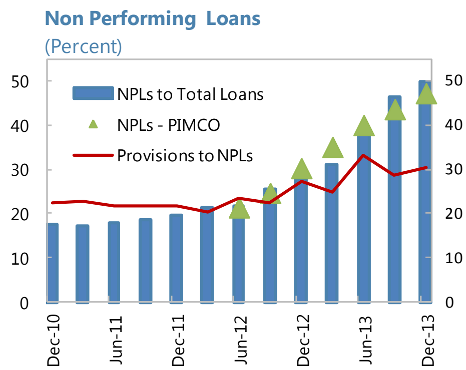
9. **Deposits have broadly stabilized, even as important relaxations of payment restrictions have been recently implemented.** Between end-March 2013 and end-February 2014, aggregate deposits (excluding bailed in amounts) declined by €10.3 billion, or 18 percent of the total. More recently, system wide average weekly net outflows have declined to about 10 percent of those observed in the immediate aftermath of the crisis (April-July). These signs of stabilization are broad based, pertaining to resident and non-resident deposits and to both domestic and foreign banks. The pace of outflows has been largely unaffected by the release at end-January of €0.9 billion out of €3 billion previously blocked deposits in Bank of Cyprus (BoC) and by the termination of the automatic renewal of fixed term deposits upon maturity and the increase in the limits for domestic transfers implemented in mid-February. As expected, the maturity profile of deposits has shortened. In anticipation of these relaxations, BoC's potential liquidity buffers were boosted by the approval by Parliament of up to €2.9 billion of government guarantees for the eventual issuance of BoC bonds to be used as collateral against Eurosystem liquidity.

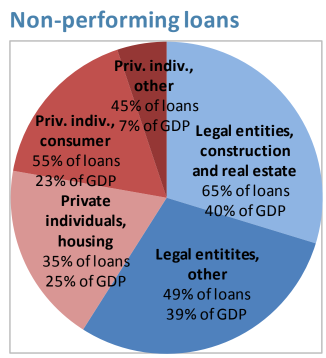
Total Deposits
(100=March 29, 2013)



Source: Central Bank of Cyprus

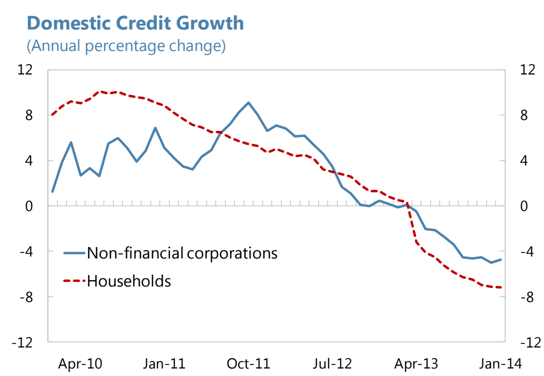
10. **The core domestic financial sector was recapitalized, but NPLs are still rising**. In early-March, the government injected €1.5 billion into the coop sector, completing the recapitalization of the core domestic financial sector. As a result, the sector's capital will reach an estimated 16 percent of risk-weighted assets, broadly in line with capitalization levels in other European periphery countries. However, non-performing loans (NPLs) for the core domestic sector reached 50 percent of total loans (€22 billion, or 135 percent of GDP) at end-December, significantly higher than elsewhere in Europe. About 60 percent of NPLs are in the corporate sector, of which half in the construction/real estate sector, which also exhibits the highest incidence of NPLs. Household NPLs are roughly equally distributed between housing and consumer loans. The evolution of NPLs has remained broadly in line with PIMCO's adverse scenario, which projects a continued increase toward 60-70 percent by mid-2015. Provisions are about 30 percent of NPLs, below the average of 50 percent of European peers.





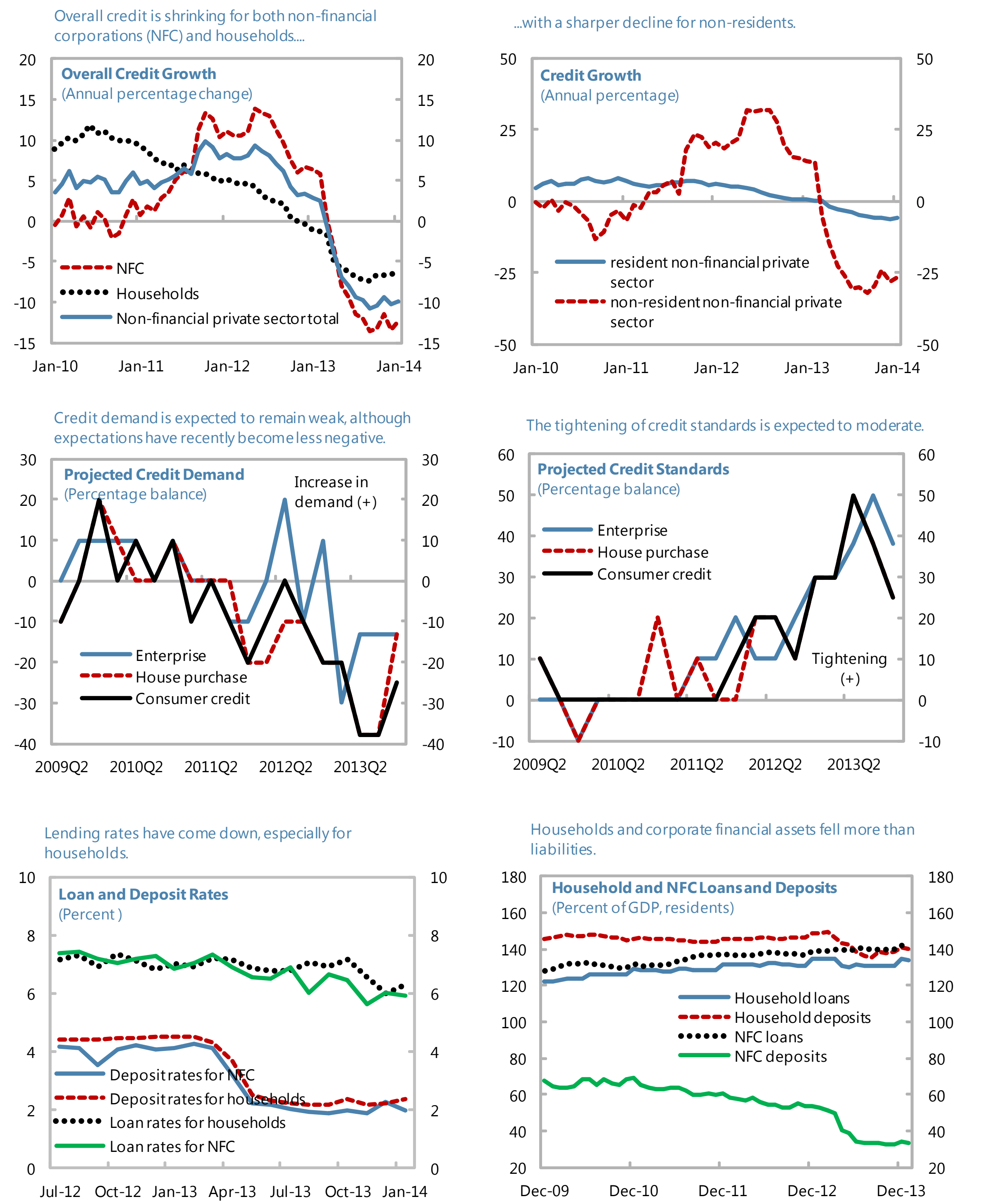
Sources: CBC; and IMF staff estimates.

11. **Credit to the private sector continues to contract** (Figure 5). Non-financial private sector credit fell by about 10 percent y-o-y in January (6 percent for residents), with corporate credit falling by 12½ percent (5 percent for residents) and household credit declining by 7 percent (both residents and non-residents). The Bank Lending Survey indicates that this is the result of both weak supply and demand, although, in the fourth quarter, the tightening in credit standards and the decline in household credit demand has slowed somewhat. Moreover, in recent months, lending rates have been declining.



Sources: CBC; and Haver.

Figure 5. Cyprus: Financial Sector Developments



Sources: Central Bank of Cyprus; ECB; and IMF staff estimates.

MACROECONOMIC OUTLOOK

12. **The macroeconomic framework has been slightly modified to incorporate recent developments**:

- ***Growth projections for 2014 and beyond remain unchanged***. Given limited new data for this year, the 2014 growth projection was maintained at -4.8 percent. This is consistent with a slowing rate of output decline during this year, as the uncertainty and immediate effects of the crisis are wearing off, domestic payment restrictions are gradually lifted, and the negative fiscal impulse declines relative to last year. Both private consumption and investment are projected to continue to contract, albeit at a lower rate than last year, with the contribution of the foreign balance moderating. The modest recovery, projected to take hold by mid-2015, is expected to be credit-less, led by tourism and other service sectors, which are relatively less indebted, exhibit lower NPLs, and are likely to finance activity and exports through generation of positive cash flow (Box 1).

Selected Economic Indicators

	2013	2014	2015
	Projection		
	(Percent change, unless otherwise indicated)		
Real GDP	-6.0	-4.8	0.9
Consumption	-7.2	-5.3	-0.1
Private consumption	-7.5	-6.3	0.7
Public consumption	-6.0	-1.5	-2.7
Fixed investment	-24.0	-18.1	1.3
Inventory accumulation 1/	-1.2	0.0	0.0
Foreign balance 1/	5.0	1.9	0.8
HICP (period average)	0.4	0.4	1.4
Unemployment rate EU stand. (percent)	16.0	19.2	18.4
Employment growth (percent)	-5.6	-4.5	0.8
	(Percent of GDP)		
National saving	10.0	10.1	10.4
Government	-2.0	-2.4	-2.4
Private	12.0	12.5	12.9
Current account balance	-1.5	0.1	0.3

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth.

- ***Unemployment and inflation were revised down modestly***. In 2014, the average unemployment rate was revised down to 19.2 percent from 19.8 percent to account for the 2013 outturn and for the deceleration in the rate of increase in recent months. Inflation was lowered to 0.4 percent from 1 percent, reflecting the lower outturn in 2013. Despite the negative inflation seen in recent months, staff expects average inflation in 2014 to remain around last year's level, with recent downward pressures to be offset by a stabilization of utility prices and by the pass through to prices of VAT increases taking effect this year.

- ***The current account was also revised slightly down in 2013 and 2014***. In 2013, the curent account deficit is projected to reach 1.7 percent of GDP, on account of a somewhat smaller decline in imports than originally anticipated, given the better than expected domestic demand outturn. In 2014, the current account was corespondingly revised down from a small surplus to broad balance.

Box 1. Cyprus: A Credit-less Recovery?

Deep recessions preceded by both a banking crisis and a credit boom are more likely to be followed by credit-less recoveries with weak investment growth. Indeed, Abiad et al. (2011) find that the lack of credit slows growth by about a third compared to recoveries with credit, while there is no apparent difference in employment dynamics (such credit-less recoveries include Finland 1991, Sweden 1991, South Korea 1997, among others). The growth difference is mainly due to the weak long-term investment caused by a lack of credit and slower productivity growth (also see Calvo et al., 2006). Consequently, the focus of this box is on prospects for investment.

Cyprus is recovering from a sharp banking crisis following a large credit boom, and its recovery is likely to be credit-less. The banking sector is undergoing a deep restructuring, and credit is falling by close to 10 percent y-o-y. In this context, it may take time before the banking sector returns to full health and credit growth can resume. To test this hypothesis, the empirically estimated coefficients of the model by Abiad et al.—a probit model regressing a binary variable for credit-less recovery on various explanatory variables, applied to 357 downturns in advanced, emerging, and developing economies—were used to estimate the probability of seeing a credit-less recovery in Cyprus. Given the peak-to-trough expected contraction in output of 13.3 percent, the results indicate a 78 percent probability that growth in the first three years following the trough of the recession (i.e., "recovery period") will be accompanied by no credit growth in real terms. This is expected to affect mostly investment, as private consumption is much less dependent on credit and is buffered by a large positive household net financial asset position.

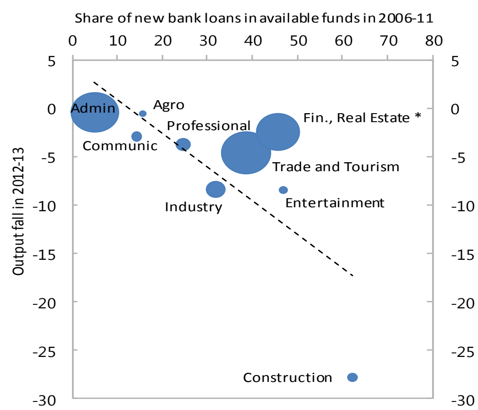
Cyprus: Probability of a Creditless Recovery

	Value	Coefficient	Contribution to probability (percent)
Banking crisis	1	0.931	34.2
Credit boom	1	0.44	16.3
Peak-to-through (percent of GDP)	-13.3	-0.045	16.2
Constant	1	-1.187	11.8
Probability of creditless recovery			78.4

Sources: Abiad et al. (2011) and IMF Staff calculations.

The lack of credit weighs more on sectors dependent on bank financing (Braun and Larrain, 2005). Data so far suggest that sectors that relied more on bank credit during the 2006-11 expansion (measured by the share of new loans in the total available funds for investment, with the latter defined as the sum of free cash flow and new loans[1, 2]) have contracted more in the current recession than sectors that relied less on bank credit. The construction sector in Cyprus is a stark example.

Output and Bank Finance
(Percent, marker's size shows relative share in GVA)



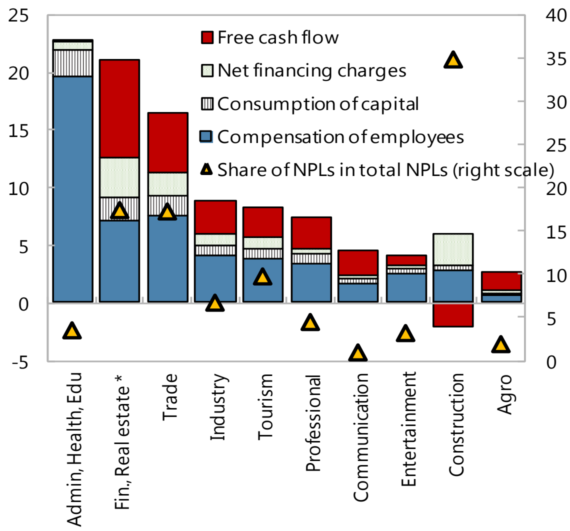
Sources: Haver and IMF Staff calculations; * Includes FISIM output and imputed rent.

Consequently, the recovery in Cyprus is expected to be driven by sectors with robust free cash flow. A positive free cash flow position, relatively low NPLs, and low reliance on credit of several sectors suggest that there are prospects for a credit-less recovery. Labor cost adjustments (total compensation of employees fell by 10 percent y-o-y in Q1-Q3 2013) have helped to protect profitability, which is currently close to the long-term average of 26 percent of gross value added

Box 1. Cyprus: A Credit-less Recovery? (concluded)

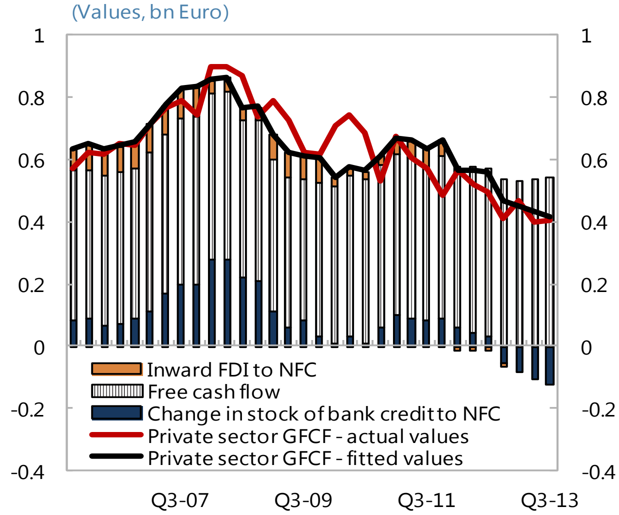
(GVA). Free cash flow in the non-financial sectors, except for construction, is currently positive and in some sectors appears strong enough to finance a modest expansion.[3] In particular, tourism, industry, communication, agriculture, and professional services (together accounting for 30 percent of GVA) are sectors with relatively strong cash flow, low credit dependence, and relatively low NPLs, that could be in a position to invest and lead the recovery, including through increased exports.

GVA by Income and NPLs
(Q3-2013; share in total; percent)



Sources: Haver and IMF Staff calculations; * Includes FISIM output and imputed rent.

Financing private investment
(Values, bn Euro)



Sources: Haver, CBC, and IMF Staff calculations.
Note: Private investment is defined as GFCF - public sector GFCF; Private investment regressed on free cash flow, change in bank credit to NFC, and FDI to NFC returns the following significant coefficients: 0.5, 0.2, and 0.3 respectively; R2 = 0.98.

The current program forecast for investment remains conservative and consistent with a credit-less recovery driven by select sectors. Staff estimates that private fixed investment has been largely financed by free cash flow (50 percent of available free cash flow), and to a lesser extent by FDI (30 percent) and bank loans (20 percent). FDI and banks' credit have dried up in the current downturn, and the free cash flow has become the only source of investment financing. The estimated free cash flow for the whole economy that could be invested is close to €2 billion (out of which €1.6 billion from the sectors mentioned above) which is more than the conservative investment projection of €1.5-1.6 billion in the projection for 2014-15.

1/ A similar concept to Rajan and Zingales (1998) measuring dependence on external finance by the share of external finance in investment.

2/ Free cash flow is the reminder from GVA after accounting for compensation of employees including self-employed, consumption of fixed capital, and net financial charges.

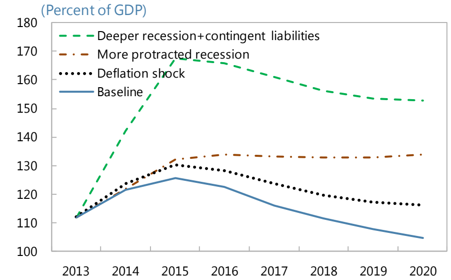
3/ The financial and real estate sectors' GVA includes FISIM output and imputed rent that are to some extent mere accounting profits and cannot be used as financing sources for growth.

References: Abiad, Dell'Ariccia, and Li, IMF Working Paper 58, 2011; Braun and Larrain, Finance and the Business Cycle: International Inter-Industry Evidence, Journal of Finance, 2005; Calvo, Izquierdo, and Talvi, Sudden Stops and Phoenix Miracles in Emerging Markets, American Economic Review Papers and Proceedings, 2006. Rajan and Zingales, Financial Dependence and Growth, American Economic Review, 1998.

13. **The outlook is subject to downside risks**. A change in depositor sentiment, in the context of important relaxations of payment restrictions underway, could risk destabilizing the system and exacerbating the recession. The risk of a deflationary spiral has also increased. While lower prices can help to improve competitiveness, a prolonged decline could weigh down on private sector balance sheets, with rising debt burdens posing a drag on economic growth. Continued deleveraging by the private sector, coupled with further tightening of liquidity conditions for companies and an exhaustion of liquidity buffers of consumers, could lead to a more protracted recession and slower recovery. Finally, the Ukraine crisis may lead to capital flight from non-resident depositors of foreign banks in Cyprus, which may affect the business service sector. On the political front, diminished support for the program following the breakup of the governing coalition raises uncertainty about program implementation and could hamper overall confidence. On the upside, if trends of economic activity observed in the second half of 2013 continue, growth in 2014 and beyond could be better than anticipated. Prospects for the exploitation of gas reserves and for reunification of the island could raise the economy's long-term growth potential.

14. **Public debt sustainability remains highly vulnerable to shocks** (Figures 7-11). Public debt was revised slightly down to 112 percent of GDP in 2013, and to just below 122 percent of GDP in 2014. Under the baseline scenario, debt is expected to peak at around 126 percent of GDP in 2015, and to decline gradually toward around 105 percent of GDP by 2020. However, debt dynamics remain highly vulnerable to shocks.[2] In particular, a more protracted recession would result in gradually rising debt toward 130 percent of GDP by 2020, while a deflation shock in 2014 could also lead to a higher long-run debt level. A shock combining a deeper recession and higher banking sector contingent liabilities could exhaust the program buffer and push debt up to about 170 percent of GDP by 2015, falling only to around 150 percent of GDP by 2020. Such developments would likely require additional financing measures and commitments from European partners to protect Cyprus's debt sustainability. The significant gross needs to finance debt repayments in 2016-2020 (about €8 billion) pose a challenge to debt management following the program.

Debt Trajectories: Baseline and Selected Shocks
(Percent of GDP)



IMF staff estimates.

15. **External debt is also a source of vulnerability** (Table 9 and Figure 6). Projected gross external debt for 2013 was revised down to 340 percent of GDP due to a decline in bank liabilities, in particular inter-bank transactions allowed under the external restrictions in place. Over the long term, external debt is projected to fall to 290 percent of GDP by 2020 as the external adjustment continues. External debt dynamics remain vulnerable to shocks, including a weaker current account, lower growth, and higher real interest rates (Figure 6). Cyprus's net investment position (IIP) is estimated to have reached around -100 percent of GDP in 2013, and is projected to fall to around -80 percent of GDP by 2020 as foreign liabilities continue to decline.

[2] Assumptions underlying the shocks are detailed in Figures 7-11 and in Annex I of the Cyprus Second Review under the Extended Arrangement under the Extended Fund Facility and Request for Modification of Performance Criteria.

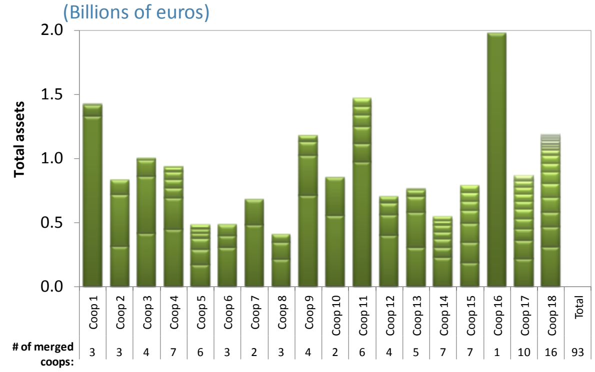
POLICY DISCUSSIONS

Discussions focused on further stabilizing the financial sector, continuing prudent fiscal policies, and accelerating the pace of structural reforms. In the financial sector, with recapitalization completed and deposits broadly stable, the focus of discussions shifted from crisis management to stabilization policies to deal with the rising level of NPLs and to normalize payment flows. On fiscal policy, it was agreed that continued prudence and flexibility in implementing the 2014 budget is called for given still high macroeconomic uncertainty. Finally, discussions on fiscal structural reforms focused on ways to overcome emerging delays and advance the authorities' ambitious reform agenda.

A. Financial Sector Policy—*Addressing NPLs and Normalizing Payment Flows*

16. **Measureable progress in the implementation of bank and coop restructuring plans is key to boosting confidence** (MEFP ¶6-8). Progress has already been made on several fronts. First, the restructuring plan for the coop sector was finalized and submitted to the European Commission, together with the independent valuation of the sector, thus meeting the end-January structural benchmark (Box 2). This allowed the injection of public funds in the sector in early March, helping to boost both its capital and liquidity position. Second, the sector's consolidation has advanced, with 85 out of 93 coops having been merged into 16 new institutions by end-February. Third, personnel cost has been reduced through the implementation of a voluntary retirement scheme and the adoption of a pay-scale equalization policy across the sector. Fourth, BoC has also made progress in the implementation of its plan by cutting costs.[3] Building on these efforts, discussions highlighted the need for additional measures to support the full implementation of restructuring plans to ensure banks' and coops' long-term viability:

The consolidation of 93 coops into 18
(Billions of euros)



Source: Central Bank of Cyprus.

- ***Enhancing governance*:** The authorities are on track to complete the mergers of CCI is by end-March (existing **structural benchmark**) and are working on filling remaining vacancies on boards and executive management teams. Moreover, an understanding was reached on the need to expand the role of the monitoring trustee appointed by the European Commission to provide independent and professional oversight over the implementation of the restructuring plan. Regarding BoC, staff reiterated the importance of insulating the management of legacy Laiki's 18 percent share in BoC from any political interference (end-January **structural benchmark**). Equally important is the disposal of Laiki's investments in

[3] BoC also reached an agreement to sell its Ukrainian subsidiary, which could help to further reduce its risk assets and increase its liquidity, but the sale has not yet closed.

Box 2. Cooperative Credit Sector Restructuring Strategy

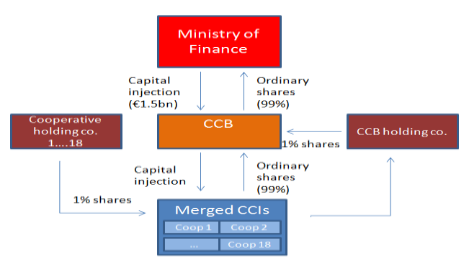
The cooperative credit sector is an important player in the Cypriot banking system. As of September 2013 it held an overall market share of 45 percent in domestic deposits and 25 percent in domestic loans. Its assets amounted to about 100 percent of GDP.

The cooperative sector ran into difficulties in part due to weak governance and poor lending policies. Regarding governance, there was a lack of effective and binding oversight of individual CCIs by its central body, the Central Cooperative Bank (CCB). Despite earlier official efforts to strengthen the CCB's role, it remained as a passive coordinating unit. Supervision was also separated from that of banks, and was based on different standards. Regarding lending practices, the sector's high degree of credit concentration on collateral-based lending led to an over-reliance on property, which in turn increased the risk of losses associated with economic downturns. Additionally, as the CCIs and their management teams enjoyed a high degree of independence, they largely defined their own loan origination and risk management practices without consideration to practices across the sector. These vulnerabilities led to substantial NPLs, loan losses, and undercapitalization of the sector at an aggregated level.

With the aim to preserve the coop sector, given its key role in the domestic economy, key measures are being taken:

- ***Recapitalization:*** The CCB was fully recapitalized by the state in early March by injecting €1.5 billion to allow the sector to achieve a capital ratio (CET1) of 9 percent ET1 (on a consolidated basis) through 2017. The recapitalization amount was identified on the basis of the PIMCO assessment under the adverse scenario, supplemented by the CBC's own assessment.
- ***Consolidation:*** The CCB will use its recapitalization resources to restore the solvency of the individual CCIs up to 4 percent CET1 (in line with similar practices for cooperative banks in other EU countries). As a precondition to receive fresh capital from the CCB, all 93 CCIs have agreed to merge into 18 new institutions based on geographical, scale, and profitability criteria. Given the CCB's role in the recapitalization of the CCIs, the CCB will participate in the appointment of new management and board teams of each individual institution following fit and proper criteria.
- ***Restructuring:*** The CCB has put in place a restructuring plan for the sector, containing a number of actions to be implemented through 2017:
  - ✓ ***Transforming the CCB into the decision center of the sector:*** The CCB will assume key responsibilities, including defining the overall strategy of the sector, as well as its risk policies (including risk appetite), capital budgeting, and funding processes. This has been achieved through an affiliation agreement signed between the CCB and CCIs as part of the recapitalization process.

New governance structure of the CCI sector



  - ✓ ***Centralizing loan restructuring and recovery:*** A special unit of the CCB will assume responsibility for a centralized loan restructuring and workout process. The restructuring of loans below a defined threshold will remain within the individual CCIs, but conducted according to policies and processes and quantitative performance targets defined by the CCB.
  - ✓ ***Streamlining operations:*** High staff costs are being addressed through voluntary redundancy schemes and harmonization of pay scales across CCIs. The number of branches will be reduced from 349 to 239 through 2015. The sector will also dispose of noncore commercial service businesses.
  - ✓ ***Gradual deleveraging:*** Loans net of provisions amount to € 11.5 billion, or about 70 percent of GDP (compared to 94 percent of GDP in 2012), and are expected to decline to 64 percent of GDP by 2016.

subsidiaries abroad in an expeditious and orderly manner to maximize recovery value and reduce risks for Laiki's creditors, including BoC. Given difficulties in finding a specialized firm or independent institution to perform these tasks, the authorities committed to find and appoint such firm/institution to do so by end-April (modified **structural benchmark**).

- ***Stepping up monitoring*:** Staff noted that while bank managers need to be given time and room to implement their strategies, experience in other countries shows that prudent but firm official monitoring is also essential to a successful restructuring process. To this end, staff welcomed the authorities' establishment of dedicated units to supervise BoC and the coops and their annual plan to step up thematic onsite inspections and reviews and boost staffing. The units will assess the banks' performance against their restructuring plan and report their findings to the CBC Board on a quarterly basis, with the first report due at end-May (new **structural benchmark**). Finally, staff and the authorities concurred on the need to reassess BoC's restructuring plan after the first year of implementation with a view to identify whether any changes are warranted. For the coop sector, understandings were reached on the need to verify in one year's time consistency of risk management practices across the sector in line with the restructuring plan.

17. **Banks' restructuring and viability critically depend on their ability to deal effectively with rising NPLs** (MEFP ¶10). A key challenge for the banks and coops is to halt and reverse the trend in asset deterioration through effective workouts of troubled loans. In this regard, BoC and the coops are putting in place specialized units and policies to deal with NPLs and early arrears. To ensure that financial institutions are adequately incorporating in their restructuring strategies the requirements of the new Code of Conduct and Arrears Management Framework, the CBC committed to complete an assessment of operational preparedness in this area by end-March for the banks (existing **structural benchmark**), and by end-May for the coops (new **structural benchmark**). Furthermore, the CBC will also finalize an assessment of bank and coop arrears management policies, procedures, and practices by end-June, with a view to develop recommendations and update the Code of Conduct and Arrears Management Framework directives as needed. Finally, to facilitate the monitoring of bank's progress with debt restructuring—including an expected increase in provisioning levels, in line with their restructuring plans and the requirements of recent guidelines coming into effect this year—the CBC will enhance reporting requirements on asset quality, early arrears, and operational debt-restructuring indicators, step up onsite and offsite monitoring, and expand the role of bank auditors.

18. **A strong legal framework is essential to facilitate NPL negotiations** (MEFP ¶10). Existing procedures for debt enforcement and restructuring are not effective, with foreclosures reportedly taking up to 20 years, large backlogs in the issuance and transfer of title deeds, and outdated insolvency laws. As a result, payment discipline is undermined, strategic defaults are on the rise, and incentives to renegotiate debt are lacking. To facilitate voluntary debt renegotiations, the authorities committed to develop by end-May a comprehensive reform strategy, in line with best international practice, covering the following areas (Box 3):

- **Foreclosure procedures**: Given substantial delays in the foreclosure process, which is currently conducted through the Land Registry, the authorities agreed to amend legislation by end-June to facilitate foreclosures through private auctions. At the same time, to protect borrowers negotiating in good faith, the existing Code of Conduct aims to minimize repossessions and urges creditors to avoid legal proceedings when borrowers are cooperative. This is expected to discourage strategic defaults and provide incentives to borrowers to negotiate. However, a more frequent resort to foreclosure could also lead to potential conflicts among multiple debtors, given the use, in some cases, of untitled land sales contracts. To address these issues, the authorities committed to prepare a report to assess the magnitude of registered but untitled land sales contracts and underlying mortgages and prepare recommendations to deal with such cases.

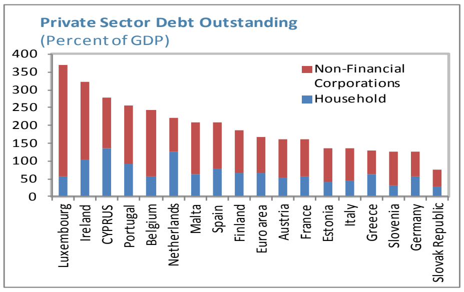
- **Corporate and personal insolvency:** The existing corporate and personal insolvency laws do not provide for effective rehabilitation mechanisms and a fresh start for unviable borrowers acting in good faith, while insolvency practitioners are unregulated. To address these weaknesses, the authorities committed to submit to parliament amendments to both the corporate and personal insolvency legislation by end-2014 (**structural benchmarks**). The new legislation is expected to provide incentives to and mechanisms for creditors to reach solutions with viable borrowers within a well-defined framework (including on treatment of government claims). Staff called for ensuring that it conforms to international best practice, includes SMEs and micro enterprises, and is appropriately communicated.

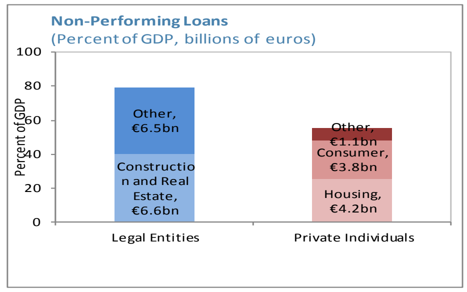
- **Institutions**: First, an understanding was reached that the office of the Financial Ombudsman is not well suited to play an enhanced role in mediating debt restructuring negotiations, as it lacks the appropriate structure and staffing, and given that other mediation options already exist. Hence, the authorities will clarify the role of the Financial Ombudsman in handling consumer complaints, including regarding compliance with the Code of Conduct. Secondly, given Cyprus's poor ranking in an international perspective on "enforcing contracts" (110th out of 189 countries), the authorities committed to review the rules of civil procedures and other court rules to identify potential inefficiencies and develop recommendations, with a view to strengthening debt enforcement, restructuring and insolvency procedures.

International evidence suggests that even after the framework is in place, it will take time for banks to effectively implement it and reduce NPLs. In this regard, understandings were reached on the need for a review of the overall reform strategy to be conducted in the second half of 2015 to evaluate its effectiveness and assess whether additional actions are needed.

Box 3. Private Sector Debt Restructuring: Main Issues

Balance sheets of Cypriot households, firms, and banks are significantly impaired. Overall private sector debt has risen rapidly and is among the highest in the euro area, with household and corporate bank debt standing at 134 and 142 percent of GDP respectively at end-December 2013. In the context of the current economic downturn, capacity to service debt has weakened, and, as a result, NPLs in the domestic banking sector reached 135 percent of GDP (€22 billion), of which 55 percent of GDP (€9 billion) for households, and 80 percent of GDP (€13 billion) for corporates. NPLs are weighing on bank's balance sheets, which are particularly exposed to the construction and real estate sector, where loans are concentrated and NLPs are the highest.





Sources: ECB, Central Bank of Cyprus; and IMF staff estimates.

There are a number of deficiencies in the debt restructuring framework, which prevent the cleanup of balance sheets:

- ***Foreclosure procedures:*** Foreclosure procedures are inefficient and hindered by substantial delays in the issuance and transfer of title deeds**.** Indeed, the issuance of a title deed in Cyprus may take up to ten years. One of the reasons is that the scope of the Land Registry Office is broad relative to its capacity, leading to significant backlogs. Also, the Land Registry is heavily involved in the foreclosure process, including property valuations. The latter are often challenged by borrowers, leading to long delays. Moreover, unregistered land sale contracts are widely used to sell/buy/lend against immovable property, creating potential conflicts between multiple debtors in foreclosure and insolvency processes.

- ***Corporate and household insolvency legislation:*** The current legal framework is outdated and inefficient. The Bankruptcy Act does not provide the practical tools needed to deleverage over-indebted individuals, while the Company Law allows debt restructuring of firms only through liquidation, which is rarely used as a rehabilitation tool. Furthermore, secured creditors are not included in the insolvency procedures, significantly limiting the use of the current procedures given that much of the lending is collateralized. Finally, insolvency practitioners are unlicensed and unregulated, opening the possibility for abuse and concentrating the workload unevenly within the profession. Fees are also unregulated and may amount to up to an excessive share of the value of the assets under administration.

- ***Institutions:*** Debt enforcement and insolvency proceedings often get delayed in courts. Due to judges' large workload and case management challenges and to attorneys' delaying tactics, enforcement and insolvency processes are unduly delayed due to frequent appeals and adjournments.

19. **Discussions also stressed the need to gradually normalize payment flows while safeguarding financial stability** (MEFP ¶3). With all milestones related to Stage 2 of the published roadmap completed, the authorities took further steps to relax restrictions by abolishing the automatic renewal of maturing term deposits and raising the limits on domestic transfers of funds. Building on these, they committed to undertake additional gradual steps in line with the milestone-based roadmap, while continuously monitoring deposit and liquidity trends so as to safeguard financial stability. Such steps include further raising limits on domestic transfers, followed by increasing limits on cash withdrawals and removing restrictions on opening new accounts, with a view to their eventual abolition. Staff welcomed the increase in liquidity buffers in BoC and the coop sector, stressing the need for their prudent but flexible use, along with ensuring flexibility on collateral requirements and ample provision of liquidity by the Eurosystem. To further boost confidence, the authorities committed to strengthen monitoring of deposit and liquidity trends, coordination between the Ministry of Finance and the Central Bank, and communication to market participants about the objectives and achievement of milestones in the banking sector strategy.

20. **The authorities reiterated their commitment to strengthen bank supervision and regulation in anticipation of broader European initiatives** (MEFP ¶9). The CBC has recently enhanced its regulatory framework by adopting a new NPL definition and guidelines for asset impairment and provisioning (the latter coming into effect in 2014) in line with best practices. Although this shows higher NPLs relative to other countries whose definitions are less stringent, Cyprus is well placed to transition to the upcoming European regulations entering into effect by end-2014, which include strict rules regarding the recognition of restructured loans as performing. In anticipation of these and other upcoming EU-wide requirements for the adoption of Basel III through 2018, the CBC will assess their potential impact for the domestic banking sector. Moreover, the authorities committed to boost supervisory staffing to meet increased needs due to enhanced domestic tasks and responsibilities related to the upcoming SSM and the EU-wide Asset Quality Review. Finally, they committed to ensure effective use for supervisory purposes of the credit register information and to revise the resolution law to enhance the Resolution Authority's effectiveness and insulate it from political interference.

21. **The authorities also committed to build on progress to date to continue to strengthen AML supervision and enhance company transparency** (MEFP ¶11). Discussions focused on three key areas:

- **Supervision of financial institutions**: The CBC allocated additional AML supervisory resources and finalized a risk-based supervisory program for 2014, meeting the end-February structural benchmark. This will allow the resumption of inspections to ensure that banks adequately implement the AML/CFT legal framework, in light of the CBC's follow up on Deloitte's audit, which confirmed the existence of breaches of compliance with AML requirements.

- **Supervision of professions**: The supervision of professions (i.e. lawyers, accountants, and administrative services providers) is being improved, and relevant supervisors are developing risk-based supervisory tools.

- **Company transparency**: The authorities committed to develop an action plan to address recommendations of a third-party assessment of the Registrar of Companies and remedy weaknesses identified by the Global Forum Report related to transparency and exchange of information for tax purposes. The plan will include actions to streamline processes in the Registrar's office to reduce existing backlogs and move toward electronic filing. It was agreed that bolstering transparency in the registration of companies by collecting and updating basic information is particularly important, especially as the registration of companies has started to pick up in recent months.

B. Fiscal Policy—*Maintaining Fiscal Prudence*

22. **The 2014 primary deficit target was reduced to reflect the over-performance in 2013 and additional non-tax revenues** (MEFP ¶12-13). The primary deficit target was reduced from 3.3 to 2 percent of GDP to account for an estimated 0.7 percent of GDP permanent savings in 2013 (largely associated with the better-than-expected social contributions collections and lower wage bill) and for an additional 0.6 percent of GDP in expected central bank dividends. Given the cyclical and one-off factors underlying the tighter targets, the fiscal impulse remains broadly unchanged. Staff highlighted the need to maintain flexibility given still large macroeconomic uncertainty, contingent liability risks associated with the existing stock of government guarantees, and uncertain costs of the upcoming welfare reform. At the same time, the authorities stressed the importance of locking in the savings from the over-performance in 2013 and maintaining firm limits on spending. While staff welcomed the authorities' intention to execute spending prudently, it highlighted the importance of minimizing across-the-board discretionary spending cuts and ensuring that institutions affected by the cuts can generate sustainable savings to avoid overruns or arrears later on. It was agreed that the adjustment of the targets does not require additional fiscal measures beyond those included in the 2014 budget and that automatic stabilizers would be allowed to operate, should the factors that led to the over-performance in 2013 prove to be temporary.

23. **The authorities committed to preserve the end-2013 level of short-term debt** (MEFP ¶14). The stock of treasury bills declined by about €240 million (1.4 percent of GDP) relative to the

level envisaged at the start of the program. The authorities noted that the comfortable liquidity position, including due to the better than expected budgetary outcomes, provided an opportunity to save on interest costs by reducing the short term debt stock. Staff stressed the need to maintain this liquidity buffer and existing sources of financing, given remaining downside risks.

24. **The authorities requested revisions to 2014 ceilings for public debt and government guarantees** (MEFP ¶15). In particular, they requested to adjust downward the end-March debt target given the 2013 lower debt base and proposed a higher end-June target to allow for the disbursement of an additional €100 million from the EIB to the government for on-lending to SMEs. They also called for adjusting downward the end-March guarantee ceiling to account for a change in EIB disbursements, while increasing the 2014 ceiling by about €200 million to accommodate new EIB loans to domestic banks to support SMEs (€100 million) and additional guarantees for existing EIB loans to the state electricity company and sewerage boards (€100 million total). There was agreement that the limited size of the new schemes does not materially alter the outlook for debt sustainability, while it would facilitate the provision of credit to the economy given the tight liquidity conditions.

C. Structural Fiscal Reforms—*Stepping-Up the Reform Momentum*

25. **Timely implementation of the social welfare reform is key to protect vulnerable groups during the downturn** (MEFP ¶16). The reform, introducing a Guaranteed Minimum Income (GMI) scheme, aims to expand coverage of social assistance to all vulnerable groups, including the working poor and those who have exhausted their unemployment benefits. After some initial delays, the authorities finalized initial costing estimates of the GMI under different eligibility and benefits assumptions, which could amount up to ¾ percent of GDP. Discussions focused on the next steps:

- ***Final design*:** The authorities are working on finalizing the selection of eligibility criteria and benefit levels so as to improve coverage and reduce poverty, as well as on identifying financing modalities through streamlining overlapping benefits (such as child, education, and housing benefits) in a budget-neutral manner. Staff called for maintaining prudent cost estimates to account for still large macroeconomic uncertainty. The final design of the system is expected to be subject to public consultation, followed by approval by the government at end-March (existing **structural benchmark**).

- ***Roll-out*:** While the authorities committed to maintain the implementation target at end-June (existing **structural benchmark**), they cautioned that this could run into operational IT-related delays, or could result in spending overruns due to the mid-year start, as some existing benefits slated for streamlining would have been fully paid as a lump sum in the first half of the year. Staff stressed the urgency to protect those outside the social safety net during the current downturn (an estimated 20,000, including young working poor and unemployed). To minimize risks, staff supported the introduction of an IT pilot test before the full roll out of the reform and suggested identifying reallocations within the 2014 budget to cover potential additional short-run costs.

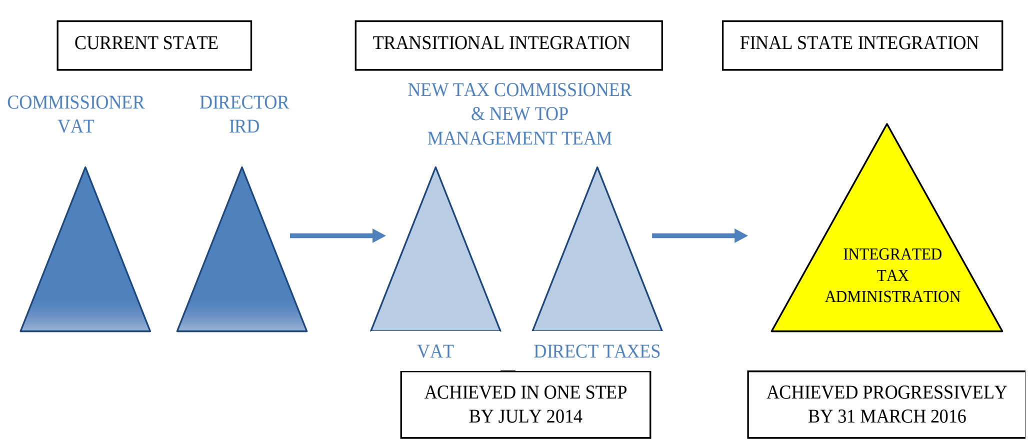
26. **Improving the efficiency and effectiveness of revenue collections is needed to safeguard fiscal sustainability** (MEFP ¶17). Discussions focused both on measures to improve collections in the short term and on the long-run reform merging the Inland Revenue Department (IRD) and VAT Services (VS) into a modern integrated revenue administration:

- ***Short-term measures:***

  - ***Combating tax evasion:*** The authorities committed to take steps to combat tax evasion associated with a large informal economy and under-reporting of personal income (end-December **structural benchmark**). To this end, they finalized a detailed annual plan for targeted joint audits and agreed to monitor the implementation of the plan for audits of large and high-risk taxpayers through new **indicative targets** (MEFP Table 2). To overcome delays in finalizing remaining legislative amendments to increase collection enforcement powers and establish self-assessment for all income taxpayers, they committed to submit these to parliament as a **prior action** for the review.

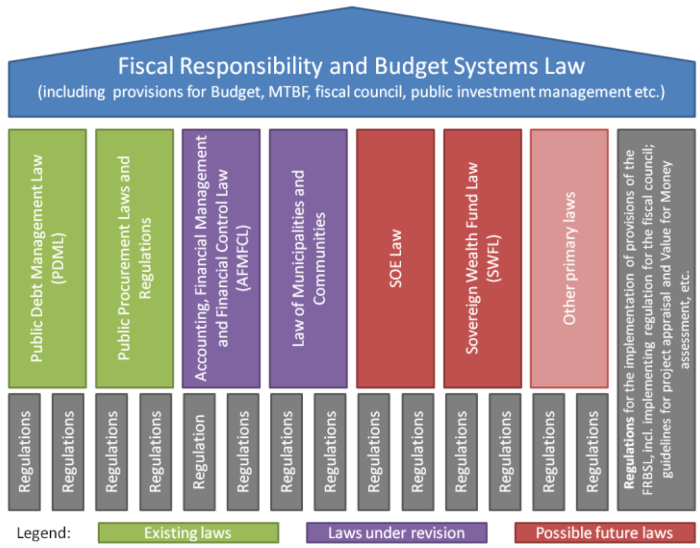
  - ***Minimizing short-term risks:*** To mitigate the risk of revenue losses during the transition to a new integrated revenue administration (see below) and help to detect slippages and take timely corrective actions, the authorities will closely monitor a set of monthly indicators including registration, filing and payment, auditing and debt collection. Regarding the latter, given increasing tax arrears—estimated to have reached over €1 billion, or 7 percent of GDP at end-2013—the authorities committed to prepare a comprehensive report to serve as a basis for a detailed tax debt-recovery plan.

- ***Long-term revenue administration reform*:** In early January, the government approved the reform plan outlining the organizational design of the new integrated tax department and the implementation timeline. In a first step, by end-April, the authorities will submit to parliament a new enabling law providing for the transfer of powers and operations from the existing separate tax agencies to the new integrated tax department (new **structural benchmark**). Subsequently, a new senior management team will be appointed to take charge of the two agencies under the new transitional structure. Staff stressed the need for



continuous consultation with the existing management and staff to ensure buy in and continuity of operations during the transition phase. The operational integration of the two departments will be done gradually, with priority to establishing an integrated unit for large taxpayers, who contribute the largest percentage of domestic tax revenue (end-December **structural benchmark**). The full implementation of the reform is envisaged in early 2016.

27. **Strengthening public financial management will require careful implementation of the new legal framework** (MEFP ¶18). After initial delays, the umbrella (FRBSL) law—strengthening budgeting, monitoring, the management of fiscal risks and of natural resources, and enhancing transparency and accountability—was adopted in mid-February as a **prior action** for the review. Prior to this, the authorities also amended the Public Debt Management Law to facilitate monitoring of government guarantees. Discussions focused on next steps to implement the new legislation through the issuance of secondary legislation and guidelines. Staff stressed the need for careful execution and prioritization of areas with higher fiscal risk, such as public investment management. The authorities committed to develop a detailed roadmap including all remaining secondary legislation/guidelines to fully implement the FRBSL. Staff also urged the authorities to enhance monitoring of risks from government guarantees.



28. **With new legislation in place, timely execution of the privatization plan is critical to increase economic efficiency and lower public debt** (MEFP ¶19). The privatization law was adopted in early March as a **prior action** for the review. The law defines the scope of the privatization program, the institutional set-up, procedures and modalities to carry out privatizations, specifies that proceeds will be channeled through the budget, and sets the requirement to regulate potential monopolies prior to privatization. As a next step, the authorities committed to establish a privatization unit by mid-May 2014, which will prepare the assets for sale once the economy recovers (depending on the asset, preparations alone can take 6-24 months). An understanding was reached that privatizations need to be undertaken on a case-by-case basis, using a variety of methods and taking into account the need to maximize revenues, protect the public interest, ensure an adequate regulatory environment, and address employment rights issues. Staff called for putting priority on those assets with greatest market value, such as the telecommunications company, which is one of the few in Europe that remains fully owned by the state.

PROGRAM MODALITIES AND FINANCING

29. **All of the program's quantitative performance criteria (PCs) have been met, but given mixed compliance with structural conditionality, three prior actions were required to complete the review**. New structural conditionality for upcoming reviews has been established (MEFP Tables 1-3).

- ***Prior actions***: The authorities have already implemented two prior actions to overcome delays relative to program commitments related to the adoption of the public financial management umbrella law (end-December structural benchmark) and adoption of the privatization law (MEFP commitment). Also as a prior action, they committed to submit to parliament measures to fight non-compliance and tax evasion (end-December structural benchmark.

- ***Quantitative PCs***: Modifications of four end-March PCs are proposed: (i) the general government primary balance; (ii) the general government primary expenditure; (iii) the stock of general government debt; and (iv) the accumulation of government guarantees. The changes to (i)-(ii) reflect a tightening of fiscal targets given the over-performance in 2013 and an updated adjustor for budgetary compensation of Laiki pension funds (TMU ¶6 and 8). The change to (iii) reflects a downward adjustment due to a lower short-term debt level in 2013 and a reduction in the debt stock level as a result of previously incorrectly included debt. The change to (iv) reflects an increase due to the need for additional guarantees for larger expected EIB disbursements to support SMEs, and loans for sewerage boards and the electricity company. Quantitative PCs are proposed for end-June 2014 (MEFP, Table 1), and indicative targets to monitor revenue administration are also proposed (MEFP, Table 2).

- ***Structural benchmarks***: Two out five SBs for the third review have been met on time and another two became prior actions for the review (Table 13). The remaining one related to entrusting to an independent party the voting rights of Laiki in BoC has been modified to also include management of the disposal of Laiki's assets and extended to end-April. Six new benchmarks are proposed (MEFP, Table 3): (i) submission to Parliament of an enabling law consolidating the two existing tax authorities into a single tax department (end-April 2014); (ii) submission to the CBC Board of the first quarterly report regarding BoC's/coops' performance in the implementation of the restructuring plans (end-May 2014); (iii) completion of the assessment of the operational capacity of coops' loan workout units, including with respect to early arrears (end-May 2014); (iv) submission to parliament of personal insolvency legislation (end-December 2014); (v) submission to parliament of corporate insolvency legislation (end-December 2014); and (vi) establishment of an integrated large taxpayers unit (end-December 2014).

30. **Implementation risks remain significant as do potential contingent liabilities.** The breakup of the ruling coalition has compromised the government's parliamentary majority, weakening political support for program policies. Moreover, resistance to privatization from labor unions and other interest groups is likely to intensify as assets are being prepared for sale and employment rights issues come to the fore. Regarding contingent liabilities, additional capital needs

as a result of the AQR exercise and stress tests cannot be excluded. Finally, litigation risks remain due to the large number of legal claims associated with the resolution of Laiki and BoC, which could result in additional fiscal costs.

31. **There are factors mitigating the various macroeconomic and implementation risks**. The implementation of the recent prior actions, together with other difficult decisions that were taken at the onset of the program, suggest that the authorities have maintained the ability to implement key program policies even under difficult political circumstances. The recapitalization of the financial sector under PIMCO's stringent assumptions ensures that financial institutions can withstand some further asset quality deterioration. At the same time, the sizeable program buffer could accommodate additional needs, including as a result of the AQR. As to litigation risks, the government has so far been successful in rejecting claims in district courts.

32. **Financing assurances for the program remain in place**. The program is expected to be fully financed through the next 12 months. Planned disbursements from the ESM/IMF (about €2.5 billion), expected additional central bank dividends (€200 million to be distributed by end-April, MEFP ¶20), and government deposits (about €1 billion at end-2013, including not-yet-deposited checks) more than cover projected financing needs in 2014 (€2.6 billion). There are good prospects for adequate financing for the remainder of the program, taking into account remaining ESM/IMF disbursements, an additional €200 million central bank dividends expected in 2015-16, and steps to prepare public assets for privatization. In addition, the authorities have identified assets and are carrying out independent appraisals needed to complete the swap of about €1 billion of debt held by the CBC for state-owned assets by mid-2014 so as to lower public debt.

33. **Capacity to repay the Fund remains adequate**. Debt dynamics and the underlying macroeconomic outlook remain broadly unchanged. Exposure to the Fund peaks in 2016 at 563 percent of quota or 6.1 percent of GDP, while debt service to the Fund, measured relative to exports and GDP, is also expected to remain manageable. External and public debt sustainability and the capacity to repay the Fund are predicated on continued external and fiscal adjustment together with a recovery in economic activity and timely implementation of the adjustment program. Risks remain, particularly related to vulnerabilities in the financial sector.

STAFF APPRAISAL

34. **The authorities have shown resolve in implementing their adjustment program, but challenges remain.** Macroeconomic outcomes have exceeded expectations, and fiscal targets were met with considerable margins. While compliance with structural conditionality was mixed, the authorities demonstrated their commitment and ability to overcome delays through the implementation of prior actions. Looking forward, the economic outlook remains difficult, with output expected to further decline this year and recover only modestly next year. In this context, and given diminished political support for program policies and renewed resistance from vested interests, policy implementation will be challenging.

35. **With the recapitalization of banks and coops completed, tangible progress is needed in the implementation of their restructuring plans.** Following the completion of the coop sector restructuring plan, the authorities injected public funds in the sector, boosting its capital and liquidity position. Significant progress has been made to consolidate the sector and rationalize costs. Bank of Cyprus has also advanced restructuring its operations by cutting costs. To further boost confidence in the financial sector, the authorities will need to further steps to strengthen banks' and coops' governance and enhance their supervision, including by closely monitoring progress in the implementation of their restructuring plans.

36. **A key challenge is dealing with the rising level of non-performing loans.** The authorities have put in place a code of conduct and general arrears management framework, and banks and coops are establishing specialized units to manage troubled loans. Ensuring that financial institutions have adequate policies and operational capacity to halt and reverse the trend in asset deterioration is critical to their successful restructuring and long-run viability. It will be equally important to implement as soon as possible a strong legal framework facilitating foreclosures, modernizing the insolvency regime, and strengthening institutions to promote voluntary debt restructuring of viable borrowers and discourage strategic defaults.

37. **Another challenge is to normalize payment flows while safeguarding financial stability.** The authorities have recently taken important steps to further relax payment restrictions in line with their published roadmap. These need to be complemented with additional gradual steps, while continuing with heightened monitoring of deposit and liquidity trends. To maintain confidence, communication to markets and coordination between the government and central bank needs to be enhanced. Adequate liquidity provisioning by the Eurosystem remains key.

38. **Supervision, regulation, and the AML framework need to be further strengthened**. The authorities are enhancing regulatory frameworks in preparation of upcoming European initiatives toward the single supervisory and resolution mechanisms. Maintaining adequate capacity during the transition period is important, given enhanced domestic supervisory tasks. The authorities are building on progress to date by strengthening AML supervision and enhancing company transparency.

39. **With 2013 fiscal targets met comfortably, the authorities continue to pursue prudent fiscal policies.** Careful execution of the budget, together with better-than-expected macroeconomic outcomes, helped to over-achieve 2013 targets. The authorities have locked in permanent savings by targeting a lower deficit level this year. Achieving their targets will require continuing to implement the budget prudently, given still high macroeconomic uncertainty and contingent risks from government guarantees. If the factors that led to the over-performance in 2013 prove to be temporary, automatic stabilizes would be allowed to operate.

40. **The implementation of structural reforms needs to be accelerated**. The authorities overcame delays by taking decisive measures to improve budget management, fight tax evasion, and put in place a legal framework for privatization. Looking forward, they will need to continue to implement their ambitious reform agenda in a timely manner. Priority should be given to the implementation of the welfare reform to protect vulnerable groups during the downturn, and to

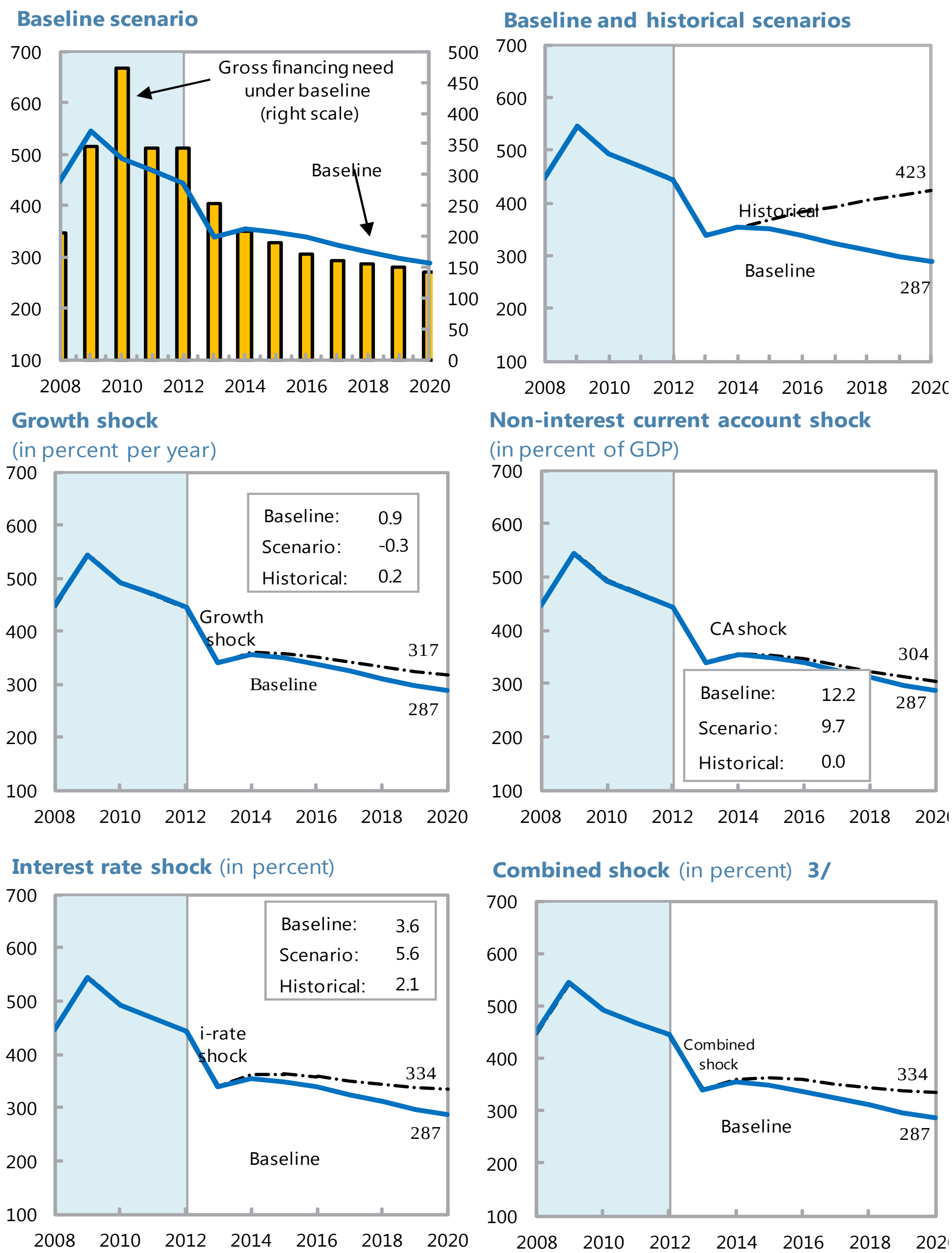
measures to protect revenues so as to safeguard fiscal targets. Efforts need to continue to advance the revenue administration reform, implement the new fiscal responsibility law, and prepare state assets for privatization.

41. **Risks remain significant, and full and timely policy implementation is essential to the program's success.** Macroeconomic and financial sector risks could jeopardize the recovery and debt sustainability. Emerging political risks and resistance from vested interests could complicate policy implementation. In this context, the authorities will need to redouble efforts to ensure strong policy implementation, which remains critical to boosting confidence and restoring growth.

42. **On the basis of progress to date and policy commitments going forward, staff supports the completion of the third review and the proposed modifications to performance criteria.**

Figure 6. Cyprus: External Debt Sustainability - Bound Tests 1/ 2/

(Percent of GDP)



Sources: Ministry of Finance; CBC; and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.

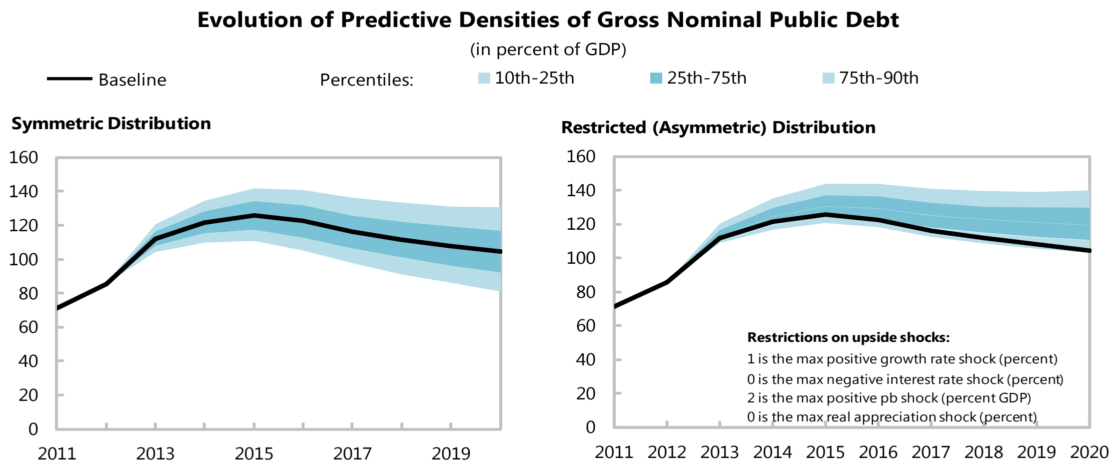
2/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead.

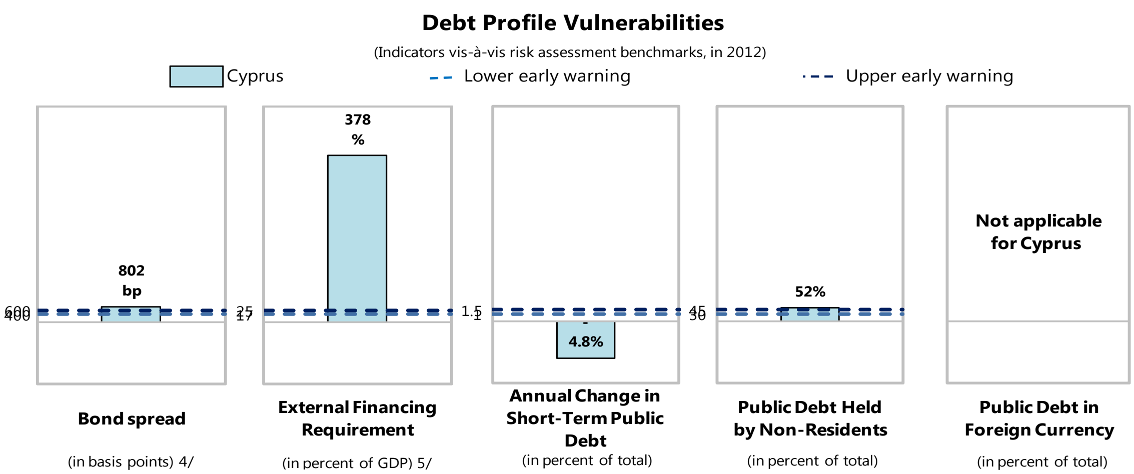
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Figure 7. Cyprus: Public Debt Sustainability Analysis - Risk Assessment */

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt





Source: IMF staff.

*/ A full DSA with a comprehensive write-up in line with the guidance will be prepared by the third quarter of 2014 or as early as circumstances warrant it.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

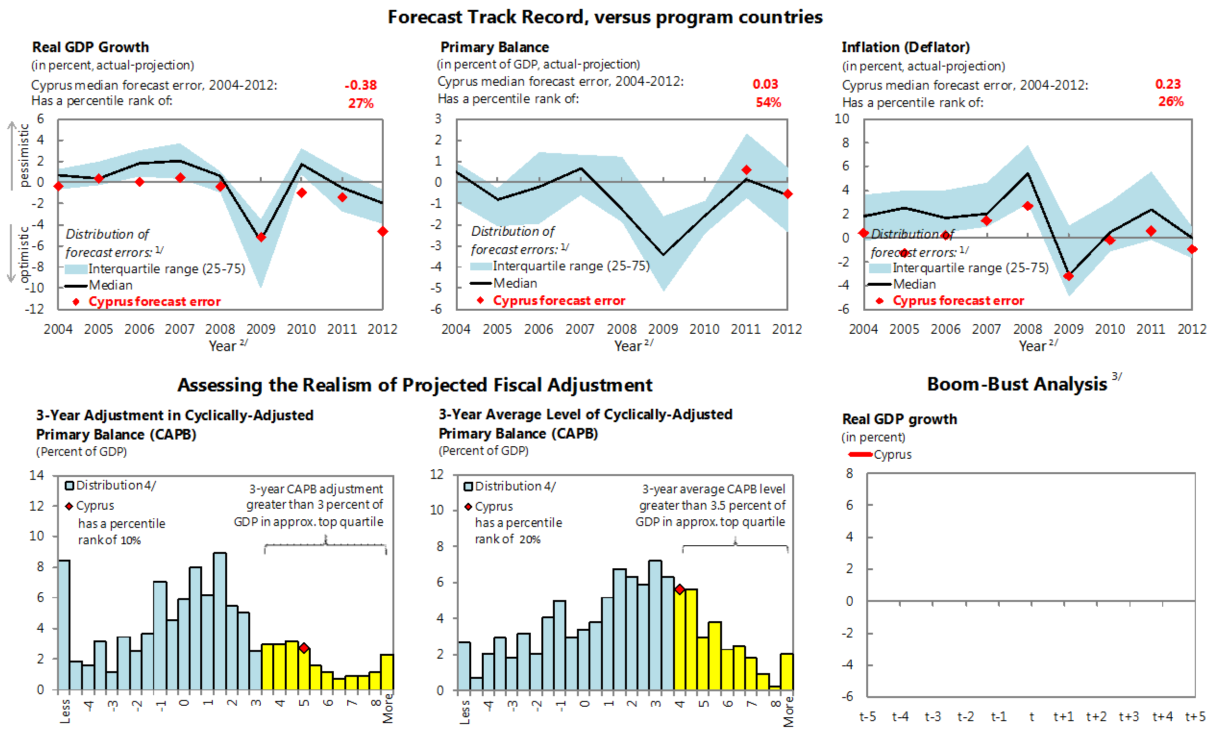
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 27-Nov-13 through 25-Feb-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 8. Cyprus Public Debt Sustainability Analysis - Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Cyprus.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 9. Cyprus: Public Sector Debt Sustainability Analysis - Baseline Scenario

(In percent of GDP unless otherwise indicated)

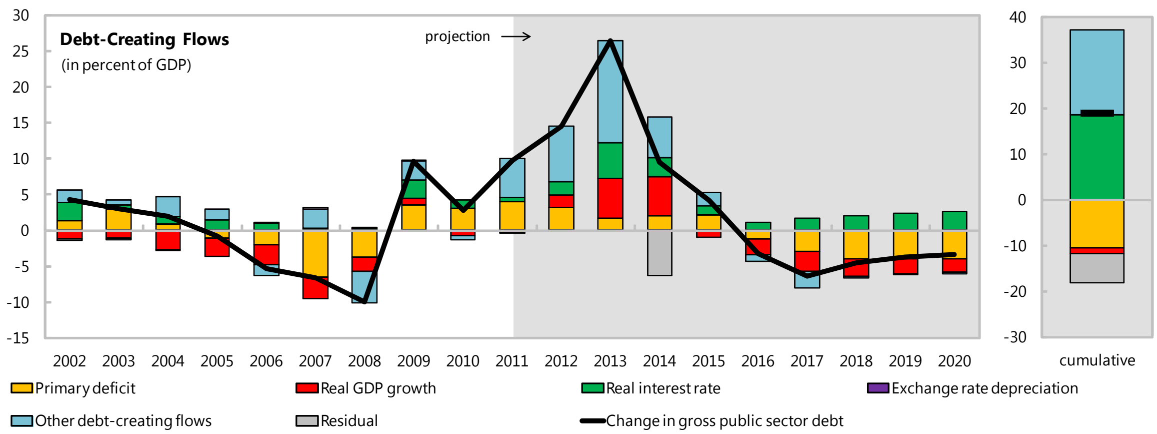
Debt, Economic and Market Indicators [1/]

	Actual			Projections							
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	63.5	71.1	85.5	112.0	121.5	125.8	122.5	116.1	111.6	107.9	104.5
Public gross financing needs	14.2	17.9	18.7	20.4	16.3	17.2	10.4	20.9	8.9	12.9	14.5
Real GDP growth (in percent)	2.7	0.4	-2.4	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation (GDP deflator, in percent)	3.0	2.8	1.9	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Nominal GDP growth (in percent)	5.8	3.3	-0.5	-8.1	-4.2	2.4	3.7	4.3	4.2	3.9	3.9
Effective interest rate (in percent) [4/]	5.1	4.0	4.4	3.3	2.8	2.6	2.7	3.5	3.8	4.2	4.6

As of February 25, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		518
5Y CDS (bp)		535
Ratings	Foreign	Local
Moody's	Caa3	Caa3
S&Ps	B-	B-
Fitch	B-	CCC

Contribution to Changes in Public Debt

	Actual			Projections									
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-0.1	9.7	14.5	26.5	9.5	4.2	-3.2	-6.4	-4.5	-3.7	-3.4	26.1	
Identified debt-creating flows	-0.1	9.7	14.5	26.5	15.9	4.2	-3.2	-6.4	-4.5	-3.7	-3.4	32.4	
Primary deficit	-0.2	3.9	3.2	1.7	2.0	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	-2.5	0.6
Primary (noninterest) revenue and gra	40.6	39.7	39.6	41.7	41.5	40.3	40.7	41.4	42.1	42.3	42.4	247.6	
Primary (noninterest) expenditure	40.4	43.6	42.8	43.3	43.4	42.4	39.5	38.4	38.1	38.3	38.4	245.1	
Automatic debt dynamics [5/]	-0.5	0.4	3.5	10.6	8.2	0.3	-1.2	-1.0	-0.5	0.3	0.7	16.3	
Interest rate/growth differential [6/]	-0.5	0.4	3.5	10.6	8.2	0.3	-1.2	-1.0	-0.5	0.3	0.7	16.3	
Of which: real interest rate	1.2	0.7	1.8	5.0	2.6	1.3	1.1	1.7	2.0	2.4	2.6	13.7	
Of which: real GDP growth	-1.7	-0.3	1.7	5.6	5.6	-1.0	-2.3	-2.8	-2.5	-2.1	-1.9	2.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.6	5.4	7.7	14.2	5.7	1.9	-0.9	-2.3	0.0	0.0	0.0	18.6	
Net privatization/asset sales proceed	0.0	0.0	0.0	0.0	-0.6	-3.1	-3.0	-2.3	0.0	0.0	0.0	-9.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	0.6	5.4	7.7	14.2	6.4	5.0	2.1	0.0	0.0	0.0	0.0	27.6	
Residual, including asset changes [8/]	0.0	0.0	0.0	0.0	-6.4	0.0	0.0	0.0	0.0	0.0	0.0	-6.4	



Source: IMF staff estimates.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

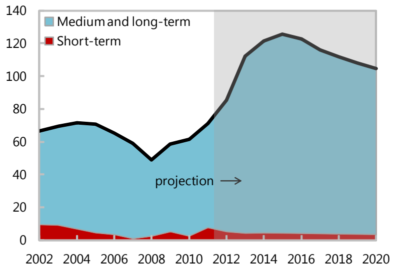
8/ For projections, includes exchange rate changes during the projection period. In 2014, the residual is the Euro 1 billion asset swap.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

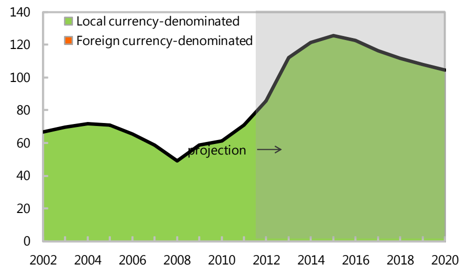
Figure 10. Cyprus: Public Debt Sustainability Analysis - Composition of Public Debt and Alternative Scenarios 1/

Composition of Public Debt

By Maturity
(in percent of GDP)



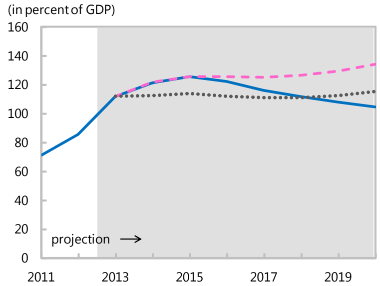
By Currency
(in percent of GDP)



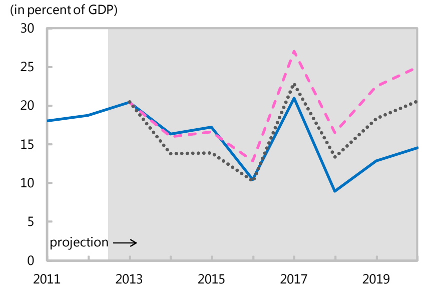
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(Percent)

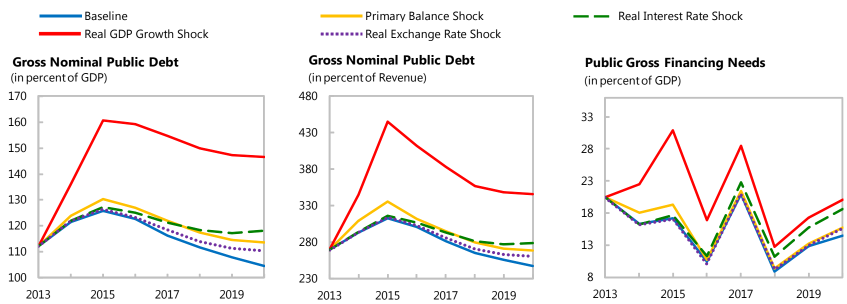
Baseline Scenario	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.8	2.6	2.7	3.5	3.8	4.2	4.6
Constant Primary Balance Scenario								
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	3.3	2.7	2.5	2.5	3.2	3.5	3.9	4.2

Historical Scenario	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-6.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-1.7	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	3.3	2.7	2.5	2.4	3.1	3.3	3.7	3.9

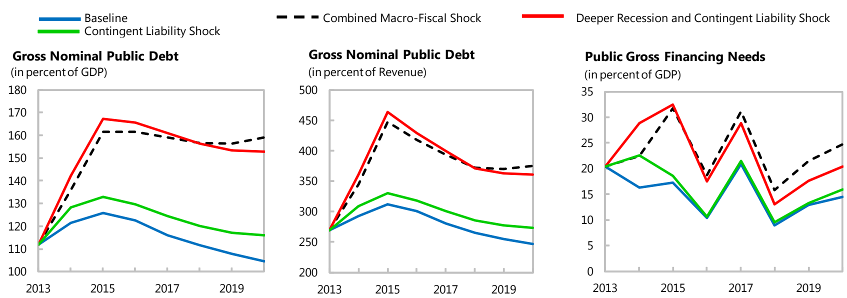
Source: IMF staff estimates.
1/ Inflation in the tables refer to GDP deflator growth.

Figure 11. Cyprus: Public Debt Sustainability Analysis - Stress Tests 1/

Macro-Fiscal Stress Tests



Additional Stress Tests



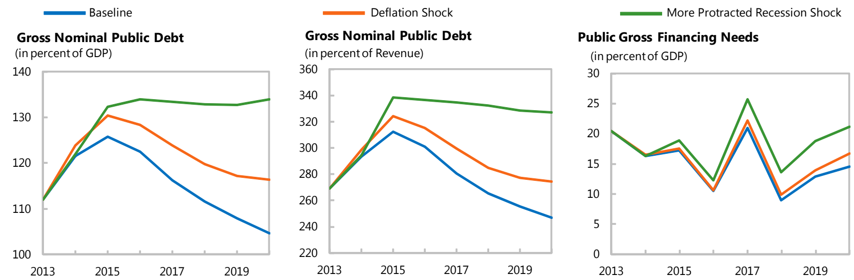
Underlying Assumptions
(Percent)

Primary Balance Shock	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-3.8	-3.9	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.2	3.3	3.7	4.0
Real Interest Rate Shock								
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	3.0	3.3	4.1	4.7	5.2	5.8
Combined Shock								
Real GDP growth	-6.0	-10.0	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	-0.8	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-7.2	-12.5	-0.9	2.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	3.1	3.5	4.3	4.9	5.4	5.9
Contingent Liability Shock								
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.6	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-8.3	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.1	3.3	3.7	3.9

Real GDP Growth Shock	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-6.0	-10.0	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	-0.8	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-7.2	-12.5	-0.9	2.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.1	3.3	3.7	3.9
Real Exchange Rate Shock								
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	0.8	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.2	3.4	3.7	4.0
Deeper Recession and Contingent Liability Shock								
Real GDP growth	-6.0	-10.0	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	-0.8	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-1.7	-13.5	-12.5	-0.9	2.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.1	3.3	3.6	3.9

Figure 11. Cyprus: Public Debt Sustainability Analysis - Stress Tests (concluded)

Additional Stress Tests



Underlying Assumptions
(Percent)

	2013	2014	2015	2016	2017	2018	2019	2020
Deflation Shock								
Real GDP growth	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	-2.3	-1.0	0.1	0.9	1.5	1.6	1.8	2.0
Primary balance	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.3	2.7	2.5	2.5	3.2	3.4	3.7	4.0

	2013	2014	2015	2016	2017	2018	2019	2020
More Protracted Recession Shock								
Real GDP growth	-6.0	-4.8	-2.0	-0.5	0.6	1.2	1.6	1.8
Inflation	-2.3	0.6	0.8	1.2	1.5	1.7	1.9	2.0
Primary balance	-1.7	-2.0	-3.2	0.3	1.4	1.9	2.1	2.6
Effective interest rate	3.3	2.7	2.6	2.5	3.3	3.5	3.9	4.2

Source: IMF staff estimates.

Table 1. Cyprus: Selected Economic Indicators, 2008-20

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Real Economy						(Percent change, unless otherwise indicated)							
Real GDP	3.6	-1.9	1.3	0.4	-2.4	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Domestic demand	8.0	-7.0	1.9	-1.5	-4.2	-10.6	-6.8	0.0	1.3	2.3	2.7	2.4	2.2
Consumption	7.4	-4.6	1.4	1.0	-2.6	-7.2	-5.3	-0.1	1.0	2.0	2.5	2.2	2.0
Private consumption	7.8	-7.5	1.5	1.3	-2.5	-7.5	-6.3	0.7	2.3	3.5	3.0	2.4	2.2
Public consumption	6.1	6.8	1.0	-0.3	-3.1	-6.0	-1.5	-2.7	-3.7	-3.3	0.6	1.1	1.3
Fixed investment	6.0	-9.7	-4.9	-8.7	-19.6	-24.0	-18.1	1.3	3.9	4.9	4.5	4.1	4.0
Inventory accumulation 1/	0.9	-1.5	1.8	-0.7	1.4	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.0	2.0	5.0	1.9	0.8	0.6	0.2	-0.3	-0.3	-0.3
Exports of goods and services	-0.5	-10.7	3.8	4.4	-2.7	-4.8	-2.7	1.9	2.8	3.5	3.5	3.5	3.5
Imports of goods and services	8.5	-18.6	4.8	-0.2	-6.4	-14.7	-7.1	0.2	1.6	3.6	4.6	4.5	4.4
Potential GDP growth	2.4	1.7	1.6	1.7	-1.5	-5.7	-4.6	0.0	0.6	1.4	1.6	1.8	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.6	-3.8	-3.0	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	0.4	0.4	1.4	1.7	1.7	1.8	1.9	2.0
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	-1.3	0.4	1.4	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	3.7	5.4	6.3	7.9	11.9	16.0	19.2	18.4	17.0	15.4	14.0	12.5	11.2
Employment growth (percent)	2.0	-0.4	-0.2	0.4	-4.2	-5.6	-4.5	0.8	1.7	2.2	2.0	1.8	1.7
Public Finance						(Percent of GDP)							
General government balance	0.9	-6.1	-5.3	-6.3	-6.4	-4.7	-5.2	-5.2	-2.0	-1.0	-0.2	-0.5	-0.7
Revenue	43.1	40.1	40.9	39.7	39.6	41.7	41.5	40.3	40.7	41.4	42.1	42.3	42.4
Expenditure	42.1	46.2	46.2	46.0	45.9	46.4	46.7	45.5	42.8	42.4	42.3	42.8	43.1
Primary Fiscal Balance	3.8	-3.6	-3.0	-3.9	-3.2	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.1	85.5	112.0	121.5	125.8	122.5	116.1	111.6	107.9	104.5
Balance of Payments						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.3	-6.8	-1.5	0.1	0.3	0.6	0.5	0.0	-0.2	-0.4
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-3.1	1.3	3.4	4.1	4.6	4.5	4.2	4.0	3.9
Exports of goods and services	45.0	40.2	41.3	42.7	42.5	44.3	45.6	46.1	46.4	46.7	47.2	47.9	48.6
Imports of goods and services	56.4	45.7	47.5	46.9	45.6	43.0	42.2	42.0	41.8	42.2	43.0	43.9	44.7
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.6	-17.8	-16.1	-15.8	-15.7	-15.8	-16.2	-16.6	-17.0
Services balance	21.0	19.9	20.6	19.9	18.5	19.1	19.5	19.9	20.2	20.4	20.4	20.6	20.8
Income, net	-3.9	-4.1	-2.2	2.0	-2.5	-1.7	-2.9	-3.4	-3.5	-3.6	-3.8	-3.8	-4.0
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.1	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.3	4.7	-29.2	-16.1	-14.1	-3.4	-0.6	0.2	0.6	1.1
Direct investment	-5.2	13.2	0.4	0.7	6.7	1.5	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment	-74.2	-101.1	-11.1	32.0	29.9	59.2	3.2	-4.2	-3.1	-2.6	-2.5	-2.5	-4.2
Other investment	93.8	98.2	19.0	-28.6	-32.1	-89.9	-19.9	-14.2	-5.0	-1.1	-0.3	-0.8	1.3
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	0.0	0.0	29.5	15.8	13.6	2.6	0.0	-0.3	-0.6	-0.8
European Union	0.0	0.0	0.0	0.0	0.0	27.9	13.7	11.5	2.1	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	1.6	2.2	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.6	10.0	13.1	8.1	10.0	10.1	10.4	11.2	11.3	11.0	11.0	10.9
Government	4.9	-0.6	-0.1	-1.8	-2.6	-2.0	-2.4	-2.4	0.8	1.8	2.7	2.4	2.2
Non-government	2.8	9.2	10.0	14.9	10.7	12.0	12.5	12.9	10.4	9.5	8.3	8.6	8.7
Gross capital formation	23.3	19.4	19.8	16.5	14.9	11.5	10.0	10.2	10.6	10.8	11.0	11.2	11.3
Government	5.0	5.1	5.0	5.0	5.4	5.8	4.6	4.5	3.9	3.7	3.8	3.9	4.1
Private	18.3	14.3	14.8	11.5	9.5	5.6	5.4	5.7	6.6	7.1	7.2	7.2	7.3
Foreign saving	-15.6	-10.7	-9.8	-3.3	-6.8	-1.5	0.1	0.3	0.6	0.5	0.0	-0.2	-0.4
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	18.0	17.9	16.4	15.7	16.1	16.7	17.4	18.2	18.9	19.6

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.

1/ Contribution to growth.

Table 2. Cyprus: Fiscal Developments and Projections, 2008–20 1/

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Revenue	43.1	40.1	40.9	39.9	39.6	41.7	41.5	40.3	40.7	41.4	42.1	42.3	42.4
Current revenue	43.0	40.0	40.8	39.9	39.5	41.6	41.5	40.2	40.7	41.4	42.1	42.3	42.4
Tax revenue	30.6	26.4	26.5	26.4	25.7	26.3	26.1	26.2	26.5	26.8	27.1	27.1	27.2
Indirect taxes	17.7	15.2	15.4	14.6	14.7	14.6	14.8	14.9	15.2	15.4	15.7	15.7	15.7
Direct taxes	12.9	11.2	11.1	11.7	11.0	11.7	11.3	11.2	11.3	11.4	11.4	11.5	11.5
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.8	9.1	9.0	9.4	9.3	9.1	9.2	9.3	9.4	9.4
Other current revenue	4.6	4.9	5.4	4.8	4.8	6.3	5.9	4.8	5.0	5.3	5.6	5.7	5.7
Sales	2.9	2.4	2.6	2.4	2.7	2.7	2.7	2.7	2.7	2.8	2.8	2.9	2.9
Other	1.8	2.5	2.8	2.3	2.1	3.6	3.3	2.1	2.3	2.5	2.8	2.8	2.8
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.1	46.2	46.2	46.3	45.9	46.4	46.7	45.5	42.8	42.4	42.3	42.8	43.1
Current expenditure	38.2	40.7	40.9	41.7	42.2	43.6	43.9	42.7	40.0	39.6	39.4	39.9	40.2
Wages and salaries	14.6	16.2	15.8	16.1	15.8	15.6	15.3	14.6	13.9	13.7	13.6	13.5	13.4
Goods and services	5.0	5.4	5.6	5.3	4.8	4.7	5.1	5.0	4.7	4.5	4.4	4.4	4.4
Social Transfers	12.2	13.5	14.4	14.7	15.0	15.8	17.1	16.9	15.7	15.2	14.9	15.1	15.1
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Interest payments 2/	2.8	2.6	2.2	2.4	3.1	3.0	3.2	3.1	3.3	4.0	4.2	4.5	4.7
Other current expenditure	3.1	2.9	2.5	2.8	2.9	3.9	2.6	2.5	1.9	1.7	1.8	1.9	2.0
Capital expenditure	4.0	5.5	5.2	4.5	3.8	2.7	2.8	2.8	2.8	2.8	2.9	2.9	2.9
Overall balance 3/	0.9	-6.1	-5.3	-6.3	-6.4	-4.7	-5.2	-5.2	-2.0	-1.0	-0.2	-0.5	-0.7
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.4	-4.7	-5.2	-5.2	-2.0	-1.0	-0.2	-0.5	-0.7
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.4	-4.7	-5.2	-5.2	-2.0	-1.0	-0.2	-0.5	-0.7
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.6	13.9	-1.3	1.2	-1.5	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.6	4.4	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares 4/	0.0	0.0	0.0	0.0	0.0	9.1	-9.5	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.1	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.4	0.4	13.4	1.2	-1.5	-2.3	0.0	0.0	0.0
Other assets	0.2	0.3	0.0	-0.4	0.0	0.0	-7.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.7	15.0	18.6	3.9	6.4	0.5	-1.3	0.2	0.5	0.7
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	1.7	-10.3	-5.6	-6.7	1.5	1.6	1.1	1.7	2.1
Loans	3.0	-0.3	0.0	4.0	12.6	28.9	9.6	13.1	-1.0	-2.9	-0.9	-1.2	-1.4
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance 5/	3.8	-3.6	-3.0	-4.0	-3.2	-1.7	-2.0	-2.1	1.2	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.5	85.5	112.0	121.5	125.8	122.5	116.1	111.6	107.9	104.5

Sources: Eurostat; and IMF staff estimates.

1/ Historical fiscal statistics are based on Eurostat and are thus reported on an accrual basis. For projections, and to be consistent with the cash basis of the program, the fiscal statistics are reported on a cash basis.

2/ Starting in 2017, part of the interest bill previously capitalized is projected to be paid annually.

3/ Projections for 2015-18 include unspecified additional fiscal measures as agreed under the program. It is assumed that 70 percent of the measures are on the spending and the rest on the revenue side.

4/ The composition of net acquisition of financial assets was corrected in 2013 by increasing securities other than shares and reducing shares and other equity to reflect the holdings of ESM bonds rather than the purchase of equity in the coops which occured in 2014. The operation is correspondingly reversed in 2014 reflecting the purchase of equity in the coops with the ESM bonds.

5/ Primary fiscal targets in 2015 and 2016 need to be adjusted for expected dividends of €0.2 billion, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

Table 3. Cyprus: Calculation of Gross Financing Requirements and Sources of Financing, 2013–17 1/ 2/

(Millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**5,845.3**	**3,444.8**	**3,544.8**	**1,947.1**	**3,648.4**
Government	3,389.1	2,596.2	2,775.4	1,738.1	3,648.4
Fiscal deficit ("+" = financing need)	816.8	850.4	844.7	342.3	180.2
Debt maturities	2,572.3	1,745.7	1,930.7	1,395.8	3,468.2
Medium- and long-term	1,596.2	995.4	1,180.4	645.5	2,717.9
Domestic 1/	138.3	364.9	271.0	421.5	2,654.3
Foreign	1,457.9	630.5	909.4	223.9	63.5
Short-term	976.0	750.3	750.3	750.3	750.3
Domestic	976.0	750.3	750.3	750.3	750.3
Foreign	0.0	0.0	0.0	0.0	0.0
Banks recapitalization/support	1,500.0	0.0	0.0	0.0	0.0
Market financing	**776.2**	**850.3**	**750.3**	**911.0**	**3,248.4**
Government	776.2	850.3	750.3	911.0	3,248.4
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	776.2	850.3	750.3	911.0	3,248.4
Medium- and long-term	25.9	100.0	0.0	160.7	2,498.1
Short-term	750.3	750.3	750.3	750.3	750.3
Net financing requirement	**5,069.1**	**2,594.5**	**2,794.5**	**1,036.1**	**400.0**
Government	2,612.9	1,745.8	2,025.0	827.1	400.0
Fiscal deficit	816.8	850.4	844.7	342.3	180.2
Debt maturities	1,796.1	895.4	1,180.4	484.8	219.8
Medium- and long-term	1,570.4	895.4	1,180.4	484.8	219.8
Short-term	225.7	0.0	0.0	0.0	0.0
Official Financing Sources and Financial Buffers	**5,069.1**	**2,594.5**	**2,794.5**	**1,036.1**	**400.0**
Domestic Financing Sources	**225.7**	**100.0**	**600.0**	**600.0**	**400.0**
Official financing sources	**4,843.4**	**2,494.5**	**2,194.5**	**436.1**	**0.0**
IMF	258.4	344.5	344.5	86.1	0.0
ESM	4,585.0	2,150.0	1,850.0	350.0	0.0

Source: IMF staff estimates.

1/ Domestic maturities in 2017 include the repayment of the Laiki recapitalization bond.

2/ Medium and long term financing in market financing in 2013 and 2014 refers to EIB financing.

Table 4. Cyprus: Balance of Payments, 2008-20 1/

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
						(Millions of Euros)							
Current account balance	-2,679	-1,808	-1,711	-602	-1,217	-238	17	44	105	88	-1	-33	-75
Trade balance (Goods and Services)	-1,954	-929	-1,084	-763	-546	210	530	659	764	791	758	754	761
Goods balance	-5,556	-4,291	-4,665	-4,349	-3,856	-2,928	-2,533	-2,549	-2,616	-2,758	-2,947	-3,136	-3,330
Exports	1,190	1,002	1,137	1,411	1,440	1,464	1,511	1,568	1,636	1,721	1,810	1,909	2,015
Imports	-6,746	-5,293	-5,802	-5,760	-5,296	-4,392	-4,044	-4,117	-4,252	-4,479	-4,757	-5,045	-5,345
Services Balance	3,602	3,362	3,581	3,585	3,310	3,138	3,063	3,208	3,380	3,549	3,705	3,890	4,091
Exports	6,538	5,779	6,049	6,262	6,167	5,817	5,664	5,856	6,111	6,426	6,761	7,130	7,524
Imports	-2,936	-2,417	-2,468	-2,676	-2,857	-2,679	-2,601	-2,648	-2,731	-2,877	-3,055	-3,240	-3,433
Current income, net	-662	-685	-379	357	-456	-275	-455	-554	-589	-632	-692	-724	-776
Current transfers, net	-63	-193	-116	-196	-215	-173	-59	-61	-70	-71	-68	-62	-60
Private	23	-107	-56	-101	-155	-89	-64	-61	-63	-62	-65	-61	-60
Public	-86	-86	-60	-94	-60	-85	5	0	-7	-9	-3	-1	1
Capital account, net	6	50	36	46	23	198	27	27	27	27	27	27	27
Financial account, net	2,765	1,835	1,647	781	847	-4,803	-2,538	-2,266	-568	-108	32	120	212
Direct investment	-890	2,224	65	132	1,197	240	79	701	784	539	545	755	785
Portfolio investment	-12,722	-17,039	-1,934	5,753	5,340	9,729	509	-677	-514	-461	-458	-476	-826
Other investment	16,085	16,558	3,313	-5,146	-5,748	-14,772	-3,126	-2,291	-839	-186	-56	-160	253
Reserves (- inflow; + outflow)	291	93	200	43	57	0	0	0	0	0	0	0	0
Program financing	…	…	…	…	0	4,843	2,494	2,194	436	-7	-57	-115	-165
European Union	…	…	…	…	0	4,585	2,150	1,850	350	0	0	0	0
IMF	…	…	…	…	0	258	344	344	86	-7	-57	-115	-165
Errors and omissions	-92	-78	31	-225	346	0	0	0	0	0	0	0	0
						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.3	-6.8	-1.5	0.1	0.3	0.6	0.5	0.0	-0.2	-0.4
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-3.1	1.3	3.4	4.1	4.6	4.5	4.2	4.0	3.9
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.6	-17.8	-16.1	-15.8	-15.7	-15.8	-16.2	-16.6	-17.0
Exports	6.9	5.9	6.5	7.8	8.0	8.9	9.6	9.7	9.8	9.9	10.0	10.1	10.3
Imports	-39.3	-31.4	-33.3	-32.0	-29.6	-26.7	-25.7	-25.5	-25.4	-25.7	-26.2	-26.7	-27.2
Services balance	21.0	19.9	20.6	19.9	18.5	19.1	19.5	19.9	20.2	20.4	20.4	20.6	20.8
Exports	38.1	34.3	34.8	34.8	34.5	35.4	36.0	36.3	36.6	36.9	37.2	37.8	38.3
Imports	-17.1	-14.3	-14.2	-14.9	-16.0	-16.3	-16.5	-16.4	-16.3	-16.5	-16.8	-17.2	-17.5
Current income, net	-3.9	-4.1	-2.2	2.0	-2.5	-1.7	-2.9	-3.4	-3.5	-3.6	-3.8	-3.8	-4.0
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.1	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Private	0.1	-0.6	-0.3	-0.6	-0.9	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.5	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.3	4.7	-29.2	-16.1	-14.1	-3.4	-0.6	0.2	0.6	1.1
Direct investment	-5.2	13.2	0.4	0.7	6.7	1.5	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.2	-101.1	-11.1	32.0	29.9	59.2	3.2	-4.2	-3.1	-2.6	-2.5	-2.5	-4.2
Other investment 2/	93.8	98.2	19.0	-28.6	-32.1	-89.9	-19.9	-14.2	-5.0	-1.1	-0.3	-0.8	1.3
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	…	0.0	29.5	15.8	13.6	2.6	0.0	-0.3	-0.6	-0.8
European Union	…	…	…	…	0.0	27.9	13.7	11.5	2.1	0.0	0.0	0.0	0.0
IMF	…	0.0	0.0	0.0	0.0	1.6	2.2	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

1/ Balance of Payments historical data and projections exclude data related to the operations by entities without a physical presence in Cyprus as data coverage on these entities is still incomplete and subject to substantial revisions. This is also consistent with the treatment of these entities in the National accounts.

2/ 2008-09 data reflect the transitions between Greek banks and their subsidiaries in Cyprus.

Table 5. Cyprus: External Financing Requirements and Sources, 2012-2020
(Millions of Euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
GROSS FINANCING REQUIREMENTS	**60,086**	**61,361**	**32,971**	**30,921**	**29,132**	**28,376**	**28,803**	**28,547**	**28,301**
Current account deficit ("-" = CA surplus)	1,217	238	-17	-44	-105	-88	1	33	75
Medium- and long-term debt amortization	5,800	12,140	3,504	3,443	3,305	3,255	4,021	4,160	4,606
Public sector	593	1,009	462	314	146	45	745	813	1,186
Banks	4,380	10,056	1,429	1,404	1,399	1,396	1,408	1,423	1,438
Other private	827	1,075	1,613	1,726	1,760	1,813	1,868	1,924	1,981
Short-term debt amortization	53,069	48,982	29,484	27,522	25,932	25,202	24,723	24,239	23,455
Public sector	8,290	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522
Central Bank	7,992	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522
General government and SOEs	298	0	0	0	0	0	0	0	0
Banks	43,727	40,414	21,718	20,317	19,443	19,396	19,583	19,822	20,066
Other private	1,053	1,075	1,021	970	1,067	1,227	1,411	1,623	1,867
EU and IMF	0	0	0	0	0	7	57	115	165
SOURCES OF FINANCING	**60,086**	**56,517**	**30,477**	**28,727**	**28,696**	**28,376**	**28,803**	**28,547**	**28,301**
Capital account (net)	23	198	27	27	27	27	27	27	27
Foreign direct investment (net)	1,197	240	79	701	784	539	545	755	785
CYP investment abroad	219	200	-157	-161	-334	-523	-545	-567	-589
Foreign investment in CYP	979	40	236	863	1,118	1,063	1,090	1,322	1,374
New borrowing and debt rollover	54,254	32,596	31,019	29,209	28,836	28,313	28,599	27,962	28,671
Medium and long-term borrowing	5,271	3,113	3,497	3,277	3,635	3,590	4,359	4,508	5,429
General Government	2,120	30	0	0	224	64	745	813	1,651
Banks	1,084	-681	1,319	1,379	1,386	1,441	1,466	1,482	1,499
Other private	2,067	3,764	2,177	1,898	2,024	2,085	2,148	2,212	2,278
Short-term borrowing	48,982	29,484	27,522	25,932	25,202	24,723	24,239	23,455	23,242
Public sector	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522	212
Central Bank	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522	212
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	21,718	20,317	19,443	19,396	19,583	19,822	20,066	21,070
Other private	1,075	1,021	970	1,067	1,227	1,411	1,623	1,867	1,960
Other	4,612	23,483	-648	-1,211	-952	-504	-368	-199	-1,183
Of which: Net errors and omissions	346	0	0	0	0	0	0	0	0
FINANCING GAP	**0**	**4,843**	**2,494**	**2,194**	**436**	**0**	**0**	**0**	**0**
ESM	0	4,585	2,150	1,850	350	0	0	0	0
IMF	0	258	344	344	86	0	0	0	0
ROLLOVER RATES									
General government	238%	3%	0%	0%	153%	140%	100%	100%	139%
Central bank	94%	90%	92%	87%	84%	81%	75%	54%	14%
Private	89%	49%	96%	97%	102%	103%	103%	103%	106%
Banks	86%	42%	93%	96%	100%	101%	101%	101%	105%
Non-financial corporates	167%	223%	119%	110%	115%	115%	115%	115%	110%

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.

Table 6. Cyprus: Monetary Survey, 2008–20

(Billions of Euros, unless otherwise indicated, end of period)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)													
Assets	118.1	139.4	135.0	131.4	128.1	90.2	89.7	88.5	87.9	88.3	89.1	90.3	91.6
Claims on Central Bank of Cyprus	1.3	3.1	2.3	2.9	3.9	2.7	2.7	2.7	2.7	2.8	2.8	2.9	3.0
Claims on Cypriot resident other MFIs	3.3	5.4	5.6	5.0	4.6	3.3	3.2	3.3	3.4	3.6	3.7	3.8	4.0
Claims on Cypriot resident non MFIs	47.2	50.3	54.0	58.2	60.6	55.0	52.6	50.7	49.7	49.3	49.2	49.3	49.8
General government	3.7	4.6	4.5	5.3	6.5	5.4	6.1	6.4	6.5	6.4	6.4	6.5	6.5
Private sector excluding brass plates 1/	39.4	42.7	46.5	48.6	49.3	46.5	43.4	41.2	40.1	39.8	39.6	39.7	40.1
Households	19.1	20.6	22.5	23.5	23.9	22.2	21.1	20.4	19.9	19.6	19.4	19.5	19.6
Non-financial corporations	19.7	21.5	23.3	24.1	24.4	23.5	21.6	20.1	19.5	19.5	19.5	19.6	19.8
Non-bank financial intermediaries	0.6	0.6	0.7	1.0	1.0	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Brass plates 2/	4.1	3.0	3.0	4.4	4.8	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1
Claims on non-residents	63.4	76.9	69.3	61.3	55.9	25.4	25.9	26.6	26.9	27.4	28.2	28.9	29.6
Other assets	2.9	3.8	3.8	3.9	3.2	3.8	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Liabilities	118.1	139.4	135.0	131.6	128.1	90.2	89.7	88.5	87.9	88.3	89.1	90.3	91.6
Liabilities to the Central Bank of Cyprus and Eurosystem	4.7	7.6	5.5	5.5	9.8	11.2	10.5	9.8	9.0	8.2	7.7	7.4	7.2
Liabilities to Cypriot resident other MFI	3.3	5.3	5.5	4.9	4.5	3.2	3.1	3.2	3.3	3.4	3.6	3.7	3.9
Deposits of Cypriot resident non MFIs	39.5	41.0	45.4	43.7	43.3	33.0	32.7	32.8	32.9	33.6	34.4	35.4	36.3
General government	0.3	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Private sector excluding brass plates	33.4	34.5	36.8	37.4	37.5	29.9	29.7	29.8	29.9	30.6	31.4	32.3	33.3
Households	23.4	24.6	25.4	26.0	26.4	23.3	23.1	23.2	23.2	23.8	24.4	25.1	25.9
Non-financial corporations	6.3	6.1	6.7	6.7	5.7	3.9	3.9	3.9	3.9	4.0	4.1	4.2	4.4
Non-bank financial intermediaries	3.6	3.9	4.7	4.6	5.4	2.7	2.7	2.7	2.7	2.8	2.9	3.0	3.1
Brass plates	5.7	6.1	8.1	5.8	5.3	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Deposits of non-residents	51.7	66.6	60.6	56.5	51.3	24.7	23.8	23.1	23.1	23.5	23.8	24.2	24.5
Debt securities	5.6	4.8	2.4	2.6	1.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital and reserves	10.0	10.8	12.8	11.3	15.1	16.2	17.7	17.7	17.7	17.7	17.7	17.7	17.7
Other liabilities	3.4	3.3	2.8	7.1	2.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Money and Credit													
General government sector credit, net	4.5	5.3	5.2	5.3	7.2	5.5	5.7	6.0	6.1	6.0	6.0	6.1	6.1
Private sector credit excluding brass plates	39.5	42.7	46.5	48.6	49.3	46.5	43.4	41.2	40.1	39.8	39.6	39.7	40.1
Brass plates credit	4.1	3.0	3.0	4.4	4.8	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1
Cypriot resident broad money (M2)	40.6	42.2	46.6	45.0	44.6	34.5	34.1	34.3	34.5	35.2	36.1	37.1	38.1
Cypriot resident narrow money (M1)	9.1	10.4	10.6	11.1	11.5	10.4	10.6	10.7	11.0	11.5	11.9	12.3	12.8
						(Percent of GDP)							
General government sector credit, net	26.4	31.6	30.1	29.4	40.0	33.6	36.3	37.4	36.4	34.5	33.2	32.0	31.0
Private sector credit excluding brass plates	230.0	253.6	267.2	272.1	275.5	282.9	275.8	255.6	240.1	228.3	217.9	210.3	204.4
Brass plates credit	23.9	17.5	17.4	24.3	26.7	18.7	19.3	18.9	18.3	17.7	17.1	16.6	16.0
Cypriot resident broad money (M2)	236.6	250.2	267.4	251.7	249.6	209.8	216.5	212.8	206.2	201.9	198.4	196.2	194.0
Cypriot resident narrow money (M1)	53.0	61.8	61.2	62.2	64.2	63.3	67.3	66.4	65.9	65.9	65.5	65.3	65.1
						(Annual percentage change)							
General government sector credit, net	...	17.4	-1.6	0.4	36.2	-22.9	3.5	5.4	0.9	-1.0	0.1	0.4	0.6
Private sector credit excluding brass plates	...	8.3	8.8	4.6	1.3	-5.6	-6.6	-5.1	-2.6	-0.8	-0.5	0.3	1.0
Brass plates credit	...	-28.1	2.3	44.0	9.9	-35.7	-1.4	0.4	0.6	0.7	0.7	0.7	0.7
Cypriot resident broad money (M2)	...	3.9	10.4	-3.4	-0.8	-22.8	-1.2	0.7	0.4	2.2	2.4	2.7	2.8
Cypriot resident narrow money (M1)	...	14.5	2.3	4.4	3.2	-9.3	1.7	1.1	2.8	4.5	3.5	3.6	3.6
Memorandum items:													
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	...	3.4	6.5	1.7	0.3	-20.2	-0.9	0.4	0.3	2.3	2.6	3.0	3.0
Brass plates deposits (y-o-y percent change)	...	6.2	33.8	-28.3	-9.4	-50.4	-1.4	0.2	0.3	0.4	0.4	0.3	0.3

Sources: European Central Bank; Central Bank of Cyprus; and IMF staff estimates.

1/ Includes public entities classified outside the general government as no information is available to separate them. The data excludes brass plates, which are companies with a physical presence in Cyprus and, therefore, treated as residents but with limited interaction with the domestic economy.

2/ Data on brass plates only became available from July 2008 onwards.

Table 7. Cyprus: Indicators of Fund Credit, 2012–20 1/

(Millions of SDRs)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Existing and prospective Fund credit									
Disbursement	0.0	222.8	297.0	297.0	74.3	0.0	0.0	0.0	0.0
Stock	0.0	222.8	519.8	816.8	891.0	884.8	835.3	736.3	594.0
Obligations	0.0	1.6	4.9	10.7	17.7	24.6	70.9	118.4	157.1
Repurchase	0.0	0.0	0.0	0.0	0.0	6.2	49.5	99.0	142.3
Charges	0.0	1.6	4.9	10.7	17.7	18.4	21.4	19.4	14.8
Stock of existing and prospective Fund credit									
In percent of quota	0.0	140.8	328.5	516.3	563.2	559.3	528.0	465.4	375.5
In percent of GDP	0.0	1.5	3.8	5.8	6.1	5.8	5.2	4.5	3.5
In percent of exports of goods and services	0.0	20.1	46.1	70.8	75.2	72.1	65.8	56.0	43.7
Obligations to the Fund from existing and prospective Fund credit									
In percent of quota	0.0	1.0	3.1	6.8	11.2	15.5	44.8	74.8	99.3
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.2	0.4	0.7	0.9
In percent of exports of goods and services	0.0	0.1	0.4	0.9	1.5	2.0	5.6	9.0	11.6

Source: IMF staff estimates.

1/ Calculated based on full disbursements of the available amounts of the proposed arrangement.

Table 8. Cyprus: Schedule of Reviews and Purchases

Availability Date	Amount of Purchase		Conditions
	Millions of SDR	Percent of Quota	
May 15, 2013	74.25	46.93%	Approval of arrangement
September 15, 2013	74.25	46.93%	First review based on end-June 2013 performance criteria
December 15, 2013	74.25	46.93%	Second review based on end-September 2013 performance criteria
March 15, 2014	74.25	46.93%	Third review based on end-December 2013 performance criteria
June 15, 2014	74.25	46.93%	Fourth review based on end-March 2014 performance criteria
September 15, 2014	74.25	46.93%	Fifth review based on end-June 2014 performance criteria
December 15, 2014	74.25	46.93%	Sixth review based on end-September 2014 performance criteria
March 15, 2015	74.25	46.93%	Seventh review based on end-December 2014 performance criteria
June 15, 2015	74.25	46.93%	Eighth review based on end-March 2015 performance criteria
September 15, 2015	74.25	46.93%	Ninth review based on end-June 2015 performance criteria
December 15, 2015	74.25	46.93%	Tenth review based on end-September 2015 performance criteria
March 15, 2016	74.25	46.93%	Eleventh review based on end-December 2015 performance criteria
Total	891.00	563.21%	

Source: IMF staff estimates.

Table 9. Cyprus: External Debt Sustainability Framework, 2008-2020
(Percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	447.4	544.1	491.9	468.2	444.3			**339.5**	**353.9**	**349.0**	**337.7**	**323.6**	**310.5**	**297.4**	**287.3**	**-3.2**
Change in external debt	100.3	96.7	-52.3	-23.6	-23.9			-104.8	14.4	-4.9	-11.3	-14.1	-13.1	-13.1	-10.1	
Identified external debt-creating flows (4+8+9)	-12.2	51.6	20.6	-39.0	32.2			16.3	15.0	-7.4	-11.5	-11.3	-10.2	-10.0	-8.9	
Current account deficit, excluding interest payments	6.6	2.1	0.9	-5.4	-4.2			-9.1	-11.8	-12.0	-12.6	-12.7	-12.3	-12.0	-11.7	
Deficit in balance of goods and services	11.4	5.5	6.2	4.3	3.1			-1.3	-3.4	-4.1	-4.6	-4.6	-4.3	-4.1	-4.0	
Exports	45.0	40.2	41.3	42.9	42.5			44.3	45.6	46.1	46.4	46.7	47.2	47.9	48.6	
Imports	56.4	45.7	47.5	47.2	45.6			43.0	42.2	42.0	41.8	42.1	42.9	43.7	44.6	
Net non-debt creating capital inflows (negative)	20.0	7.0	1.8	-7.2	-12.7			-13.3	-1.1	-3.5	-4.1	-2.6	-2.5	-3.5	-3.2	
Automatic debt dynamics 1/	-38.8	42.5	17.8	-26.4	49.0			38.7	27.9	8.2	5.2	3.9	4.6	5.5	5.9	
Contribution from nominal interest rate	9.0	8.6	8.9	8.8	11.0			10.6	11.3	11.1	11.4	11.4	11.5	11.3	11.2	
Contribution from real GDP growth	-10.7	8.9	-7.2	-2.0	12.2			28.2	16.6	-2.9	-6.2	-7.5	-6.9	-5.8	-5.3	
Contribution from price and exchange rate changes 2/	-37.1	24.9	16.1	-33.2	25.8			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	112.5	45.1	-72.8	15.3	-56.1			-121.1	-0.5	2.5	0.2	-2.7	-2.9	-3.1	-1.2	
External debt-to-exports ratio (in percent)	993.3	1352.4	1191.4	1091.1	1044.8			766.3	776.4	757.8	728.6	692.5	658.1	621.1	590.9	
Gross external financing need (in billions of US dollars) 4/	52.1	81.2	109.4	85.3	79.0			55.0	44.1	41.7	39.7	39.1	40.0	40.0	39.6	
in percent of GDP	206.5	346.0	473.6	343.1	343.2	5-Year	5-Year	252.6	207.8	189.1	172.0	160.5	156.2	150.1	143.1	
Scenario with key variables at their historical averages 5/								**339.5**	**350.6**	**367.3**	**382.0**	**393.8**	**405.3**	**413.1**	**423.4**	**4.8**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation									
Real GDP growth (in percent)	3.6	-1.9	1.3	0.4	-2.4	0.2	2.4	-6.0	-4.8	0.9	1.9	2.3	2.2	1.9	1.8	
GDP deflator in US dollars (change in percent)	12.0	-5.3	-2.9	7.2	-5.2	1.2	7.9	0.8	2.3	2.9	2.9	2.9	2.9	1.9	2.0	
Nominal external interest rate (in percent)	3.0	1.8	1.6	1.9	2.2	2.1	0.6	2.3	3.2	3.2	3.4	3.6	3.7	3.8	3.9	
Growth of exports (US dollar terms, in percent)	10.4	-17.0	1.0	12.0	-8.4	-0.4	12.3	-1.3	0.3	4.9	5.5	6.2	6.2	5.5	5.5	
Growth of imports (US dollar terms, in percent)	21.5	-24.6	2.2	7.0	-10.7	-0.9	17.5	-10.6	-4.4	3.2	4.4	6.2	7.1	6.1	5.9	
Current account balance, excluding interest payments	-6.6	-2.1	-0.9	5.4	4.2	0.0	4.9	9.1	11.8	12.0	12.6	12.7	12.3	12.0	11.7	
Net non-debt creating capital inflows	-20.0	-7.0	-1.8	7.2	12.7	-1.8	12.7	13.3	1.1	3.5	4.1	2.6	2.5	3.5	3.2	

Source: IMF staff estimates.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Cyprus: Restrictive Measures on Transactions

(Euros)

	2013			2014
	27-Mar	2-Aug	22-Nov	24-Feb
Cash withdrawals (per day per person)				
Natural person	300	300	300	300
Legal person	300	500	500	500
Cashless payments/transfers w/o justification (per day per account)				
To other credit institutions in Cyprus				
Natural person (per month)	5,000	15,000	15,000	20,000
Legal person (per month)	5,000	75,000	75,000	100,000
For the purchase of goods and services w/o mandatory justification (per transaction) 2/	5,000	300,000	no limitation	no limitation
To institutions abroad				
Transactions within normal business w/o Committee's approval	5,000	500,000	1,000,000	1,000,000
Payments via debit or credit card (per month)	5,000	No limit	No limit	No limit
Exports of euro notes or foreign currency per person per journey	1,000	3,000	3,000	3,000
Monthly transfer of deposits/funds abroad regardless of the purpose	5,000	5,000	5,000	5,000
Opening of new accounts is prohibited except: to deposit funds from abroad, for term deposits created with cash for a minimum of three months, for loans related to new customer credit facilities	Yes	No 1/	No 1/	No 1/
It is prohibited to add new beneficiaries in a current account and cash cheques	Yes	Yes	Yes	Yes
Transactions of international customers of foreign banks exempted from restrictions	No	Yes (15 banks)	Yes (16 banks)	Yes (16 banks)
Mandatory rollover of maturing term deposits by 1 month (in percent of deposit value)	90%	80%	80%	none
Termination of fixed term deposits prior to maturity	Only to repay a loan within same institution	Additional transactions allowed	Additional transactions allowed	Additional transactions allowed

Sources: Central Bank of Cyprus and Ministry of Finance.

1/ Or subject to prior approval by the committee.

2/ But a credit institution still reserves the right to request justifying documents.

Table 11. Cyprus: Selected Reforms - Measures Completed		
Measures	Completion time	Macrofinancial implications
Developing and implementing fiscal structural reforms		
Implemented a reform of the COLA wage indexation mechanism in the public sector by extending its freeze to the end of the program and limiting its application to 50 percent of the price index thereafter	December 2012	Strengthen fiscal sustainability
Adopted the 2013 and medium term budget with consolidation measures of about 4.5 percent of GDP	December 2012	Strengthen fiscal sustainability
Reformed the General Social Insurance Scheme and to government pension scheme, and freeze public sector pensions	January 2013	Reduce implicit government liability
Rolled over and extended the maturity of €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and rolled over the €1.9 billion recapitalization bond of Laiki	June 2013	Facilitate government financing
Amended the Public Debt Management Law to assign responsibility for monitoring the stock of guarantees to the Public Debt Management Office	December 2013	Allow more regular assessment of risks stemming from government guarantees
Adopted the 2014 budget with consolidation measures of about 2.3 percent of GDP	December 2013	Strengthen fiscal sustainability
Adopted a law on Fiscal Responsibility and Budget Systems	February 2014	Strengthen budget formulation and execution
Resolving, recapitalizing, and restructuring financial institutions		
Independently assessed banking sector capital needs	February 2013	Identify capital shortfall
Adopted a modern bank resolution law	March 2013	Minimize fiscal costs
Completed resolution of Laiki and disposed of Greek operations	March 2013	Strengthen financial sector stability
Completed BoC recapitalization and exit from resolution	July 2013	Strengthen financial sector stability
Recapitalized Hellenic Bank from private sources	October 2013	Strengthen financial sector stability
Recapitalized the coop sector	March 2014	Strengthen financial sector stability
Strengthening supervision and regulation		
Harmonized NPL classification to best practice	September 2013	Strengthen financial sector stability
Unified supervision of CCIs and banks under the CBC	September 2013	Protect consumers
Passed legislation to prohibit banks and coops from lending to their independent board members and removing board members in arrears on debts to their banks	September 2013	Strengthen oversight of bank credit-risk management practices
Established the legal framework for a credit register	November 2013	Allow banks to make better informed loan decisions
Restructuring private sector debt		
Finalized a code of conduct for banks and a loan arrears framework	September 2013	Assist debt restructuring
Strengthening the AML framework		
Amended legislation to provide the widest possible range of cooperation to foreign counterparts	December 2012	Strengthen the sustainability of the business model
Conducted an audit by Deloitte and assessment by Moneyval of AML implementation practices by the banks	August 2013	Strengthen the sustainability of the business model
Amended legislation to improve transparency of companies and trusts	September 2013	Strengthen the sustainability of the business model
Strengthened the effectiveness and adequacy of resources for the AML/CFT supervisory function for financial institutions	February 2014	Secure adequate resources to perform AML supervision

Table 12. Cyprus: MEFP Commitments

Measures	Deadline	Rationale
Financial Sector Policies		
Restructuring financial institutions		
Authorities to complete the mergers of 93 coops into 18 new institutions	End-March 2014	Enhance viability
Main conclusions of the quarterly report on progress relative to BoC's proposed set of targets for key financial and operational indicators to be made public	End-March 2014	Enhance transparency
CBC to require Hellenic Bank to submit a business plan through end-2015, including capital and funding plans	End-March 2014	Strengthen financial sector stability
Resolution Authority to instruct Laiki's Special Administrator to appoint well recognized and independent consulting or auditing firms or international institutions	End-April 2014	Dispose Laiki's assets and be entrusted with the voting rights
Authorities to develop a revised roadmap for the full disposal of the entrusted Laiki's assets	End-April 2014	Maximize value for creditors
Authorities to inject capital into individual coops	End-April 2014	Ensure capital adequacy
CBC and CCB - in consultation with the Ministry of Finance management unit - to agree on quantitative indicators	End-April 2014	Monitor implementation of restructuring plan
Authorities to ensure that all new board members and key managers of the CCIs are appointed after obtaining CBC clearance on fit and probity matters	End-May 2014	Strengthen governance
CBC to complete an assessment of CCB's implementation of effective local and risk management programs for the CCIs	End-January 2015	Ensure appropriate risk management practices
CBC to complete a comprehensive technical assessment of BoCs restructuring plan	End-February 2015	Identify areas requiring strengthening
Strengthening supervision and regulation		
Authorities to harmonize regulatory and supervisory frameworks for CCIs with those of commercial banks	End-March 2014	Maintain prudent level of risks
Plan to transfer CCI supervision to CBC to be fully operational	End-March 2014	Ensure adequate supervision
New prudential regulations covering underwriting standards, proper loan-collection practices, and appropriate collateral valuation practices to enter into force	End-March 2014	Ensure conservative implementation of accounting and provisioning treatment
Authorities to amend resolution law	End-March 2014	Strengthen Resolution Authority
CBC to require BoC and the coops to publicly disclose an agreed subset of operational and financial indicators on a quarterly basis	End-March 2014	Step up reporting requirements
CBC to instruct banks to submit estimates on profitability and coverage ratio to NPLs by end-June	End-March 2014	Ensure adequate supervision
CBC to revise the governance directive to specify the interaction between banks' internal audit units and bank supervisors, in line with best practice	End-April 2014	Strengthen governance
CBC to complete with external technical support an assessment of the plans to use the credit register for supervisory purposes relative to best practices	End-May 2014	Ensure adequate supervision
CBC units to assess BoC and CCB reports against selected operational and financial targets and submit quarterly reports to the CBC Board	End-May 2014	Step up reporting requirements
Credit register to be operational	End-September 2014	Allow banks to make informed loan decisions
CBC to request a standalone assessment against the "Basel Core Principles for Effective Banking Supervision" to be completed	End-December 2015	Assess supervisory effectiveness
Restructuring private sector debt		
CBC to instruct the banks to submit monthly reports on early arrears, and quarterly key performance indicators for debt restructuring	End-March 2014	Enhance banks' reporting
CBC to complete an assessment of the operational capacity of the commercial banks' loan workout units to implement their plans	End-March 2014	Strengthen official monitoring of banks
Authorities to establish a task force to prepare a study assessing the magnitude of registered but untitled land sales contracts and underlying mortgages	End-March 2014	Address backlog and delays in the issuance of title deeds
Authorities to clarify the role of the Financial Ombudsman in handling consumer complaints on compliance with the Code of Conduct during restructuring negotiations	End-March 2014	Strengthen existing institutions
CBC to instruct banks to submit monthly reports on early arrears and quarterly key performance indicators for debt restructuring	End-March 2014	Strengthen official monitoring of banks
CBC to complete a second round of inspections to verify banks' compliance with the Code of Conduct and impose sanctions as needed	End-May 2014	Ensure effective official monitoring
CBC to complete an assessment of the operational capacity of the cooperative sector's loan workout units to implement their plans	End-May 2014	Strengthen official monitoring of coops
Authorities to prepare a reform of the debt restructuring legal framework to be approved by the Council of Ministers	End-May 2014	Address lack of effective debt restructuring
CBC to complete an assessment of banks' and coops' arrears and early arrears management policies, procedures, and practices	End-June 2014	Strengthen official monitoring
CBC to require banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring	End-June 2014	Ensure external independent assessment
Authorities to amend legislation to allow for the seizure and sale of loan collateral through private auctions to be conducted by mortgage creditors	End-June 2014	Address lack of timely foreclosure processes

Table 12. Cyprus: MEFP Commitments (concluded)

Measures	Deadline	Rationale
Task force on title deeds to develop recommendations	End-June 2014	Facilitate the issuance of title deeds
CBC to update the Arrears Management Framework and the Code of Conduct directives as needed and instruct the banks and the coops to implement recommendations	End-July 2014	Strengthen official monitoring
Authorities to identify the core functions of the Land Register and amend legislation, as necessary	End-September 2014	Address backlog and delays in the issuance of title deeds
Authorities to submit to Parliament legislation for the effective rehabilitation of viable companies and for procedures for licensing and regulation of insolvency practitioners	End-December 2014	Facilitate return to normal operations of viable but troubled companies
Authorities to submit legislation to parliament to permit viable individuals to restructure their debt	End-December 2014	Facilitate modern personal insolvency procedures
Authorities to complete a review of the rules of civil procedure and other court rules	End-December 2014	Identify potential inefficiencies
Authorities to review the private sector debt restructuring legal framework to assess results and define additional measures as needed	End-June 2015	Review effectiveness of debt restructuring framework
Strengthening the AML framework		
CBC to apply appropriate supervisory measures following up on AML audit findings	End-March 2014	Ensure appropriate AML supervision
Council of Ministers to adopt an action plan aiming to ensure adequate, accurate, and current basis information on all types of legal persons registered in Cyprus	End-March 2014	Bolster capacity of Registrar of Companies
CBC to implement an inspection program in the course of 2014 covering 4 banks by end-June and another 7 banks by end-December	End-June 2014; End-December 2014	Resume onsite AML supervision
Registrar to revise its pricing policy on access to basic information on all Cyprus-incorporated companies	End-June 2014	Make available basic information free of charge while ensuring budget neutrality
CBC and relevant AML supervisors to develop and implement the necessary risk-based tools for off-and onsite AML supervision of financial institutions (by end-June 2014), lawyers and accountants (by end-September 2014), and trust and company service providers (by end-December 2014)	End-June 2014; End-September 2014; End-December 2014	Enhance supervision
Normalizing financial flows		
Set up a joint CBC-Ministry of Finance task force to design a well-targeted communication strategy	End-March 2014	Normalize financial flows
Enhance coordination between the CBC and the MOF by establishing a high-level committee to inform about market developments and advise on next steps	End-March 2014	Normalize financial flows
Structural Fiscal Reforms		
Social welfare		
Authorities to initiate consultation with social partners on the elements of the social welfare reform	End-March 2014	Ensure adequate and equitable social protection
Council of Ministers to approve the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI	End-March 2014	Ensure adequate social protection and eliminate duplicate benefits
Authorities to complete IT pilot testing phase	End-May 2014	Implement comprehensive social welfare reform
Authorities to implement the social welfare reform	End-June 2014	Implement comprehensive social welfare reform
Revenue administration		
Authorities to prepare a report on tax debt covering IRD and VS tax accounts.	End-March 2014	Gauge the size and nature of tax debt
Authorities to submit to Parliament the law consolidating the two existing tax agencies into a single Department of Taxation	End-April 2014	Improve efficiency of revenue administration
Authorities to finalize two pilot comprehensive field tax audits	End-June 2014	Conduct targeted joint audits for large tax payers and high-risk sectors
Authorities to prepare a plan, specifying the modalities to recover debt, which include case-by-case installment schemes, set-offs, and other options	End-June 2014	Gauge the size and nature of tax debt
Authorities to establish an integrated unit for large taxpayers in the new department	End-December 2014	Improve efficiency of revenue administration
Public financial management		
Authorities to prepare a roadmap detailing the steps required to fully implement the FRBSL, including additional legislation and guidelines, and their prioritization	End-April 2014	Strengthen public financial management
Authorities to adopt secondary legislation and guidelines for public investment management, including for project appraisals	End-June 2014	Strengthen public financial management
Privatizations		
Privatization unit to become fully operational	Mid-May 2014	Support the privatization process
Authorities to appoint financial advisors for the three privatization transactions	End-September 2014	Initiate preparation for the privatizations
Authorities to privatize the telecommunications company (CyTA) and the commercial activity of the ports administration (CPA)	End of program	Finalize privatization
Authorities to privatize the electricity company (EAC)	Mid-2018	Finalize privatization
Program financing and monitoring		
Authorities to conduct an independent valuation of state assets	End-March 2014	Prepare for debt-to-asset swap
CBC to allocate central bank profits to the government expected to result in the transfer of €0.2 billion to the budget	End-April 2014	Limit financing needs
Authorities to complete a second valuation on behalf of the CBC	End-May 2014	Prepare for debt-to-asset swap
CBC to conduct a debt-to-asset swap to be decided by the CBC in accordance with its rules and the Treaty, aiming to reduce public debt by approximately €1 billion	End-June 2014	Lower public debt
CBC to transfer an additional €0.2 billion to the budget	End of program	Limit financing needs

Table 13. Cyprus: Conditionality for the Third Review

Measures	Timing	Status
Performance criterion		
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous	Met
Structural benchmarks		
Adoption of a law on fiscal responsibility and budget systems	End-December 2013	Completed as a prior action on February 13
Adoption of measures to fight tax evasion	End-December 2013	Prior action for completion of the review
Resolution Authority to instruct the Special Administrator to entrust the voting rights of legacy Laiki equity stake in BoC to a well-recognized and independent consulting or auditing firm(s) or international institution(s)	End-January 2014	Not Met
Completion of an independent fair value assessment of the CCB's and CCI's assets aimed at quantifying the size of the government's stake in the sector and submission of the final restructuring plan of the CCI sector to the European Commission	End-January 2014	Met
Adoption by the CBC of a plan to strengthen the effectiveness and adequacy of resources allocated to the AML/CFT supervisory function	End-February 2014	Met

Appendix 1. Cyprus—Letter of Intent

Nicosia, March 13, 2014

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

In the attached update of the Memorandum of Economic and Financial Policies (MEFP) of April 29 2013, as supplemented and modified by previous MEFPs, we describe progress and policy steps towards meeting the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Policy implementation under the program has remained broadly on track:

- Fiscal performance through end-December continued to exceed expectations, while the decline in output has been somewhat less than anticipated. As a result, we have met all performance criteria (PCs). The PCs on the primary balance of the general government was met with a comfortable margin, due to prudent execution of expenditure and revenue over-performance relative to projections.

- We have made progress toward complying with the requirements of structural conditionality, but some actions have suffered delays, and one structural benchmark (SB) was missed (Table 2).

  - The independent fair value assessment of the cooperative sector and the submission of its restructuring plan to the European Commission (end-January SB) were completed on time. Moreover, following approval of the plan by the Commission, €1.5 billion in capital was injected into the sector.

  - The SB on strengthening the effectiveness and adequacy of resources allocated to AML/CFT has also been met.

  - Parliamentary adoption of the fiscal responsibility and budget systems law (FRBSL) and of measures to fight tax evasion (end-December SBs) were delayed due to longer than anticipated legal vetting procedures. The first was adopted on February 13 and we will submit legislation for the latter as prior actions for the completion of the review.

  - The SB on entrusting the voting rights of legacy Laiki equity stake in BoC to a well-recognized and independent entity was missed. We are planning to complete this action by end-April (modified SB).

Looking forward, we remain fully committed to our program's objectives to restore the health of the financial system, strengthen the sustainability of public finances, and adopt structural reforms so as to support long-run growth, while protecting the welfare of the population:

- In the financial sector area, we will ensure implementation of the restructuring plans of Bank of Cyprus (BoC) and the coop sector, while we continue to strengthen supervision and regulation. In addition, we will revamp our debt restructuring framework to facilitate the voluntary workout of non-performing loans. Finally, in the near term, we are taking steps to gradually lift payment restrictions under stage two of our roadmap, while safeguarding financial stability.

- Regarding public finances, reflecting the significant over performance in 2013, we have revised our 2014 fiscal primary deficit target and will continue to execute our budget prudently, given still high macroeconomic uncertainty and potential contingent risks.

- We remain committed to our ambitious structural reform agenda. To protect vulnerable groups during the downturn, we aim to implement a welfare system reform in July. Our plans to modernize revenue administration by integrating the two main tax collection agencies are also advancing. To strengthen budget processes, we will work on implementing our new FRBSL law. Finally, to kick-start the privatization process, we have adopted a privatization law establishing the legal and institutional framework for privatizations as a prior action for this review.

Financing of our program remains adequate. We are making progress toward securing additional financing and reducing public debt through the allocation of central bank profits, a debt-to-asset swap, and privatization.

Based on the above, we request the following:

- Completion of the third review under the EFF arrangement and the fourth purchase under this arrangement in the amount of SDR 74.25 million.

- Modification of the end-March 2014 PCs on: (i) the general government primary balance, the general government primary expenditure; and the stock of general government debt; (ii) and on the accumulation of general government guarantees (Table 1).

- Establishment of new quantitative PCs for end-June 2014 (Table 1).

- Establishment of new or modified SBs on the following: (i) appointment of an independent institution to dispose of Laiki's assets and manage its voting rights in BoC, by end-April 2014; (ii) submission to the CBC Board of the first quarterly report regarding BoC's/coops' performance in the implementation of the restructuring plans, by end-May 2014; (iii) submission to Parliament of an enabling law consolidating the two existing tax authorities into a single tax department, by end-April 2014; (iv) completion of the assessment of the operational capacity of coops' loan workout units, including with respect to early arrears, by end-May; (v) submission to parliament of personal insolvency legislation, by end-December 2014; (vi) submission to parliament of corporate insolvency legislation by end-December 2014; and (vii) establishment of an integrated large taxpayers unit, by end-December 2014 (Table 3).

We are fully committed to the policies set forth in the attached MEFP, which we believe are adequate to achieve the objectives under the program. We stand ready to take any measures that may become appropriate for this purpose as circumstances change. We will consult with the Fund on the adoption of any such actions in advance of revisions to the policies contained in this letter and the MEFP, in accordance with the Fund's policies on such consultations.

Sincerely,

/s/	/s/
Harris Georgiades Minister of Finance	Panicos Demetriades Governor of the Central Bank of Cyprus

Attachment 1. Cyprus—Memorandum of Economic and Financial Policies

A. Recent Developments and Outlook

1. **While the recession in 2013 has been less severe than anticipated, economic conditions remain difficult.** Output contracted significantly in the first three quarters of last year, with domestic demand particularly hit. Still, the output decline for the full year (preliminarily estimated at 6 percent) is significantly lower than previously expected (7.7 percent), reflecting on one hand, resilient performance of the tourism and professional service sectors, and, on the other hand, a smaller-than-anticipated decline of private consumption. Nevertheless, the situation remains difficult, with unemployment, especially for youth, rising toward very high levels, while disposable incomes are falling. In the banking sector, while signs of stabilization are emerging following the recapitalization of our banks and coops, non-performing loans are increasing, and credit to the private sector continues to decline.

2. **The macroeconomic outlook remains challenging**. We continue to expect a difficult year ahead, with output falling by 4.8 percent as the economy continues to adjust. Efforts to reduce the currently very high levels of private sector debt and ongoing fiscal consolidation will continue to pose a drag on growth. Our economy is projected to return to modest growth of about 0.9 percent next year and to gradually improve toward 2 percent in the medium- to long-run. This projection is based on full and timely implementation of policies detailed in our adjustment program, aimed at restoring the health of our financial sector and putting public finances on a sustainable path through fiscal consolidation and structural reforms. Still, downside risks to the medium-term outlook remain significant.

B. Financial Sector Policies

Restoring the health of our financial sector is a key priority under our program, aiming to strengthen banks' balance sheets so as to pave the way for a sustainable recovery. Following the recent recapitalization of the system, the program now focuses on gradually relaxing payment restrictions, restructuring banks and the coop sector, facilitating the voluntary workout of non-performing loans, strengthening regulation and supervision, and enhancing transparency.

Normalizing financial flows

3. **We remain committed to normalizing payment flows while safeguarding financial stability.** The timely removal of administrative restrictions and capital controls is necessary to support the economic recovery, yet this process also needs to preserve financial stability. Our strategy, detailed in our roadmap published in August 2013, aims to balance these two objectives through a gradual relaxation of restrictions as milestones in our financial sector policy agenda are reached, while taking into account the level of confidence in the banks and other financial stability indicators. In accordance with the roadmap, we have already completed our first stage of relaxations

in the second half of 2013, including through facilitating domestic transfers without justifying documents of up to €1 million and allowing the opening of new term accounts with cash. In February 2014, we have also achieved the last milestone related to the second stage of relaxations under the roadmap and—based on our analysis of recent deposit and liquidity trends, also taking into account the independent assessment regarding market confidence—we are now taking steps to implement these relaxations in a manner consistent with financial stability. Specifically:

- By end-March, we will set up a joint CBC-Ministry of Finance task force to design a well-targeted ***communication strategy*** aiming to regularly communicate to market participants information regarding our roadmap and the progress already made in the implementation of our banking sector strategy.
- On February 21, we ***abolished restrictions*** related to the automatic renewal of maturing fixed-time deposits and ***increased limits*** on domestic transfers.
- To safeguard financial stability, we are continuing to ***monitor*** market conditions. We will enhance coordination between the CBC and Ministry of Finance through the establishment, by end-March, of a high-level committee to inform about market developments and advise on next steps. On this basis, we will take additional steps to raise limits on cash withdrawals and gradually increase domestic transfer limits.

4. **In this context, we will continue to ensure adequate banking system liquidity**. The Central Bank of Cyprus (CBC) stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. Additionally, we stand ready to provide additional government guarantees in line with state aid rules of up to €2.9 billion for the issuance of bank bonds that can be used as collateral against liquidity, if necessary to safeguard financial stability.

Restructuring financial institutions

5. **We are taking steps to ensure that Bank of Cyprus (BoC) will adequately implement its restructuring plan**. Since the bank has been recapitalized in July 2013, it has started to restructure, including by having reduced operational costs by 42 percent, having limited its risks by reaching agreement on the sale of its Ukrainian operations, and having prepared and submitted to the CBC its arrears management plan. The agreement on the sale of Ukrainian operations, together with the recent parliamentary approval of bank bond guarantees, boosted its potential liquidity buffers. The bank liberalized blocked deposits amounting to €0.9 billion. A supervisory unit has been set up at the CBC to monitor BoC's progress with the implementation of its restructuring plan. By end-February 2015, it will complete a comprehensive technical assessment of BoC' restructuring plan with the aim to identify areas that require further strengthening and review.

6. **We are also preparing for the disposal of legacy Laiki's assets.** To this end, the Resolution Authority has instructed Laiki's Special Administrator to appoint by end-April 2014 (modified **structural benchmark**) well recognized and independent consulting or auditing firms or

international institutions to provide services associated with the management of the disposal process of Laiki's assets abroad and be entrusted with the voting rights associated with Laiki's share participation in BoC. As part of the agreed terms of reference, a revised roadmap for the full disposal of the assets will be developed by end-April with a view to maximize value for creditors.

7. **Having completed the fair value assessment, restructuring plan, and recapitalization of the coop sector, we will ensure that the sector is restructured and its governance strengthened**. A new CEO has recently been appointed to lead the restructuring process, which is primarily focused on completing the mergers of individual coops, reducing operating costs, and setting up an effective arrears management process. So far 85 out of 93 coops have already merged into 16 new institutions, and the remaining 8 coops will be merged into 2 institutions. We will complete the mergers by end-March 2014 (**structural benchmark**) and inject capital into individual coops to ensure compliance with the 4 percent individual CT1 ratio for all CCIs by end-April. We remain committed to allow the cooperative central bank (CCB) to operate on a commercial basis without undue political interference. To this end:

- We will strengthen the ***governance*** of the sector by ensuring that all new board members and key managers of the CCIs are appointed by end-May 2014, after obtaining CBC clearance on fitness and probity matters. Immediately after the approval of the recapitalization aid and associated restructuring plan and commitments by the EC under state aid rules, a monitoring trustee will assume his tasks in the coop sector and submit quarterly reports on governance and operations, as well as ad-hoc reports as needed. The monitoring trustee will work under the direction of the EC. In line with EU state aid rules, the trustee will be responsible for overseeing the implementation of the restructuring plan. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee will closely follow the sector's operations, have access to Board meeting minutes, and be an observer at the executive committee and other critical committees, including risk management and internal audit functions.

- The CBC and CCB—in consultation with the Ministry of Finance management unit—will agree by end-April 2014 on quantitative indicators to allow for an adequate ***monitoring*** of the implementation of the coops' restructuring plan.

- To limit risks and ensure appropriate and consistent ***risk management*** practices across the sector, by end-January 2015, the CBC will complete an assessment of CCB's implementation of effective local and risk management programs for the CCIs on the basis of common policies and tools as well as a consolidated management program at the CCB level in line with the restructuring plan.

Strengthening supervision and regulation

8. **We are stepping up reporting requirements and monitoring of BoC and the coops.** This will be key to ensuring an adequate implementation of their restructuring plans. To this end, we have already put in place a work plan for the supervisory units responsible for BoC and the coop sector, respectively, including thematic on-site inspections and off-site reviews on loan restructuring and risk management, operations, and governance. Furthermore, we have allocated additional resources to the two supervisory units, including support from debt restructuring experts. The CBC has instructed BoC and the CCB to submit, starting with end-April, quarterly reports on the implementation of key actions described in its restructuring plan and on progress relative to agreed operational and financial targets. The two CBC units will assess these on a quarterly basis against selected operational and financial targets. The first quarterly report of the units will be submitted to the CBC Board by end-May **(structural benchmark**). In addition, to further strengthen market confidence on BoC's and the coops' progress with implementing their restructuring plans, by end-March, the CBC will require them to publicly disclose an agreed subset of operational and financial indicators on a quarterly basis.

9. **We are also taking steps to strengthen bank supervision and regulation in anticipation of broader European initiatives.** As we are preparing for the upcoming integration to the single supervisory mechanism (SSM), we have taken steps to enhance supervision and regulation, including by issuing new regulations on loan origination and asset impairment and provisioning and by adopting a new law on establishing a credit register. At the same time, submission of draft legislation to introduce early corrective actions has been suspended to allow for prior coordination with upcoming SSM policies. Taking into account the imminent increase in the tasks of the CBC, owing in particular to the requirements imposed on the banking supervision department, we are giving high priority to the recruitment of additional resources with adequate qualifications. Looking forward:

- By end-March, we will amend our ***resolution law*** to strengthen the effectiveness of the resolution authority.
- With the aim to ensure timely ***implementation of newly introduced and upcoming EU rules on capital requirements and NPLs***, the CBC has instructed banks to submit estimates of their potential impact on capital by end-April and, by end-March, will instruct them to submit estimates on profitability and coverage ratio to NPLs by end-June. Also by end-April, the CBC will revise the governance directive to specify, among others, the interaction between banks' internal audit units and bank supervisors, in line with best practice.
- By end-May, with external technical support, the CBC will complete an assessment of the plans to use the ***credit register*** for supervisory purposes relative to best practices.

Restructuring private sector debt

10. **We are revamping our debt-restructuring framework to facilitate loan workouts so as to clean up bank, firm, and individual balance sheets**. Voluntary private sector debt restructuring is key to support the reduction of both NPLs and the high level of private sector indebtedness, so as to pave the way for a sustainable economic recovery. We are fully committed to facilitating this process by establishing a sound operational and legal framework with appropriate incentives and safeguards while avoiding interference in negotiations between borrowers and creditors. To this end, our efforts are concentrated in two key areas:

- **Enhancing banks' operational preparedness for arrears management:** We have already developed a code of conduct and arrears management framework. On this basis, we are continuing to work on three fronts:

    - ***Bank reporting*:** Banks have submitted to the CBC their strategies and plans for arrears management. In this regard, by end-March, the CBC will instruct the banks to submit, starting with end-March data, monthly reports on early arrears (including number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans), and quarterly key performance indicators for debt restructuring.

    - ***Official monitoring***: The CBC has appointed a reputable international consultancy firm which will assist it in completing an assessment of: (i) the operational capacity, including with respect to early arrears, of the commercial banks' loan workout units to implement their plans by end-March (existing **structural benchmark**), and, by end-May for the cooperative sector (**structural benchmark**), and (ii) an assessment of their arrears management policies, procedures, and practices, including the soundness of mechanisms and strategies to manage troubled assets within the institution/sector by end-June. On this basis, the CBC will instruct banks and the coops to implement the recommendations of the assessments no later than end-July. Also by end-July, the CBC will update the Code of Conduct and Arrears Framework directives as needed.

    - ***External independent assessment***: By end-June, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.

- **Enhancing our debt restructuring legal framework:** At present, voluntary negotiations between debtors and creditors are not leading to effective debt restructurings, contributing to a high level of NPLs and high private sector indebtedness. To address this problem, we are committed to implement a comprehensive package of reforms aiming to strengthen our legal framework, on the basis of international best practice. To this end, we will prepare a reform framework —to be approved by the Council of Ministers by end-May—covering the following areas:

- ***Foreclosure procedures***: The lack of timely foreclosure processes encourages potentially fraudulent behavior, undermines payment discipline, reduces the incentives for debt restructuring, contributes to the growing NPLs, and impedes the functioning of the insolvency framework. To address these issues, by end-June we will amend legislation to allow for the seizure and sale of loan collateral through private auctions to be conducted by mortgage creditors, while limiting the role of the Land Register in the auction process. Moreover, given the backlog and delays in the issuance of title deeds, which may further hinder foreclosures, by end-September, we will identify the core functions of the Land Register and amend legislation, as necessary. Further, by end-March we will establish a task force comprised of representatives of the Ministry of Finance, Central Bank, the Law Office of the Republic, and the Land Register to prepare a study assessing the magnitude of registered but untitled land sales contracts and underlying mortgages. The task force will develop recommendations by end-June.

- ***Corporate and personal insolvency*:** A revised corporate insolvency regime is needed to facilitate the return to normal operations of viable but troubled companies. To this end, by end-December we will submit to Parliament legislation for the effective rehabilitation of viable companies, as well as for procedures for the licensing and regulation of insolvency practitioners assisting in the restructuring process (**structural benchmark**). Modern personal insolvency procedures are also needed to permit viable individuals to restructure their debt. Also by end-December, we will submit to Parliament legislation in this regard (**structural benchmark**).

- ***Institutions***: An effective implementation of our debt restructuring strategy also requires strengthening existing institutions. In particular, by end-March, we will clarify the role of the Financial Ombudsman in handling consumer complaints regarding compliance with the Code of Conduct during restructuring negotiations. Moreover, by end-December, we will complete a review of the rules of civil procedure and other court rules to identify potential inefficiencies and develop recommendations.

We will review the private sector debt restructuring legal framework in the second half of 2015 with a view to assess results and define additional measures as needed.

Strengthening the AML framework

11. **We remain committed to strengthen the implementation of our AML/CFT framework.** Having amended the AML/CFT legal framework, in line with best practices, we continue making progress in its implementation. We have strengthened the effectiveness and adequacy of the AML/CFT supervisory function for financial institutions, including by allocating resources for a total

of 7 full-time experienced supervisors by end-2014 (end-February **structural benchmark**) and have published statistics that reflect sustained exchange of financial information with other financial intelligence units. In pursuing our efforts to implement the action plan articulated following the external audit we commissioned, we are concentrating on three areas:

- ***Resuming onsite AML supervision by CBC***: Having secured adequate resources to perform our supervisory functions, we plan to implement an inspection program in the course of 2014, starting in March and covering 4 banks by end-June, and another 7 banks by end-December.
- ***Taking appropriate supervisory measures following-up on the AML audit findings***. The CBC has continued to make progress in following up on the auditor's findings regarding possible breaches of compliance with AML requirements by banks. Having identified breaches of varying degrees of severity in the audited banks, by end-March, the CBC will apply appropriate supervisory measures.
- ***Enhancing the operations of the Registrar of Companies***: A third party assessment of the Registrar of Companies has been finalized. To bolster its capacity, we will finalize and the Council of Ministers will adopt an action plan by end-March aiming to ensure that adequate, accurate and current basic information on all types of legal persons registered in Cyprus could be obtained by the Registrar of Companies and be accessible by the public in a timely manner.

C. Fiscal Policy

Our fiscal policy aims to strengthen our public finances and place debt on a sustained downward path to facilitate our return to the international debt markets.

12. **We have met our fiscal targets in 2013 with considerable margin.** We have achieved a primary deficit (on a cash basis) of 1.7 percent of GDP compared to our adjusted target—taking into account additional compensation for pension funds—of 3.2 percent of GDP for 2013 and compared to the outturn of 3.3 percent of GDP in 2012. This performance reflects both the better-than-expected macroeconomic outturn and a difficult but unavoidable fiscal consolidation primarily aimed at reigning in public spending. Indeed, our prudent execution and control of discretionary spending served us well in managing uncertainties given the difficult economic circumstances. International financial support helped to finance our deficit, avoiding the need for an otherwise even sharper adjustment.

13. **Given the over-performance, we are revising our primary deficit target for 2014 to 2 percent of GDP.** The revision reflects permanent improvements in our wage bill and social contributions (0.7 percent of GDP), as well as additional expected central bank dividends (0.6 percent of GDP). To help meet our targets, we will continue to maintain a prudent execution of the 2014 budget, given still high macroeconomic uncertainty and contingent liability risks. If necessary, we stand ready to consider reallocations within the 2014 budget to facilitate the introduction of our

welfare reform in mid-2014. We remain committed to our long-run primary surplus target of 4 percent of GDP by 2018, which requires additional measures in the outer years.

14. **We are committed to maintaining the current short-term debt levels going forward.** Given the better than expected fiscal performance and our interest in lowering interest costs, we have reduced our stock of short-term debt at end-December 2013 by about 1.4 percent of GDP relative to a year ago. Going forward, we are committed to preserve the current level of short-term debt to ensure sufficient financing given still large macroeconomic uncertainty. We will revise our debt targets for 2014 accordingly.

15. **We will continue to support our SMEs through the provision of government guarantees.** We have secured about €600 million in EIB loans to be on lent or provide trade credits to our SMEs in 2014-2016. Of this amount, we expect €100 million to be disbursed as a direct loan to the government in the second quarter of 2014. For the remainder, we plan to provide guarantees of about €150 million in 2014, given the expected schedule of disbursements. In addition, we plan to provide additional guarantees amounting to €75 and €87 million respectively for loan disbursements for ongoing EIB- financed sewerage board projects and for loans to the electricity company EAC. We will modify our debt and guarantee targets accordingly to reflect these developments.

D. Structural Fiscal Reforms

Our fiscal adjustment program is complemented by a set of ambitious structural reforms with the aim of (i) improving the protection of vulnerable groups, (ii) strengthening the administration of public resources through effective public financial management and a more efficient tax administration, and (iii) privatizing state-owned enterprises to enhance economic efficiency and support public debt reduction.

16. **We remain committed to implement a comprehensive social welfare reform to protect vulnerable groups during the downturn.** The reform, centered on a new Guaranteed Minimum Income scheme (GMI), aims at ensuring adequate and equitable social protection, while preserving work incentives. The GMI will be complemented by other well-targeted benefits, such as child or education benefits. In March, we will initiate consultation with social partners on the elements of the reform, which have already been developed and costed. On this basis, by end-March 2014, the Council of Ministers will approve the final design of the new system, including decisions on the type, level, and eligibility criteria of the GMI, as well as on the level and scope to streamline other benefits (existing **structural benchmark**). We remain committed to implement the reform by end-June 2014 (existing **structural benchmark**), provided that the IT pilot testing phase is completed successfully by end-May.

17. **We are also taking steps to improve the efficiency and effectiveness of our revenue administration**.

- ***Integrating VAT and Inland Revenue services*:** We remain committed to reforming our revenue administration. In this regard, in early January, the Council of Ministers approved the plan to create a new function-based tax administration integrating the existing Inland Revenue Department (IRD) and VAT Services (VS), aimed at improving the efficiency of tax administration. As a first step, by end-April, we will submit to parliament the enabling law consolidating the two existing tax authorities into a single Department of Taxation by transferring powers and existing operations of the IRD and VS to the new department (**structural benchmark)**. By end-December 2014, we will establish an integrated unit for large taxpayers—which account for the largest share of revenues—in the new department (**structural benchmark**).

- ***Short-term measures to boost tax collections*****:** We are intensifying efforts to protect revenues during the downturn. To this end, we are focusing on several areas:

  - ***Monitoring***: To mitigate the risk of revenue loss during the integration of the tax departments, we will closely monitor monthly performance indicators including registration, filing and payment, auditing and debt collection. This will allows us to detect slippages and consider timely corrective actions.

  - ***Auditing***: We have developed a work program for conducting targeted joint audits for large taxpayers and high-risk sectors during 2014, including by setting numerical audit targets. On this basis, we plan to finalize two pilot comprehensive field tax audits by end-June.

  - ***Tax debt recovery:*** In order to gauge the size and nature of tax debt, including assessing the amounts that are directly and immediately collectible, by end-March 2014, we will prepare a report on tax debt covering IRD and VS tax accounts. On this basis, we will prepare a plan by end-June, specifying the modalities to recover debt, which include case-by-case installment schemes, set-offs, and other options.

  - ***Enforcement powers***: To facilitate the debt recovery process and provide incentives to remain current on tax obligations, as a **prior action** for conclusion of the third review, we will submit to Parliament legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to garnish assets, or prohibit the alienation or use of assets, including property and bank accounts.

18. **We continue to improve public financial management**. In this regard, we are taking a number of steps. First, the Fiscal Responsibility and Budget Systems Law has been adopted as a **prior action**, aiming to strengthen budget formulation and execution, public investment management, and the management of fiscal risks. Second, we have amended the Public Debt Management Law to facilitate the monitoring of government guarantees. Third, also to improve monitoring of fiscal risks associated with state owned enterprises (SOEs) and semi-government entities, we have supplemented the 2014 budget with an SOE annex. Finally, to avoid budget overruns, we have introduced pre-invoicing controls, making government orders subject to pre-commitment validation. Going forward, by end-April, we will prepare a roadmap detailing the steps

required to fully implement the FRBSL, including additional legislation and guidelines, and their prioritization. In this context, also by end-June, we will adopt secondary legislation and/or guidelines for public investment management, including for project appraisals.

19. **We remain fully committed to our privatization objectives**. Through privatization of state assets, we aim to improve economic efficiency, reduce our public debt, and encourage foreign direct investment in our economy. In this regard, we have adopted a privatization law as a **prior action**. The approval of the law will allow for the establishment of a unit to manage the privatization process, which will become fully operational by mid-May. Once the unit is in place, we will initiate preparations for the privatization of the state-owned enterprises with the highest commercial value. We will start with the telecommunications company (CyTA) and the commercial activities of the ports administration (CPA), which we aim to privatize before the end of our program. Privatization of the electricity company (EAC) will require substantial preparations, including unbundling the activities of the company, and is expected to be finalized by mid-2018. In this regard, we will appoint financial advisors for these three transactions by end-September.

E. Program Financing and Monitoring

20. **We remain committed to limit financing needs and lower public debt.** The CBC will allocate central bank profits to the government (in line with CBC duties under the Treaties and the Statute) expected to result in the transfer of €0.2 billion to the budget by end-April, after finalization of the CBC's financial accounts, and of an additional €0.2 billion during the program period. Separately, we are conducting an independent valuation of state assets, to be finalized by end-March, followed by a second valuation on behalf of the CBC, to be completed by end-May. On this basis, we aim to conduct a debt-to-asset swap to be decided by the CBC in accordance with its rules and the Treaties, aiming to reduce public debt by approximately €1 billion by end-June.

21. **Implementation of policies under our program will continue to be monitored through quarterly PCs and reviews.** Our program includes continuous performance criteria, indicative targets, and structural benchmarks, which are defined in the attached Technical Memorandum of Understanding (TMU). As is standard in IMF arrangements, there is a continuous performance criterion on the non-accumulation of external payment arrears. We also include in our program a continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple practices.

22. **We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.**

Table 1. Cyprus: Quantitative Conditionality 1/
(Millions of euros)

	Performance criteria					Indicative targets	
	Dec-13			Mar-14	Jun-14	Sep-14	Dec-14
	Target	Adjusted target	Actual				
Floor on the general government primary balance 2/	-435	-518 4/	-272	-22	-65	72	-307
Ceiling on the general government primary expenditure 2/	7,205	7,288 4/	7,121	1,504	3,143	4,734	6835
Ceiling on the stock of general government debt	18,668	18,620 5/	18,407	18,399	18,183	18,233	19129
Ceiling on the accumulation of new general government guarantees 2/	25	129 6/	51	0	127	207	312
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		-0.3	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		-31	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ The target was adjusted to reflect the compensation of pension funds for the losses related to the resolution of Laiki bank.
5/ The target was adjusted to reflect a correction of the end-March 2013 debt level on account of sewerage boards debt incorrectly classified within the general government.
6/ The target was adjusted to reflect the provision of guarantees for the EAC Vassilikos Power Plant Phase IV loan.

Table 2. Cyprus: Revenue Administration Indicative Targets 1/
(Cumulative number of audits since January 2014)

	Indicative targets			
	Mar-14	Jun-14	Sep-14	Dec-14
Number of comprehensive field audits of large taxpayers 1/	0	2	4	6
Number of comprehensive field audits of high risk taxpayers 2/	0	8	16	24

1/ Large taxpayers are defined as those with annual turnover above a certain threshold as defined by the tax administration procedures.
2/ High risk taxpayers are defined as those that meet selection criteria set by internal tax administration procedures.

Table 3. Cyprus: Existing and Proposed Conditionality	
Measures	Timing
Prior Actions	
Submission to parliament of measures to fight tax evasion (TMU ¶17)	Before Board meeting
Adoption by Parliament of the legal framework for privatizations (TMU ¶18)	Before Board meeting
Adoption by Parliament of the fiscal responsibility and budget systems law	Before Board meeting
Proposed New or Modified Structural Benchmarks	
Appoint a well-recognized and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights of legacy Laiki equity stake in BoC and manage the disposal of Laiki's assets abroad	End-April 2014 (Modified structural benchmark)
Submission to Parliament of the new Cyprus Tax Department's enabling law	End-April 2014
Completion of the assessment of the operational capacity of cooperative credit institutions' loan workout units, including with respect to early arrears	End-May 2014
CBC units responsible for the supervision of BoC and the coops to submit to the CBC Board the first quarterly report regarding BoC's/coops performance against selected operational and financial targets	End-May 2014
Submission to parliament of legislation to modernize personal insolvency procedures	End-December 2014
Submission to parliament of legislation to modernize corporate insolvency procedures and to regulate insolvency practitioners assisting in the restructuring process	End-December 2014
Establishment of an integrated large taxpayers unit	End-December 2014
Existing Structural Benchmarks	
Completion by the CBC of an in-situ assessment of the degree of operational capacity of the banks' loan workout units to implement their arrears management plans	End-March 2014
Approval by the Council of Ministers of the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium term budget ceilings	End-March 2014
Merger of the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014
Implementation of a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs	End-June 2014

Attachment 2. Cyprus—Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the Fund, European Commission and ECB on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the European Commission, ECB and the Fund with the necessary information for program monitoring.

2. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those that prevailed on April 15. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.308099 dollar, €1 = 129.0309 Japanese yen, €1.15222= 1 SDR.

3. For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the Fund.

A. Quantitative Performance Criteria and Indicative Targets

Floor on the General Government Primary Cash Balance (performance criterion)

4. For the purposes of the program, the general government includes the institutions listed under this category according to ESA 95 for Excessive Deficit Procedure (EDP) reporting purposes. In particular, the general government includes:

- *The central government*. Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.

- *The local governments*. Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.

- *The social security funds*. These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.

- *Any newly created institution defined as general government under ESA 95.* This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

5. The performance criteria are set on the general government cash primary balance (GGPCB), defined as the general government cash balance (GGCB) minus general government interest receipts plus general government interest payments. In turn, GGCB is defined as total revenue (tax revenue, social security contributions, grants and other revenue) minus total expenditure. The payment of called guarantees will be recorded as cash expenditures. Privatization receipts, as defined below, and the proceeds from the sale of land and buildings, will be excluded from revenue. The floor on the GGPCB in each year will be measured cumulatively from the start of that calendar year.

- Privatization receipts are those receipts associated with the disposal to private owners by a government unit of the controlling equity of a public corporation or quasi-corporation.

- The floor on the GGPCB will be adjusted downwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.

6. The floor on the GGPCB will be adjusted as follows:

- The 2014 targets will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €78 million.

- The 2014 targets will be adjusted upwards by the dividends received from the CBC in excess of €180 million and in excess of €40 million from the semi-government organizations.

- The 2014 targets will be adjusted downwards by the dividends received from the CBC below €180 million and below €40 million from the semi-government organizations.

Ceiling on the General Government Primary Expenditure (performance criterion)

7. General government primary expenditure (GGPE) includes compensation of employees, goods and services, subsidies, social benefits, other recurrent expenditure, and capital expenditure.

- The ceiling on the GGPE will be adjusted upwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.

8. The 2014 ceilings on the GGPE will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Laiki bank up to €78 million.

Ceiling on the stock of General Government Debt (performance criterion)

9. The general government debt constitutes total outstanding gross liabilities as defined by ESA95. This includes the debt of all institutions included in the general government as defined above and other ESA 95 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.

10. The ceiling on the general government debt will be adjusted:

- Upwards (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upwards (downwards) by the amount of any increase (decrease) to the disbursement of the Cyprus Entrepreneurship fund EIB loan, currently projected at €100 million.
- Upwards, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- Upwards by the amounts disbursed under the EIB loan to finance projects authorized in the 2014 budget under the National Strategic Reference Framework.

Ceiling on the Accumulation of new General Government Guarantees (performance criterion)

11. The ceiling on new general government sector guarantees shall include domestic and external guarantees granted during the test period, as well as guarantees for which the maturity is being extended beyond the initial contractual provisions. The ceiling shall exclude guarantees granted under a risk sharing instrument of the EU structural funds (see COM (2011) 655 final) that do not create contingent liabilities for the Cypriot State. Government entities outside of the general government (e.g. state owned enterprises) but within the non financial public sector are not

permitted to grant guarantees. The stock of guarantees at end March 2013 was €3.1 billion. For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.

12. The ceiling on the accumulation of new general government guarantees will be adjusted:

- Upwards for the issuance of government guaranteed bonds to be used in monetary policy operations to boost BoC's liquidity up to €2.9 billion.
- Upwards (downwards) by the amount of any increase (decrease) of the disbursement of EIB and/or Council of Europe Development Fund loans to be guaranteed by the government in 2014 relative to the amounts presented in Table 1 of the MEFP. The annual provision of guarantees cannot exceed €312 million.

Ceiling on the Accumulation of External Arrears (continuous performance criterion)

13. External payment arrears are defined as payments on debt to non-residents contracted or guaranteed by the general government, which have not been made within seven days after falling due. The stock of external payment arrears as of end-March 2013 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

14. Domestic expenditure arrears are defined as unpaid invoices that have past the due date by 90 days. In case no due date is specified on the supplier contract, an unpaid commitment is considered to be in arrears 90 days after the initiation of the invoice. The stock of domestic expenditure arrears as of end March 2013 was €0 million.

Ceiling on the Accumulation of VAT Refund Arrears by the General Government (performance criterion)

15. VAT refund arrears consist of unpaid VAT refunds that have past the due date for payment established in the tax legislation and/or the corresponding regulations. The stock of VAT refund arrears as of end March 2013 was €140 million.

B. Monitoring of Prior Actions and Structural Benchmarks

16. **Adopt a law on fiscal responsibility and budget systems (prior action).**

Specification. The adopted legal framework will contain the following elements:

- It will provide a comprehensive coverage of the general government sector and the government's financial relationships with state enterprises and other public entities that are outside the boundary of the general government sector.
- It will incorporate provisions (i) on fiscal transparency and accountability requiring the government to articulate a comprehensive, legally based and independently monitored fiscal

strategy consistent with EU requirements and (ii) for the development over time of a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down approach to budget preparation that is closely linked to the process of fiscal policy-making, and providing more flexibility to ministries and semi-governmental organizations.

17. **Submit to parliament measures to fight tax evasion (prior action)**

Specification. The measures will include the following:

- Amendments of relevant legislation to establish self-assessment for all income taxpayers;
- Legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to garnish assets, or prohibit the alienation or use of assets, including property and bank accounts.

18. **Adopt a privatization law establishing the legal and institutional framework for privatizations (prior action)**

Specification. The privatization law will include the following elements: (i) the definition of the scope of the privatization program; (ii) the institutional set-up to govern the process; (iii) the procedures and modalities to carry out privatizations; (iv) specification that proceeds will be channeled through the budget; and (v) the requirement to regulate potential monopolies prior to privatization.

19. **The CBC to adopt a plan aimed at strengthening the effectiveness and adequacy of resources for the AML/CFT supervisory function for financial institutions (end-February 2014)**

Specification. In order to address supervisory capacity issues, for the purposes of this structural benchmark:

- The authorities will develop, in consultation with Fund staff, a supervisory program for 2014, taking into account the risks faced by Cyprus that will include a combination of full AML/CFT inspections and thematic reviews focused on risks related to third party introducers, Politically-Exposed-Persons, and the laundering of the proceeds of tax evasion.
- In order to enable the AML/CFT supervision unit to implement its 2014 annual inspection program, adequate resources and staffing will be dedicated to perform all its supervisory tasks, including for off- and on-site activities. In this regard, by end-February, full-time resources will be allocated to complement the existing two full-time AML dedicated staff with a minimum of five additional experienced supervisors over the course of 2014.
- By end-February, tenders will be submitted to complement resources with external auditors with recognized supervisory experience, including for AML/CFT, to ensure that each onsite inspection visit can be supported by external support.

AML supervision's implementation:

- On a quarterly basis, in the context of the program review starting in the fourth quarter of 2013, the supervisory competent authorities will, on a confidential and anonymized basis grant Fund staff access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

- With regard to the CBC, in line with the 2014 annual inspection program, onsite supervision missions will start in the first quarter and step-up during the year, as capacity builds and resources are expanded. The total number and quarterly profile of these inspections, as well as staffing objectives and levels will be subject to periodic review by the CBC and the Fund in light of experience.

Exchange of financial intelligence:

The Financial Intelligence Unit (FIU) will communicate to Fund staff, on a quarterly basis, detailed statistics on financial information exchanged with other FIUs, both upon request and spontaneously, with a breakdown by country

C. Reporting Requirements

20. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance, Cystat, and the Central Bank of Cyprus. The authorities will transmit to the IMF staff any data revisions in a timely manner. Table 1 describes the supporting data needed for monitoring of the quantitative targets, the required frequency of the data, the institution/department responsible for providing the data, and the timing for provision of the data.

Table 1. Cyprus: Reporting Requirements

Information required	Data Frequency	Institution/Department responsible for providing information	Maximum time lag for submission after the end of the reporting period
Detailed execution of revenues, expenditure and financing provided in EDP reporting format	Monthly	MOF. Budget Department/Cystat Government Financial Statistics.	27 days after the end of the month, except end-December data which will be provided30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident). Details on any financial balance sheet transactions	Monthly	MOF. Public Debt Management Unit.	27 days after the end of the month
Central Government Debt stock by type of debt instrument, maturity, currency, type of debt holder. Interest bill for each type of debt instrument on a monthly basis for the current year and the next year, and annual for each year thereafter until 2020	Monthly	MOF. Public Debt Management Unit.	27 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure and VAT refund arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Customs & Excise Department, VAT Service	15 days after the end of the month
Stock of government guarantees and their monthly flows by institution.	Quarterly	MOF. Treasury Department.	27 days after the end of the month
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the domestic operations of the banking system – aggregate monetary balance sheet of credit institutions by institutional category	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the banking system (consolidated, including foreign operations), aggregate balance monetary balance sheet of credit institutions by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period

Table 1. Cyprus: Reporting Requirements (Concluded)

Individual operational balance sheet of the domestic operations of the largest banks and coops with detailed information on deposits (by maturity, currency, and type of depositor), central bank funding, interbank funding, debt securities, loans provided to the public and the private sector, 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Details for the largest banks and coops on liquid assets (cash and securities), liquidity position (i.e. the pool of assets eligible for ELA but not already encumbered), other assets and liabilities 1/	Daily	Central Bank of Cyprus	Next working day
Deposits by institution, currency, and residency and end-of-day liquidity buffers	Daily	Central Bank of Cyprus	Next working day
Financial soundness indicators—core set, deposits, NPLs, capital adequacy ratios	Quarterly	Central Bank of Cyprus	60 days after the end of the month

1/ Reporting requirements for cooperative banks will be revisited after the CBC becomes their supervisor.

Attachment 3. Memorandum of Understanding on Specific Economic Policy Conditionality (European Commission)

The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus. The key programme objectives are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions and strengthening supervision;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

In the financial sector area, key objectives constitute the implementation of the restructuring plans of Bank of Cyprus (BoC) and the coop sector, and the continued strengthening of supervision and regulation. In addition, a reform of the debt restructuring framework will be undertaken with a view to facilitating the voluntary workout of non-performing loans. Finally, the Cypriot authorities will continue to gradually lift capital restrictions in line with their roadmap, while safeguarding financial stability.

Progress since November

Work continued to address the challenges, in particular the downsizing and the restructuring of the banking sector, as well as the related regulatory reforms. First, Bank of Cyprus and the Cooperative Central Bank submitted to the CBC their restructuring plans, together with the capital and funding plans. The new Board of the Cooperative Central Bank put forward a roadmap for the next three months with key actions to undertake in order to kick-start the reform of the sector and appointed the new General Manager in December 2013. Second, the Central Bank of Cyprus adopted the loan origination directive on 4 December, thereby addressing some major causes for the build-up of NPLs in the sector. Third, the authorities proceeded with the implementation of the regulatory and supervisory reform as envisaged in the MoU. Supplementary information on the new Code of Conduct for dealing with troubled borrowers was published in November in order to enhance public awareness of the new framework. The effectiveness and governance of the Resolution Authority was reviewed. The series of non-performing loans according to the new definition have been published by the Central Bank of Cyprus. Work on the monitoring of banks' management of arrears, namely through key performance indicators, is progressing. In particular, the Central Bank of Cyprus has enhanced its operational capacity to follow the implementation of the restructuring plan of Bank of Cyprus.

As programme implementation has progressed, macro-financial stability has shown signs of improvement and the situation in the banking sector has started to normalise. The deposit base has stabilised and banks' liquidity buffers have strengthened. The Parliamentary Committee on Financial and Budgetary Issues approved the issuance of guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. A joint CBC-Ministry of Finance task force will be set up **by end-February** to design a well-targeted communication strategy aiming to regularly communicate to market participants, information regarding the roadmap and the progress already made in the implementation of the banking sector strategy.

1.2. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, and in order to safeguard financial stability, approval has been obtained from the House of Representatives for the issuance of additional government guarantees of up to EUR 2.9 billion on 27 January 2014 as contingency collateral in case of need, in line with State aid rules.

1.3. The Bank of Cyprus and the Cooperative Central Bank submitted their first capital and funding plans in November 2013 and January 2014, respectively. The CBC will continue to receive the updated plans **on a quarterly basis** and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.

Regulation and supervision of banks and cooperative credit institutions

1.4. Following the establishment of the legal framework for the credit register in December 2013, the authorities commit that the central credit register will be operational **by end-September**. By **end-May**, with external technical support, the CBC will complete an assessment of how to use it for supervisory purposes relative to best practices.

1.5. Having reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning, the CBC started introducing regulatory amendments. A new loan origination directive was adopted in October 2013. The new provisioning and disclosure directive will be finalised **by end-February** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-March** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts. Furthermore, with the aim to ensure timely implementation of newly introduced and upcoming EU rules on capital requirements and NPLs, the CBC has instructed banks to submit **by end-April** estimates of its potential impact on capital and **by end-June** profitability and coverage ratio.

1.6. Banks with restructuring plans will be required to submit, starting from **April 2014** and with reference date end-December 2013, **quarterly** reports describing the progress with the implementation of the restructuring plans. The reports will contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to the banks. The CBC units responsible for the supervision of BoC and coops will assess **on a quarterly basis** these reports. The first assessment of these reports will be submitted to the CBC Board by **end-May**.

1.7. The CBC (i) has put in place a work plan for 2014, including thematic on-site inspections and off-site reviews on loan restructuring and risk management, operations, and governance issues for the supervisory units responsible for BoC and the coop sector; and (ii) will provide them with sufficient resources to contract necessary technical support from banking and troubled debt restructuring experts. In addition, CBC will clarify the allocation of tasks and responsibilities in the governance structure of the CBC to effectively carry out the supervisory tasks of the central bank in line with SSM requirements.

1.8. The CBC will integrate stress-testing into regular off-site bank supervision, taking into account the entry into force of CRD IV and CRR and the related developments and timelines in the Single Supervisory Mechanism.

1.9. Following the legal integration of the supervision of the cooperative credit institutions into the CBC, the operational integration will be completed **by end-March 2014** in line with the action plan of September 2013. This action plan includes steps to recruit experienced staff and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector.

1.10. By **end-April**, the governance directive will be revised specifying, among others, the interaction between banks' internal audit units and bank supervisors, in line with best practices.

1.11. The accounts of cooperative credit institutions are subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC has the right to overturn the selection of an auditor by any cooperative credit institution. The consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.

1.12. The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. Taking into account the imminent increase in the tasks of the CBC, owing in particular to the requirements imposed on the banking supervision department, recruitment will be accelerated and additional resources, with sufficient qualifications, will be allocated without delay.

1.13. The authorities will, in consultation with EC, ECB and IMF and informing the ESM, review the effectiveness of the Resolution Authority, including its composition and governance, with a view to adopting legislative and operational changes **by end- March**.

Monitoring of corporate and household indebtedness

1.14. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The annual Financial Stability Report, to be published at year-end will include an extended analysis on corporate and household indebtedness. Exceptionally to the year-end timing of the publication, the first report will be published by **end-April**. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.

1.15. Measures will be taken to deal with troubled borrowers. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs.

- In order to ensure compliance with the new framework for the management of arrears, **by end-March 2014**, the CBC, with external technical support, will complete an assessment of the operational capacity of the commercial banks' loan workout units, including with respect to early arrears. Following the completion of the merger process for the cooperative credit institutions, the corresponding deadline will be **end-May**.

- Banks will be required to report quarterly on restructuring progress and management of NPLs, with reference date **end-March** and submitted **by end-May**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).

- The CBC will, with assistance of an external expert, review banks' arrears management policies and practices, taking into account international best practices. This review will be completed **by end-June** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions. Following the findings of the review, as needed, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced by **end-July.**

- By **end-June**, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.

- The role of the Financial Ombudsman with regard to hearing complaints on compliance with the arrears management process will be clarified **by end-March**.

- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new administrative measures which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced.

<u>Increasing financial transparency</u>

1.16. Based on the findings of the April 2013 audit undertaken by MONEYVAL and an independent auditor, the Cypriot authorities have progressed in enhancing the anti-money laundering (AML) framework in line with best practices and are committed to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).

- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1).

- The supervisory competent authorities are reviewing their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions.

- On a quarterly basis, in the context of the programme review starting Q4-2013, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts related to money laundering and tax matters.

To ensure that adequate, accurate and current basic information on all types of legal persons registered in Cyprus could be obtained by the Registrar of Companies and be accessible by the public in a timely manner, the Cypriot authorities have committed to reform the Department of Registrar of Companies as foreseen in section 3.10.

The Cypriot authorities commit to maintain efforts to ensure that the widest possible exchange of information with other FIUs is achieved, either spontaneously or in response to requests. The Cypriot FIU has taken the initiative to provide the programme partners with a breakdown of requests made and received and spontaneous disseminations on a quarterly basis (within 14 days of the end of the quarter), starting with Q4 2013, and publish this information on the FIU website on an annual basis.

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

1.17. The CBC increased the minimum Core Tier 1 capital ratio from 8 percent to 9 percent in December 2013. The CBC is assessing the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, **by end-March** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the EU-wide stress test. In no circumstances will this revision lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.

Management of legacy Laiki

1.18. In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority will instruct the Special Administrator to appoint **by end-March** a well-recognised and independent consulting or auditing firm(s) or international institution(s) to provide services associated with the management of the disposal process, and be entrusted with the voting rights associated with Laiki's shares participation in BoC. As part of the terms of reference for the appointment of the consultants agreed in consultation with the EC, ECB and IMF and informing the ESM, a revised roadmap for the full disposal of the assets will be developed by **end-April** with a view to maximize value for creditors.

Restructuring of Bank of Cyprus

1.19. To strengthen confidence in the bank, by end February the CBC agreed with BoC on the quarterly operational and financial indicators that will be communicated to the public on progress being made in the implementation of the restructuring plan.

1.20. Going forward the CBC will complete **by end-February 2015** a comprehensive technical assessment of BoC's restructuring plan with the aim to identify areas that require further strengthening and review.

Restructuring and recapitalisation of Hellenic Bank

1.21. Following the successful recapitalisation of Hellenic Bank with privately raised funds, the CBC has required Hellenic Bank to submit **by end-March** a business plan covering the period up to end-2015.

Restructuring and recapitalisation of cooperative credit institutions

1.22. The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion for which funds were deposited in a securities account with the CBC to boost confidence in the system. This ensures that there will be no contribution required from depositors to achieve the recapitalisation of the sector. Following a fair value assessment of the CCB and CCIs' assets and after the approval of the restructuring plan by the EC, these EUR 1.5 billion of state funds will be injected in the Cooperative Central Bank in exchange for common shares.

1.23. To this end, the restructuring plan for the cooperative sector was submitted to the EC in January 2014. The terms and remuneration of the public support will comply with the EU state aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections, will be subject to specific management rules and restrictions and to a restructuring process, which will be scrutinised by an external monitoring trustee to assume his tasks immediately after the approval of the recapitalisation aid and associated restructuring plan and commitments by the EC under state aid rules. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and will work under the direction of the EC. In line with the EU state aid rules the trustee will be responsible for overseeing the implementation of the restructuring plan. This includes, inter alia, verifying proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee will closely follow the bank' operations and shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.

1.24. In line with the strategy for the restructuring and recapitalising of the sector that was published in July 2013, the individual cooperative credit institutions will be merged into a maximum of 18 entities **by end-March**. These mergers are designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive by **end-July**.

1.25. Upon completion of legal mergers of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99 percent stake and ensure compliance with the 4 percent individual core tier 1 ratio. These operations will be finalised by **end-April**, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9 percent or the new minimum capital requirement to be determined as per paragraph 1.17.

1.26. Based on the new legal framework for the management of the stake of the State in the cooperative sector, a relationship framework between the State and the Central Cooperative Bank was established, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions and undue political interference. Compliance with the relationship framework will be reviewed **on a quarterly basis** by the monitoring trustee, who will also report any breaches of the framework to the EC. The authorities will inform the ECB, the ESM, and the IMF of the conclusions of that report.

1.27. As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise. In particular such expertise will be drawn upon to develop policies and practices in the areas of arrears management and corporate restructuring. In addition, it will ensure that the recruitment of executive and senior management of the CCB and CCIs take place in line with international best practices and will be completed by **end-May**. The selection criteria for the CCB will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB and IMF and informing the ESM. As part of the relationship framework the CBC and CCB, in consultation with the Ministry of Finance management unit, will agree by **end-April** on quantitative indicators to allow for an adequate monitoring of the implementation of the coops' restructuring plan. In addition, main indicators and conclusions used in the monitoring exercise will be released as part of the quarterly public reporting in order to enhance confidence.

1.28. To limit risks and ensure appropriate and consistent risk management practices across the sector, by **end-January 2015**, the CBC will complete an assessment of the CCB's implementation of effective local and risk management programs for the CCIs on the basis of common policies and tools as well as a consolidated management program at the CCB level in line with the restructuring plan.

C. Legal framework for private debt restructuring

1.29. All unnecessary legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral. Furthermore, they will establish a Task Force (comprising representatives of CBC, Ministry of Finance, the Law Office of the Republic and the Land Register) **by end-March** to prepare a study assessing the magnitude of registered, but untitled land sales contracts and underlying mortgages and develop recommendations **by end-June**.

1.30. The authorities will, in consultation with EC and IMF and informing the ECB and ESM, prepare a comprehensive reform framework to be endorsed by the Council of Ministers **by end-May**, establishing appropriate corporate and personal insolvency procedures. On the basis of that framework, legislation will be prepared and submitted to the House of Representatives **by December 2014**.

1.31. The legal framework in relation to foreclosures and the forced sales of mortgaged property will be amended in consultation with the EC and the IMF and informing the ECB and the ESM, and adopted **by end-June**, to allow for private auctions to be conducted by mortgage creditors, while limiting the role of the Land Register in the auction process.

1.32. In the context of these reforms, the authorities will initiate a review by **end-June** and, **by end-December**, will formulate recommendations on the Civil Procedure Code and Court Rules in order to ensure the smooth and effective functioning of the revised foreclosure and insolvency frameworks.

1.33. The authorities will review the private sector debt restructuring legal framework in the **second half of 2015** with a view to assessing results and define additional measures as needed.

2. Fiscal policy

<u>Key objectives</u>

Putting public finances on a sustainable path is of overriding importance in order to stabilise the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term economic prospects of Cyprus.

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3 percent of GDP primary surplus in 2017, 4 percent of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2014, listed in Annex 1; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 and have progressed in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[1] will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.7 of this Memorandum, will not be undertaken over the course of the programme period.

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-2020 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

In accordance with Regulation 472/2013, Cyprus shall provide all the information that the programme partners consider to be necessary for the monitoring of the implementation of the economic adjustment programme. The Cypriot authorities will consult ex-ante with the European

[1] Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3.

Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

In line with State aid rules, the Government shall not implement any measures involving State aid towards Cyprus Airways until the approval of a restructuring plan by the European Commission.

Fiscal policy in 2014

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 277 million (1.8 percent of GDP) in 2014[2], respecting the EDP recommendation of a headline deficit of no more than 8.4 percent in 2014. To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).

Fiscal policy in 2015-16

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 340 million (2.1 percent of GDP) in 2015 and a surplus of at least EUR 201 million (1.2 percent of GDP) in 2016[3], respecting the EDP recommendation of a headline deficit of no more than 6.3 percent of GDP in 2015 and 2.9 percent of GDP in 2016.

After review by and consultation with the programme partners the 2015 and 2016 Budget Laws will be adopted, respectively, **by December 2014** and **December 2015**.

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document. Any deviation from the budgetary objectives contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided to the programme partners. In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3 percent of GDP in 2017 and 4 percent of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the

[2] The ESA95 budgetary targets are not comparable to, but remain consistent with the respective cash-based budgetary target set in the context of the economic adjustment programme.

[3] These targets need to be adjusted for expected dividends of EUR 0.2 billion, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) take further steps to control the growth of health expenditure; (3) enhance tax revenues by improving tax compliance and collection; (4) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (5) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (6) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While acknowledging that the Cypriot authorities have recently introduced substantial reforms (as noted in Annex 1), which, according to the results of the actuarial study which were peer reviewed in the Ageing Working Group of the Economic Policy Committee in September 2013, have adequately addressed the issue of the high projected increase in pension spending and secured the long-term financial viability of the pension system through 2060, it remains important to monitor the long term financial sustainability of the system and consider further reform steps, if needed.

The Cypriot authorities have agreed to provide **by February 2014** all information necessary to verify that, to the extent it falls under the control of their executive and legislative powers, all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

Health care reform

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted:

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed **by Q2-2014** with the programme partners and all co-payments for using public health care services;
b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aiming at full implementation **by Q2-2015**;
c) taking into account the economic conditions, the implementation of the necessary complimentary reforms, the results of the updated actuarial study and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place **by mid-2016**. The NHS will ensure its financial sustainability while providing universal coverage. By **mid-2015**, a first stage of NHS, e.g. primary care, will be put into place. This first stage will

be defined and adopted with the full roadmap to NHS **by April 2014**, which will also clarify the role of Ministry of Health and the HIO. The amending bill to NHS will be submitted to the House of Representatives **by Q2-2014**. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded;

e) complete the design of the IT-infrastructure necessary for implementing the NHS, explore all options for improving the IT-infrastructure via the most cost-effective web-based applications as an alternative to the currently-defined IT tender **by Q1-2014**;

f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q2-2014**;

g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

Furthermore, the Cypriot authorities will consider establishing a system of family doctors acting as gate-keepers for access to further levels of care.

Budgetary framework and public financial management

3.3. The Cypriot authorities will:

- enact a Fiscal Responsibility and Budget System Law (FRBSL applicable to the entire general government sector**, prior to the granting of the fourth disbursement of financial assistance.** The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts on budget documentation and statistics ensuring that adopted measures are fully effective;

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the FRBSL, including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance **by mid-March 2014**;

As regards expenditure controls in the state budget, which shall avert the risk of overspending against existing appropriations and/or accumulating arrears, the Cypriot authorities will:

- remove the risk of overspending by making sure that spending commitments, as these will be defined in the FRBSL, of the central government are subject to pre-commitment validation by Q1-2014. All outstanding commitments should be timely and properly recorded and reported, on a quarterly basis, in the accounting system.

- improve the monitoring of government guarantees through a risk assessment analysis. To this end, ensure appropriate human resources at the Public Debt Management Office to carry out proper risk assessment of the outstanding stock of government guarantees.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- regularly update the inventory of PPPs, including contingent liabilities and include it both in the annual budget law and in the annual financial report;

- put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, the Directorate General for European Programmes, Coordination and Development and the Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL;

- implement secondary legislation and/or guidelines for public investment management, including project appraisals, in line with the FRBSL provisions by June 2014.

- commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any projects that reached commercial close by end-October 2012.

State-owned enterprises and privatisation

3.5. As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets:

- the Cypriot authorities will submit to the House of Representatives the law regulating the creation and the functioning of SOEs at the central and local levels, in order to enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure by end-February 2014. No additional SOEs will be created until the legal framework has been adopted.

- the Head of the new SOEs Unit and the Unit's supporting staff will start their work by end-March 2014;

- the Cypriot authorities will submit a plan by Q2-2014 with detailed timelines for the review of those SOEs that are under internal review and will be restructured; and

- each SOE will submit a strategic plan to the competent minister for approval, in consultation with programme partners, as set out in Part V of the SOEs Law **by Q3-2014.**

3.6. The Cypriot authorities will implement the privatisation plan submitted to the programme partners to help improve economic efficiency by encouraging more vigorous competition and greater capital inflows and restore debt sustainability. The plan includes the privatisation of, inter alia, CyTA (telecoms), EAC (electricity), CPA (commercial activities of ports), as well as real estate and land assets. CyTA and CPA will be privatised within the programme period and EAC by mid-2018.

An appropriate regulatory framework is a prerequisite for the privatisation of natural monopolies. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and the relevant secondary legislation.

In order to pursue the privatisation process in the most diligent way, the Cypriot authorities will:

- enact the Privatisation Law, prior to the granting of the fourth disbursement of financial assistance;

- establish the Privatisation Unit through the appointment of its Head and its experts, in line with the provisions of the Privatisation Law; the Unit will be fully operational by mid-May 2014. The terms of reference for the appointments will be prepared in consultation with programme partners;

- appoint independent advisors with relevant expertise and develop a plan with detailed intermediate steps and timings for disposing of the identified real estate assets by Q3-2014;

- appoint independent advisors for the CPA privatisation by Q2-2014, in accordance with the privatisation plan;
- appoint independent advisors for the privatisation of CyTA and EAC by Q3-2014, in accordance with the privatisation plan.

The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion by the end of the programme period and an additional EUR 400 million by 2018 at the latest, which will be used for public debt reduction.

Revenue administration, tax compliance, and international tax cooperation

3.7. The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. Most of the short-term programme has been implemented. However, the following actions will be completed **by Q1-2014:**

- attributing personal responsibility for payment of company taxes to those, who - in the case of non-listed companies - truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence and taking the necessary steps to ensure tax fraud is prosecuted as a criminal offence;
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer;
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk; and
- conducting an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

The long-term reform will include the following sets of measures:

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis, as well as on an evaluation of different risk treatment strategies. To further progress, the authorities will

- make the data from the IRD, VAT Services and Customs and Excise Department available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q1-2014**;
- cleanse the income tax registers **by Q2-2014** and VAT registers **by Q3-2013**, by removing inactive cases and put in place a process to maintain the registers up-to-date;
- further improve the joint work programme for large and high risk taxpayers and provide a progress report **by Q2-2014**; and
- finalise the compliance risk management module for large taxpayers **by Q3-2014.**

- The full integration of the two tax departments, based on the adopted integration implementation plan. As next steps, the authorities will, amongst others:

  1. submit to the House of Representatives the enabling legislation to establish the new tax agency **by April-2014**; and
  2. set up the integrated large tax payer unit **by Q4-2014**.

In addition, the authorities will reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the VAT gap) by Q2-2014.

3.8. The Cypriot authorities will safeguard the timely and effective exchange of information on tax matters, fully ensuring the applicability of laws and standards governing international exchange of tax information. In this respect, the Cypriot authorities will enhance the practice of timely delivery of relevant and accessible tax information to other EU Member States. The authorities will:

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;

- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and

- submit by end-February 2014 to programme partners a comprehensive action plan to address the shortcomings identified in Phase 2 of the peer review by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, with a view to achieve full compliance with the OECD supplementary review. The action plan shall be implemented by Q2-2014. In addition, the authorities will monitor closely further progress in responding timely to tax information requests by third countries and, starting from end-March 2014, submit to the programme partners quarterly performance updates.

In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending on 31 December 2013, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD. **In 2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits conducted in 2014. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country.

Immovable property tax reform

3.9. The Cypriot authorities will reform the immovable property tax with the objective to improve the fairness of the tax burden and to increase the efficiency of the tax administration. To this end, the authorities will:

- implement a General Valuation (GV) for all immovable properties. The new values of immovable properties shall be determined on the basis of tangible building- and plot-related characteristics by Q2-2014;

- implement the recurrent immovable property tax based on the updated valuations for the tax year **2015**, at the latest. The design of the immovable property tax shall ensure progressivity and proceeds consistent with measure I.27 of Annex 1.

The Department of Lands and Surveys (DLS) and the Inland Revenue Department will prepare **by Q1-2014** a joint action plan outlining the required intermediate steps and deadlines, which will ensure a smooth and timely implementation of the new immovable property tax.

In addition, the authorities will:

- by Q4-2014, conduct an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV and identify possible missing parameters. Refine, if needed, the CAMA in light of this assessment by Q2-2015;

- conduct an assessment of the variance between GV assessed values and market price by Q4-2014. On this basis and following international best practices, by Q1-2015 enact legislation specifying the frequency of the mandatory update of the values; and

- implement by Q2-2015 the recommendations of a study on the scope for consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope for shifting revenues from transaction fees and taxes to recurrent taxation.

Public administration reform

3.10. The Cypriot authorities have commissioned an independent external review of possible further reforms of the public administration. The review includes a horizontal and a sectoral element.

The horizontal element will be undertaken by the World Bank and the UK public administration and will include reviews of:

- the appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and

- the introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The results of the horizontal review will be presented **by Q3-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q4-2014**.

The sectoral element will examine:

- the role, competences, organisational structure, size and staffing of relevant ministries, services and independent authorities;

- the possibility of abolishing, merging or consolidating non-profit organisations or companies and state-owned enterprises; and

- the possibilities for the re-organisation and re-structuring of local government,

and comprises two batches:

- the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. The results of the first batch will be presented by Q1-2014. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers by Q2-2014. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives by Q3-2014. The reform will start to be implemented by Q4-2014, in accordance with the reform plan.

- the second batch will cover all remaining Ministries (Labour and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defense, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Planning Bureau being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provision of 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented by Q4-2015. They will include cost estimates and implementation timelines with detailed intermediate steps. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers by Q1-2016. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives by Q2-2016. The reform will start to be implemented by Q3-2016, in accordance with the reform plan.

- In addition, the authorities will review the impact of the changes to the public sector working hours and will present their findings to the programme partners **by Q4 2014.**

Welfare system

3.11. The existing welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), and enhancing the protection of vulnerable households, the Cypriot authorities will implement the reform plan of the welfare system, **as of 1 July 2014.**

The Cypriot authorities will ensure that the reform will be achieved through:

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance;

- improving the targeting of benefits; and

- providing work incentives to avoid welfare dependency.

To this end, the Cypriot authorities will take the following steps:

- on the basis of the level of the minimum consumption basket covering basic needs in order to achieve a decent standard of living, define the level, the composition and the eligibility criteria of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme and estimate its overall costing by end-February 2014;

- refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria across different benefit schemes by end-February 2014;

- adopt the final design of the reformed welfare system by the Council of Ministers by Q1-2014 after consultation with social partners, followed by consultation and review by programme partners. The adopted reform would define all benefits, their respective level, and eligibility criteria, as well as the overall costing of the system;

- ensure that a comprehensive database and the necessary IT requirements are in place to support the administration of the reformed welfare system by May 2014; and

- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April 2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted **by end-May 2014**.

4. Labour market

Key objectives

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustment (COLA) of wages and salaries

4.1. To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities are reforming the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. This reform acts on relevant elements of the indexation system, as follows:

i. a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;

ii. a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and

iii. a move from full to partial indexation, with the rate of wage indexation being set at 50 percent of the rate of increase of the underlying price index over the previous year.

As foreseen in section I.2 (Annex 1) of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by Q2-2014**.

Minimum wage

4.2. With a view to preventing possible adverse competitiveness and employment effects, the Cypriot authorities commit that, over the programme period, any change in the minimum wage covering specific professions and categories of workers should be in line with economic and labour market developments and will take place only after consultation with the programme partners.

Activating the unemployed and combating youth unemployment

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.11.

4.4. In their assessment of current activation policies, the Cypriot authorities have identified a series of challenges pertaining to the system. These include: the difficulties faced by the Public Employment Services in serving an increased number of unemployed people; the lack of a coherent and homogeneous framework for the continuous monitoring and evaluation of the different schemes, which impedes the proper evaluation of the activation system as a whole; the need for increased coordination across different ministries and departments of the administration and the need to reduce fragmentation; and the absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information.

Therefore, the Cypriot authorities will ensure the implementation of a set of agreed measures to address the identified shortcomings and weaknesses. These will include:

i. the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes. A comprehensive report will be presented **by Q3-2014** and as of then the new methodology will be applied, thereby enabling the assessment of the performance and effectiveness of all schemes;

ii. completing the process of harmonisation, automatic collection, processing and exchange of data across the various schemes and between all implementing bodies **by Q1-2014**;

iii. ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;

iv. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q2-2014**; and

v. measures to enhance the cooperation between the public employment services and the benefit-paying institutions in the activation of the unemployed.

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present by April 2014 the revised National Action Plan for Youth

Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative aimed at establishing a Youth Guarantee, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets. For this purpose, the authorities will submit by April 2014 a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients, budgetary allocations and sources of financing.

5. Goods and services markets

Key objectives

Addressing issues of a structural nature is critical for rebalancing the Cypriot economy, restoring its growth potential and improving competitiveness. Removing unjustified obstacles in services markets can have a significant impact on growth, in particular for the services-intensive Cypriot economy. In addition, improving the quality and reducing the cost of regulated professional services can play an important role for the business environment and for Cyprus' competitive position. Since tourism is one of Cyprus' largest sectors and an important potential driver of future growth, a reinvigoration of the competitiveness of this sector is warranted. Improving the regulation of administration related to the real estate sector will contribute to the overall functioning of the housing market and help to foster foreign demand at a time when the prospects of this sector are affected by downside risks. Finally, the exploitation of the domestic offshore natural gas potential offers the medium- to long term prospect for reducing Cyprus' energy import dependency and the security and sustainability of energy supply. This would help to address Cyprus' sustained current account deficit and high public debt. However, these positive effects will accrue only after overcoming the challenges of financing and planning the infrastructure investments, designing efficient energy markets and an adequate regulatory regime.

Services Directive and regulated professions

5.1. The Cypriot authorities stand ready to adopt any further necessary amendments towards the full implementation of the Services Directive. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

The Cypriot authorities will further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the access and exercise of activity. The Cypriot authorities will finalise their review **by Q1-2014**. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q3-2014**.

Competition, transparency and sectoral regulatory authorities

5.2. The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:

- continuing to provide sufficient and stable financial means, as well as qualified personnel in order to enhance its effective and on-going operation by Q2-2014;
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries by end-March 2014; and
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition by Q2-2014. The CPC may seek technical assistance to achieve this objective.

The Cypriot authorities will ensure **by Q2-2014** that the General Auditor's Office has sufficient financial means and personnel to carry out its functions and increased tasks, as originally stipulated by the European Commission's Monitoring Report on the Implementation of the Commitments made in the Accession Negotiations by Cyprus (Chapter 28, Financial Control/External Audit) and as restated in the 2014 EU Anti-Corruption Report.

The Cypriot authorities will continuously ensure that powers and independence of the National Regulatory Authorities (NRAs) are effective in accordance with the EU Regulatory Framework.

Housing market and immovable property regulation

5.3. Action is required to ensure property market clearing, efficient seizure of collateral, and restoring demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- define deadlines for the issuance of building certificates and title deeds and ensure their enforcement by Q1-2014; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year by Q4-2014 (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. Moreover, prepare a joint action plan to streamline the processes within the DLS and between the DLS, the Local and District Authorities and the Ministry of Interior Technical Services by Q2-2014;

- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services by Q4-2014; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**.

<u>Tourism</u>

5.4. Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:

- present a progress report on the implementation of the action plan twice per year including an assessment of its implementation based on performance indicators, by Q1 and Q3 every year, starting from 2014.
- present a plan enhancing the coordination of the competent authorities having a direct link with tourism by Q2-2014. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.
- start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. This strategy, which will include a concrete action plan, will be adopted by Q1-2014. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

<u>Energy</u>

5.5. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented, particularly during and after the transformation of the sector;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector in the form of a concise summary report (first draft to be delivered by Q4-2014) and a collection of more detailed reports. This strategy constitutes a living document to be developed and updated under the full authority of the Cypriot Government and including at least the following three key elements, on which further work should be presented to the programme partners for consultation according to the timeline specified below:

1. updates on the *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan takes into account the relevant technical and commercial uncertainties and risks and hence should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; next update **by Q2-2014.**

   Prior to finalisation of the forthcoming energy sector Government Agreement (GA) and its supplementary agreements between the Republic of Cyprus and the Contracting Parties to a Production Sharing Contract, the Cypriot authorities will undertake a financial and budgetary impact analysis of the GA and its supplementary agreements. The impact assessment will evaluate in detail the potential financial and budgetary impacts on the general government position of the various options for a LNG project development plan and financing arrangements, with a particular focus on budgetary commitments that may arise before or at the time of taking the final investment decision. The GA and its supplementary agreements shall be consistent with the fiscal targets until 2016 and thereafter, as defined in this MoU.

2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, the prospects of privatisation of SOEs in the energy sector, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; and full unbundling of gas suppliers and customers, in particular electricity companies. The Cyprus authorities will provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate the intended duration of the latter derogations. An advanced intermediate draft **by Q2-2014,** with a view to a final outline **by Q4-2014**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-

recognized best practices., The resource fund, whose establishment and objectives are foreseen in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. To the extent that the FRBSL, does not cover the elements listed above, they should be provided for by the specific law on the resource fund, an advanced draft of which, informed by technical assistance advice will be submitted to programme partners **by Q2-2014,** before its submission to the House of Representatives.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time and collated in one summary document. In addition, the strategy should take into account the uncertainty about the actual size of domestic, offshore, commercially-viable, natural gas fields and possible changes in international gas prices and demand. As regards the later, appropriate data should be firmly based on *alternative world energy scenarios* from an internationally-reputed organisation. The strategy will be based on an appropriate level of technical assistance on technical aspects in this context.

6. Technical assistance

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-June 2014**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

7. Growth Strategy

7.1 Developing a comprehensive and coherent growth strategy based on Cyprus' competitive advantages would help the Cypriot authorities to kick-start the economy. The growth strategy should be integrated in the national institutional framework leveraging on the on-going public administration reform, public financial management reform, other commitments in Cyprus' Economic Adjustment Programme and relevant EU initiatives. The Cypriot authorities may request technical assistance to further develop this strategy.

<u>Annex 1</u>

Budgetary measures adopted by Cyprus in or after December 2012

<u>Fiscal measures with effect in 2012</u>

Expenditure measures

I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0 percent; EUR 1001-1500: 6.5 percent; EUR 1501-2000: 8.5 percent; EUR 2001-3000: 9.5 percent; EUR 3001-4000: 11.5 percent; above EUR 4001: 12.5 percent.

I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see 4.1).

I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.10); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

Revenue measures

I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095 percent to 0.11 percent with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

<u>Fiscal measures with effect in 2013</u>

Expenditure measures

I.9 Ensure a reduction in total outlays for social transfers by at least EUR 113 million through: (a) the abolition of a number of redundant and overlapping schemes such as the mothers allowance, other family allowances and educational allowances; and (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

I.10 Ensure a reduction of at least EUR 29 million in the total outlays of allowances for employees in the public and broader public sector by:

i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;

ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15 percent; and

iii. reducing the daily overseas subsistence allowance for business trips by 15 percent. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50 percent (20 percent - 45 percent of overseas subsistence allowance instead of 40 percent - 90 percent currently paid).

I.11 Reduce certain benefits and privileges for state officials and senior government officials, in particular by:

i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;

ii. abolishing the right to duty free vehicles for employed and retired senior public sector officials; and

iii. extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8 percent on the pensionable earnings of these individuals.

I.12 Implement the following measures regarding the Government Pension Scheme (GEPS):

i. freeze public sector pensions;

ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5 percent per month of early retirement so as to make early retirement actuarially neutral;

iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

iv. introduce a permanent contribution of 3 percent on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8 percent on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;

vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4 percent to 6.8 percent; and

vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.

viii. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;

ix. introduce a change of indexation of all benefits from wages to prices; and

x. pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013).

I.13 Implement further reform steps under the General Social Insurance Scheme by:

i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5 percent per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;

ii. freezing pensions under the Social Security Fund for the period 2013-2016;

iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.

iv. increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age;

v. introduce an early retirement penalty of 0.5 percent per month of early retirement so as to make early retirement actuarially neutral;

vi. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;

vii gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012); and

viii. ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013).

I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.

I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.

I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

The additional permanent expenditure measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.17 Introduce the following measures to control healthcare expenditure:.

a. abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5 percent of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

b. increase fees for medical services for non-beneficiaries by 30 percent to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

c. introduce effective financial disincentives for using emergency care services in non-urgent situations;

d. introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

e. adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

I.18 Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.

I.19 Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.

I.20 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8 percent; EUR 2.001-3.000: 1 percent; EUR 3.001-4.000: 1.5 percent; above EUR 4001: 2.0 percent.

Revenue measures

I.21 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.22 Increase excise duties on beer by 25 percent from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.23 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.24 Increase the standard VAT rate from 17 percent to 18 percent.

I.25 Introduce a tax of 20 percent on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.26 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

The additional permanent revenue measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.27 Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.

I.28 Increase the statutory corporate income tax rate to 12.5 percent.

I.29 Increase the tax rate on interest income to 30 percent.

I.30 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11 percent to 0.15 percent with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.31 Complete the increase in fees for public services by at least 17 percent of the current values

<u>Fiscal measures with effect in 2014</u>

Expenditure measures

I.32 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.33 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3 percent on all wages.

I.34 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

I.35 Introduce as of the budget year 2014 structural reform measures in the educational system, notably, a reduction of the number of teachers seconded to the Ministry of Education and Culture, the removal of 1:1.5 teaching time ratio from evening schools of general and technical and vocational education, the elimination of teaching time concession to teachers for being placed in two or more educational districts, the elimination of mentoring components for pre-service and in-service training for newly appointed teachers and the reduction of the cost of afternoon and evening programmes.

I.36 Ensure additional expenditure savings by a further reduction of public sector allowances and streamlining of overtime compensation, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees;

I.37 A further targeting of social pensions;

I.38 An abolition of income tax exemption for certain pension schemes;

I.39 A reduction in the tax-free threshold for lottery gains;

Revenue measures

I.40 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0 percent; EUR 1,501 – 2,500: 2.5 percent; EUR 2,501 – 3,500: 3.0 percent; and > EUR 3,501 - : 3.5 percent.

I.41 Increase the standard VAT rate from 18 percent in 2013 to 19 percent in 2014.

I.42 Increase the reduced VAT rate from 8 percent to 9 percent.

I.42 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.43 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

I.44 A reform of the tax system for motor vehicles with effect from budget year 2014, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

I.45 An introduction of a contribution of 3 percent on salaries of casual employees servicing on a contract basis, who receive gratuity, including volunteers of 5 years services and police constables.

Annex 2

The AML Action Plan by Cyprus on customer due diligence and entity transparency

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Compliant
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Compliant Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Compliant
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Compliant
1.3	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Compliant Q2-2014
2	**Reliance/introduced business**		

	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Compliant
	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Compliant
3	**Suspicious Transaction Reporting**		
	Changes in the legal framework.	3.1 MOKAS to reiterate and clarify through further training the requirements to report STRs, including the new duty to report issues relating to tax crimes as of December 2012, in coordination with relevant supervisory authorities.	Q1 - 2014
4	**Transparency of beneficial ownership**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC).	Compliant

		4.1.2. In the case of nominees, either a) require nominee directors[1] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	Compliant
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant Ongoing
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Compliant
5	**<u>Supervision of financial institutions</u>**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[2] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant

[1] Under Cyprus law, there is no legal concept of "nominee director", but it is used with reference to professionals who provide director services.

[2] in accordance with BCP 2 and FATF 26-27.

		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[3] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[4]	Ongoing
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[5] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Compliant
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD);	Q2 – 2014

[3] FATF Immediate Outcome (IO) 3.

[4] See BCP 2.6c.

[5] The off-site supervisory tool will include monthly reporting by obliged entities on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

		- monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1.a. CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. 5.5.1.b. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Compliant Q1-2014
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of the pilot reviews, and develop an onsite supervisory program for 2014. 5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise. 5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise. 5.5.3.4 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customised supervisory strategies to all financial institutions under its responsibility.	Q2 - 2014
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections. 5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Q2 - 2014
6.	**Supervision and monitoring of lawyers, accountants and TCSPs**		
6.1	**Align resources with risks** **Establish an effective**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT	Ongoing

	monitoring structure for AML/CFT matters	experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	
6.2	**Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation**	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	Q1-2014 (CBA and ICPAC) Q3-2014 (CySEC)
		6.2.2.1 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of business and professionals. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews. 6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise. 6.2.2.3 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customized supervisory strategies to all business and professions under monitoring.	Q2-2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program	Q2 – 2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.4	**Establish Formal AML/CFT Training Program**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR - recordkeeping - compliance function - risk assessment systems etc.	Q2– 2014 (CBA and ICPAC) Q4-2014 (CySEC)
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting	Ongoing

		access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	
		Subsequent to the successful development of the tools stipulated under 6.2 and 6.3, the Supervisory authorities will undertake the following: 6.5.2 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews, and come-up with a supervisory program for 2014	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)
		6.5.3 Implement the new examination/verification procedures through pilot onsite inspections of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the procedures using the results of the pilot inspections.	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.10 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour and Social Insurance
ii. Ministry of Communications and Works
iii. Ministry of Energy, Commerce, Industry and Tourism (excluding the Companies Registrar and Official Receiver, to be covered in the first batch of studies)
iv. Ministry of Interior
v. Ministry of Defense (excluding the National Guard and Cyprus Army)
vi. Ministry of Justice and Public Order
vii. Ministry of Foreign Affairs

Note: Ministry of Finance, including Treasury and Planning Bureau, will be reviewed under the PFM.

Constitutional Powers /Services

i. President's Office and Council of Ministers
ii. Law Office
iii. Audit Office
iv. Public Service Commission

Independent Services/Authorities

i. Educational Service Commission
ii. Internal Audit Service
iii. Office of the Commissioner for Administration (Ombudsman)
iv. Office for the Commissioner of Personal Character Data Protection
v. Tender Review Body
vi. Refugee's Review Body

Independent Services/Authorities to be excluded from the external review and justified in the Notes below

i. Office for the Commissioner of State Aid Control
ii. Authority for the Supervision of Cooperative Societies[1]
iii. Competition Protection Commission

[1] The relevant organisation is dealt within the context of the financial sector part of the MoU.

INTERNATIONAL MONETARY FUND

CYPRUS

March 24, 2014

THIRD REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—SUPPLEMENTARY INFORMATION

Prepared By European Department

1. **This supplement provides information that has become available since the issuance of the staff report on March 14, 2014.** This information does not alter the thrust of the staff appraisal.

2. **National accounts data confirm that real GDP declined by 5.4 percent in 2013.** Nominal GDP fell by 6.9 percent in 2013, with the deflator declining by 1.5 percent. The downturn was driven by falling investment and consumption, with net exports contributing positively to growth. On the supply side, output fell across the board, with the construction and financial sectors contributing most to the contraction. In the fourth quarter, real GDP declined by 0.8 percent q-o-q and 5 percent y-o-y, confirming the trend of slowing rates of decline since the second quarter. Public consumption recorded a sharp decline in the last quarter, reflecting a reduction in government purchases of goods and services. The data suggest that the contraction in private consumption in 2014 could be smaller than currently forecasted, although, in light of balance sheet stresses, considerable uncertainty still surrounds the overall pace of economic recovery. A full re-assessment of the macroeconomic framework will be undertaken during the next review.

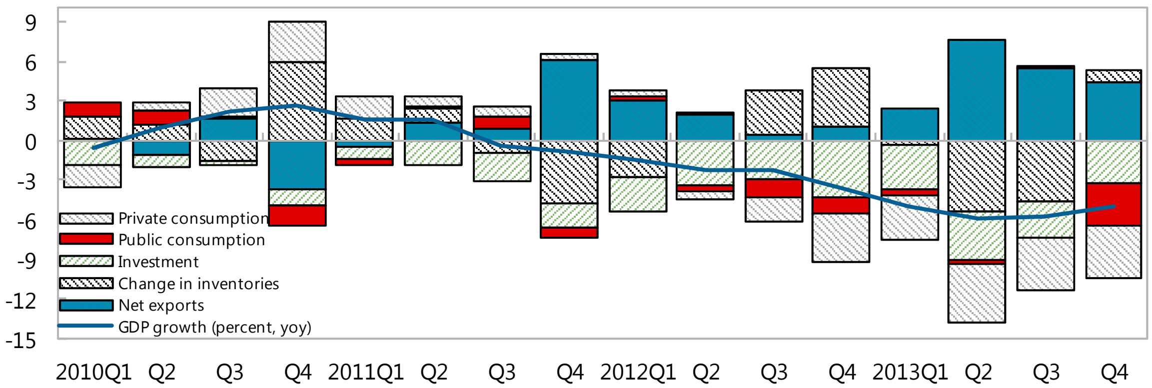
GDP Components--Quarterly (year-on-year)

	2013Q1	2013Q2	2013Q3	2013Q4	2013
Real GDP	-5.0	-6.0	-5.7	-5.0	-5.4
Domestic demand	-7.2	-13.2	-10.7	-9.2	-10.1
Consumption	-4.3	-5.3	-4.5	-8.2	-5.6
Private consumption	-4.8	-6.5	-5.9	-5.8	-5.7
Public consumption	-2.7	-1.3	0.4	-17.0	-5.0
Fixed investment	-20.5	-24.4	-18.9	-22.8	-21.6
Inventory accumulation 1/	-0.3	-5.3	-4.5	0.8	-2.4
Foreign balance 1/	2.4	7.7	5.5	4.5	5.0
Exports of goods and services	-8.0	-5.7	-1.9	-0.8	-4.2
Imports of goods and services	-12.4	-20.9	-12.7	-10.3	-14.1

Sources: Eurostat, Cystat; and IMF staff estimates.

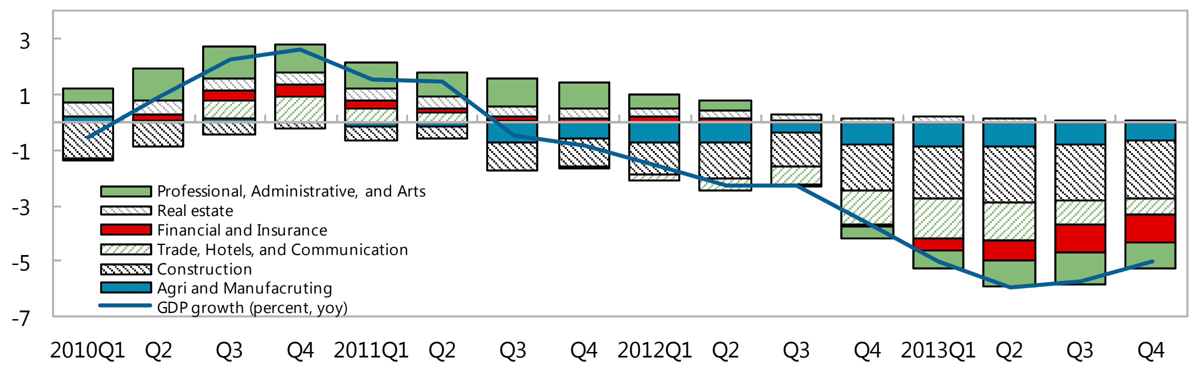
1/ Contribution to growth.

Contributions to GDP Growth
(Percentage point)



Sources: Cystat; Eurostat; and IMF staff estimates.

Contributions to GDP Growth
(Percentage point)



Sources: Cystat; and IMF staff estimates.

3. The authorities met the prior action on short-term measures to fight tax evasion. On March 20, 2014, legislation was submitted to parliament establishing self-assessment for all income taxpayers and increasing the enforcement collection powers of the revenue administration. The latter provides the revenue administration with the authority to seize assets and garnish bank accounts and prohibits the alienation of immovable property in cases of non-compliance. Following its adoption by parliament, the authorities are expected to issue regulations in line with international best practice to guide the implementation of the new legislation.

4. The authorities have also met the end-March structural benchmark on the merger of cooperative credit institutions. On March 24, the authorities completed the mergers of the 93 CCIs into 18 pillar institutions. Having recapitalized the sector as a whole by injecting funds into the cooperative central bank in early March, they are now working on recapitalizing the individual institutions, with 11 such recapitalizations already completed.

Press Release No.14/143
FOR IMMEDIATE RELEASE
March 28, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review Under the Extended Fund Facility for Cyprus and Approves €83.3 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Cyprus's performance under an economic program supported by a three-year, SDR 891 million (about €1 billion, or US$1.4 billion) extended arrangement under the Extended Fund Facility (EFF). The completion of this review enables the disbursement of SDR 74.25 million (about €83.3 million, or US$114.6 million), which would bring total disbursements under the arrangement to SDR 297 million (about €333.2 million, or US$458.5 million). The Executive Board also approved the modification of end-March fiscal performance criteria.

In addition to the extended arrangement, approved by the Fund on May 15, 2013 (see Press Release No. 13/175), Cyprus' economic program is also supported by financial assistance from the European Stability Mechanism (ESM) amounting to €9 billion. The program is intended to stabilize the country's financial system, achieve fiscal sustainability, and support the recovery of economic activity to preserve the welfare of the population.

Following the Executive Board discussion, Ms. Christine Lagarde, Managing Director and Chair, said:

"The Cypriot authorities are to be commended for keeping program implementation on track, meeting their fiscal targets with significant margins, advancing fiscal structural reforms, and completing the recapitalization of the financial system. While the macroeconomic outturn in 2013 was better than expected, the outlook is challenging. Full and timely policy implementation, broad public acceptance, and continued support from Cyprus's European partners remain critical to the program's success.

"Significant progress has been made in the financial sector, notably the completion of the recapitalization and consolidation of the cooperative credit sector. Going forward, full implementation of banks' and coops' restructuring plans and strong governance are essential to further bolster confidence. In turn, this can help facilitate further steps to relax payment restrictions gradually in line with the authorities' roadmap, while safeguarding financial stability.

"The successful resumption of credit and output growth depends critically on progress with reducing non-performing loans. Prompt implementation of a strong insolvency framework is necessary to provide adequate incentives for voluntary debt restructuring negotiations. Continued efforts are needed to strengthen banking supervision and regulation and implement the anti-money laundering framework.

"Prudent fiscal policies have contributed to permanent budgetary savings and reduced the budget deficit. In light of persistent macroeconomic uncertainty, cautious budget execution will need to be maintained this year. The ongoing fiscal adjustment should be complemented by structural reforms to enhance the welfare system and protect vulnerable groups, modernize the revenue administration, further strengthen public financial management, and prepare state-owned assets for privatization."

Statement by Mr. Menno Snel, Executive Director for Cyprus, and Mr. Ektoras Kanaris, Advisor to the Executive Director
March 28, 2014

Exactly a year ago from today, the events of March 2013 left Cyprus faced with a shattered banking system, its citizens in despair and a future that looked grim, laden with uncertainty. Twelve months later, with the help of Cyprus's international partners, outlines of recovery may be faint, but are now visible. The authorities, through firm and ambitious reforms, have been abiding strictly to the terms of the EU-IMF memoranda, which are viewed as the necessary steps to correct the island's weaknesses, setting the stage for sustainable growth. In implementing these reforms, the society has held together, with social cohesion proving to be an invaluable asset in the country's endeavours.

The third review shows that Cyprus continues to perform strongly under the programme, which remains on track and well financed, with all performance criteria observed with considerable margins. All structural benchmarks, but one, were observed by the time of this review, with the remaining one on track to be completed by end-April 2014. The Cypriot authorities remain committed to their goal of restoring the economy to a sustainable footing through the painful, but necessary, structural reforms taken to date and going forward.

On March 4, 2014 the politically sensitive, large-scale privatisation programme was approved by parliament. While the latter was faced with significant headwinds, the parliament tackled the issue with soberness and despite a breakup of the governing coalition a few days earlier. Staff rightly points out that this development may weaken the government's ability to advance its reform agenda, as policy makers may seek to find more common ground and build consensus. Nevertheless, this example along with other extremely difficult decisions of the past, evidence the authorities' abilities to implement program policies even under difficult political circumstances.

Clearly, the fundamentals, when seen on their own, are not flattering for the state of the economy. Cyprus is in the midst of a deep recession, unemployment is high and the banking sector is still unable to support the economy. However, they conceal the considerable successes of the last year. The reforms to date have been bold and numerous, the economy did not shrink as much as was originally feared and the banking system has been fully recapitalised and is now in the process of an ambitious restructuring. In turn, society's expectations have been steadily improving. The Economic Sentiment Indicator has been on the rise every month since April 2013 and is now at the highest level since mid-2011. The improved market perceptions of Cyprus's financial position have also been reflected in sovereign bond yields which have declined to the lowest level since May 2011, while rating agencies have started reversing a long trend of successive downgrades. These developments are promising, even as the report is rightly mindful of the outlook's fragility.

Macroeconomic developments

The economic situation remains difficult, but the outturn continues to over perform relative to programme expectations. According to the latest flash estimate, real GDP contracted by 5.4 percent in 2013, against the newly revised programme projection of -6 (down from a programme forecast of -7.7 during the last review and -8.7 percent at the start of the programme). Indeed, Cyprus's economy has so far proved more resilient than expected. The over performance was largely attributed to better than envisaged private consumption reflecting households' efforts to smooth consumption. At the same time, a number of indicators such as retail sales, tourism receipts, and professional services have also proven to be relatively rigid. External demand made a positive contribution to GDP as the deceleration of imports was larger than that of exports.

Looking forward, a significant deleveraging process is expected to take place through the banking sector, which together with the fiscal adjustment already underway, will entail a drag on growth. At the same time, the banking system's constrained liquidity renders the banks apprehensive to the provision of credit. Overall, growth is expected to be about -4.8 percent in 2014 before picking up to 0.9 percent in 2015 mainly from export growth. Restoration of confidence in the banking system and a potentially more comfortable liquidity position in the future could gradually loosen the tight credit conditions and provide more upside in the outlook. Clearly, the baseline is subject to risks which are well articulated by staff and we agree with their analysis in that regard. We note that medium-term growth projections do not yet incorporate the potential upside from the exploitation of natural gas resources, including related forthcoming infrastructure investments.

Unsurprisingly, unemployment has been taking the brunt of the adjustment, increasing sharply from 11.9% in 2012 to 16% in 2013, reaching 17.2% during the 4th quarter of 2013, the third highest in the EU. The authorities have been looking for ways to promote employment within their limited policy space. Nevertheless, the labour market is also proving to be more flexible than the indications at the beginning of the programme. By the last review, some nascent signs of stabilization had started to emerge, which have since been more persistent. Specifically, the unemployment increase had been gradually decelerating towards the end of 2013, before changing direction and decreasing to 16.8 percent in January 2014. Moreover, wages in both the public and private sectors have been reduced considerably. While the cost of adjustment is painful, it is contributing towards improved competitiveness. According to Eurostat's latest publication, Cyprus saw a decline in its labour costs of 6.5 percent in Q4 2013, the sharpest adjustment across the eurozone.[1] At the same time, the public sector workforce was significantly reduced over the last year, with the sector's employees numbering at their lowest level since 2007. The public sector is expected to be further reduced going forward through early retirement schemes as the SOEs gear up for privatisation.

[1] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-19032014-AP/EN/3-19032014-AP-EN.PDF

Cyprus's small size and open economy facilitated the adjustment of the current account, which moved to a small surplus of 0.3 percent of GDP in the third quarter of 2013 compared with a deficit of 5.7 percent of GDP a year ago. This was largely due to a notable decline in the import of goods and better export performance, though at a lower rate than in the previous quarter. The higher tourism receipts were partly offset by further decline in the export of financial and other business services.

Public Finances

Fiscal consolidation remains a cornerstone of the domestic adjustment strategy, evidenced by the authorities' continued strong record of compliance with their fiscal targets and beyond. The 2014 budget, which envisaged even more consolidation on top of programme requirements, will bring the total fiscal adjustment for 2013-14 to around 10 percent of GDP. Performance through end December has exceeded expectations, reaching a primary balance of -1.7 percent of GDP for 2013, comparing favourably with an adjusted forecast of -3.2 percent of GDP. While this outcome was positively influenced by the milder than expectedrecession, it was largely due to the sizeable consolidation measures undertaken by the authorities, coupled with strong execution and tight expenditure control.

For 2014, the primary deficit target was reduced to 2 percent of GDP from 3.3 percent of GDP to reflect the over-performance in 2013 as well as high expected dividend income. Considering Cyprus's hard earned credibility in identifying and delivering on fiscal measures, staff's suggestion, to temporarily accommodate shortfalls should the overperformance in 2013 prove to be temporary, appears prudent. Even so, this will have to be balanced with the authorities' strategy to stay ahead of the curve and will be discussed with Cyprus's international partners further into the year should the need arise. For the time being,the latest available numbers for January 2014 are reasonably encouraging, pointing to a primary surplus of 1 percent of GDP compared to a programmed 0.4 percent of GDP.

Financial Sector

Programme success ultimately runs through the stabilization of the financial sector which remains the authorities' key concern and priority. To this end, strong action has been taken over the last year with confidence in the sector, while still hampered, gradually improving. The significant moderation of deposit outflows serves as a useful proxy. According to the latest published data from the Central Bank, the deposit base was €46.9 billion in January from €47 billion in December and €47.2 billion in November. More importantly, the relative stability of deposits following the release of about €1 billion of previously frozen deposits at end-January was another encouraging signal.

These developments were likely supported by the authorities' and credit institutions' comprehensive reform strategy. Since the last review, the Central Bank and the European Commission approved the restructuring plan of Bank of Cyprus (BoC) and the Cooperative

Sector respectively. The latter offered a strong vote of confidence, confirming that the measures will enable the sector to become viable in the long term without continued state support. Moreover, this triggered the injection of €1.5 billion of state funds into the Cooperative Central Bank, bringing the entire core domestic financial sector's capital to around 16 percent of risk weighted assets. In the meantime, fundamental restructuring of the banking sector continues apace with branch closures, voluntary staff redundancy schemes and wage cuts contributing to the reduction of operating costs.

In the area of private debt restructuring, the banks are establishing specialized units to deal with troubled borrowers while the authorities are revamping their legal and operational framework to provide tools that will facilitate the voluntary workout of non-performing loans. The insolvency reform and revised foreclosure procedures are part of a broader Government strategy for dealing with mortgage arrears and should assist in cleansing unrecoverable loans from banks' balance sheets. This complements the Central Bank's Mortgage Arrears Management Framework, the Code of Conduct for borrowers and creditors, and the loan origination directive which was issued to address some major causes for the build-up of NPLs in the sector.

Finally, the stabilization of deposit outflows helped banks to improve somewhat their liquidity buffers. Similarly, the ECB's accommodative monetary policy stance and collateral policies have been broadly supportive in this process. At the same time, the authorities would welcome renewed support for unlocking cheaper liquidity that would further increase the prospect of a successful programme. In turn, this could significantly boost confidence, reduce fragmentation of the financial system and would ultimately provide new impetus to the banks' efforts to effectively support the economic recovery. In the interim, in order to provide for unexpected outflows, domestic liquidity was complemented by the authorities' approval of the issuance of guarantees of up to EUR 2.9 billion on January 27, as contingency collateral in case of need. Nevertheless, low liquidity buffers restrict the provision of credit to the private sector which had accelerated to about -10 percent y-o-y by January 2014.

In February 2014, the authorities completed the last milestone related to the second stage of relaxations under the capital controls. Building on signs of improved confidence in the banking sector, including indicators of liquidity and investor confidence, the authorities proceeded with the second stage of relaxation steps, allowing for the abolition of the measure that forced the automatic renewal of fixed-term deposits upon maturity and further increases in the limits for domestic transfers. The third stage should see all restrictive measures relating to cash withdrawals and the prohibition in the opening of new accounts removed. This is now pending on tangible progress with the implementation of BoC's restructuring plan as the other criterion, merging the 93 Coops into 18 institutions, was completed as of March 24.

Structural reforms

The implementation of the structural reform agenda has also advanced. As outlined in the report, the government is steadfastly moving forward with a comprehensive social welfare reform aimed at protecting vulnerable groups during the downturn. The scheme, inter alia, introduces a general minimum income for vulnerable groups and will be financed by consolidating and better targeting other social benefits to remain within the 2014 envisaged envelope. The authorities intend to roll out the scheme by June 2014.
Notable progress was also observed in the area of revenue administration, aimed at supporting the consolidation efforts. The reform plan, which was drawn up with the support of technical assistance from the Fund, will improve the efficiency of collection by integrating the Inland Revenue Department and VAT services into a new function-based tax administration. The enabling legislation to formally establish the new integrated tax agency will be adopted by July 2014. As a more short-term response, and to enhance voluntary compliance, a work programme of targeted joint audits that will run through the year is already in place. Moreover, on March 20, legislation was submitted to the Parliament, providing the revenue administration with the authority to seize assets, including property and bank accounts, while prohibiting the alienation or use of assets in cases of noncompliance.

In the area of public financial management the House adopted the Fiscal Responsibility and Budget Systems Law in mid-February as a prior action for this review. The Law, which is a leap toward the enhancement of transparency and accountability, provides among other things the legal basis for macro-fiscal policy-making, budget formulation approval and execution, as well as the establishment of a Fiscal Council.

Finally, despite its political sensitivity, the Cyprus Privatization Plan was adopted by the House earlier this month. This has been a landmark decision which enables the authorities to embark on the privatization process. Already, around two weeks after parliament gave the green light, the Council of Ministers launched the privatisation procedures for the Limassol port by liberalizing the port’s commercial arm. A unit to manage the privatization process will be established by mid-May while financial advisors for the major transactions, relating to the largest state-owned enterprises, will be appointed by end-September.
Overall, the government places great emphasis in the area of structural reforms and has already embarked on an overhaul, beyond the above, of the goods and services market, public administration, the pension system, the healthcare system and more. These reforms will create the conditions for Cyprus to regain its competitiveness and generate the foundation for a sustainable economic model.

Conclusion

Cyprus continues to demonstrate strong ownership and implementation of its programme. Despite the difficult environment in which the authorities operate in, the political commitment remains strong while every effort is being made to maintain strong social cohesion. Steadfast implementation has produced tangible results with indications that the healing process is already underway. While significant challenges remain as staff rightly point out, success does not seem out of reach. Numbers are ahead of profile, market perceptions have improved, banks have been fully capitalized under prudent assumptions and the authorities are investing in the future by addressing structural challenges. In terms of financing, 2014 needs are more than covered as the government has been building on its deposits while, at the same time, the significant program buffer remains intact which is conservatively embedded in the debt forecasts. The latter could comfortably cover additional fiscal needs even under a severe growth shock.

While a difficult adjustment is still ahead, with the guidance of EU and IMF staff, Cyprus has placed itself in a good position to continue along the agreed path. In support of the continuing efforts by the government and the people of Cyprus, the authorities are requesting the Board's approval of the completion of the third review and associated modifications of performance criteria.