INTERNATIONAL MONETARY FUND

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CYPRUS

June 2015

FIFTH, SIXTH, AND SEVENTH REVIEWS UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY; REQUEST FOR WAIVER OF NONOBSERVANCE OF A PERFORMANCE CRITERION; AND REPHASING OF ACCESS—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

In the context of the fifth, sixth, and seventh reviews Under the Extended Arrangement Under the Extended Fund Facility; Request for Waiver of Nonobservance of a Performance Criterion; and Rephasing of Access, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 19, 2015, following discussions that ended on May 8, 2015, with the officials of Cyprus on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on June 4, 2015.
- 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 IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
June 19, 2015

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Washington, D.C. 20431 USA

IMF Completes Fifth, Sixth, and Seventh Reviews of Cyprus' EFF and Approves €278.4 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the combined fifth, sixth and seventh reviews of Cyprus's economic adjustment program supported by the Extended Fund Facility (EFF). The completion of these reviews enables the disbursement of SDR 222.75 million (about €278.4 million), which would bring total disbursements under the program to SDR 594 million (about €742.4 million).

The Executive Board also approved a revised schedule of future disbursements and reviews, given the delay in concluding the current ones. Conclusion of the eighth review is now expected to take place during September 2015, with two more reviews following on a quarterly basis.

The three-year, SDR 891 million (about €1 billion) arrangement was approved on May 15, 2013 (see Press Release No. 13/175). Cyprus's economic program is also supported by financial assistance from the European Stability Mechanism (ESM) amounting to €9 billion.

Following the Executive Board's discussion, Mr. David Lipton, IMF First Deputy Managing Director and Acting Chair, issued the following statement:

"Cyprus's Fund-supported reform program continues to produce positive results. Economic and fiscal outcomes have been better-than-expected, with growth turning positive in the first quarter of 2015 and public finances exceeding targets. Liquidity and solvency in the banking system have improved, allowing the elimination of external payment restrictions. Going forward, it will be important to maintain the reform momentum and strong program ownership.

"Addressing the high level of non-performing loans remains an urgent priority to preserve financial stability and boost growth and job creation. In this respect, adoption of the new insolvency and foreclosure legislation is a key step. To maximize the legislation's effectiveness, it will be important to make any necessary adjustments to correct identified deficiencies that hinder implementation.

"Continued efforts are needed to strengthen banking supervision and build the capacity of the banking system to restructure loans in a sustainable manner. It is important that financial institutions continue to implement their loan restructuring plans, monitor progress on the basis of performance indicators, and address any deviations.

"The strong fiscal performance is impressive. Nevertheless, high public debt together with sizeable contingent liabilities warrants continued prudence and efforts to lock in fiscal savings from better-than-expected macroeconomic developments. Thorough implementation of the new welfare system is important to protect vulnerable groups, while public investment allocations need to be executed to support economic recovery.

"The authorities should continue to advance structural reforms to strengthen public finances and lay the ground for sustained growth. Fiscal reforms should focus on revenue administration, public financial management, and public administration. Progress in privatization and further efforts to improve the business environment and reduce unemployment are also needed", Mr. Lipton said.

INTERNATIONAL MONETARY FUND

CYPRUS

June 4, 2015

FIFTH, SIXTH, AND SEVENTH REVIEWS UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY; REQUEST FOR WAIVER OF NONOBSERVANCE OF A PERFORMANCE CRITERION; AND REPHASING OF ACCESS

EXECUTIVE SUMMARY

Economic developments have been encouraging. The recession in 2014 was milder than expected and GDP growth was positive in the first quarter of 2015 for the first time in almost four years. The fiscal outturns have exceeded program projections by a large margin. Liquidity and solvency in the banking system have improved, allowing the removal of all external payment restrictions.

Program performance has been generally strong. Compliance with quantitative conditionality has been good and the authorities have advanced structural reforms. The reviews were held up by delays in establishing a private sector debt restructuring framework, but the new insolvency and foreclosure frameworks are now in place.

Further efforts are needed to put Cyprus's economy on a sound footing. Effective implementation of the new private debt restructuring framework will be essential to address the high level of non-performing loans and, hence, to consolidate financial stability and boost growth. The authorities should maintain prudent public finances given the still-high public debt, and continue their structural reforms, which are critical to support the sustainability of public finances and growth.

Maintaining the reform momentum will be challenging. A difficult political environment could continue to complicate passage of important pending reforms.

Completion of the reviews would make available SDR 222.75 million (about €280 million). Total access under the arrangement is SDR 891 million (563 percent of quota, about €1 billion). The European Stability Mechanism has released €5.7 billion (of €9 billion committed); an additional €100 million will be disbursed upon completion of this review cycle.

Approved By
Philip Gerson and Sanjaya Panth

Discussions on the reviews started in Nicosia in July 2014 and were completed in May 2015. Fund staff 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. The team comprised M. Lewis (head), D. Velculescu (former head), R. Agarwal, S. Chen, J. Garrido, A. Hajdenberg, A. Kosonen, Y. Lu, A. Luca, J. Menkulasi, S. Pompe, N. Rendak, P. Sharma, A. Simone, M. Vazquez, and O. Wuensch. V. Guzzo and M. Heracleous (IMF resident representative office) assisted the mission. Mr. Kanaris (OED) attended some of the meetings and C. El Khoury contributed from headquarters. A. Myaing provided assistance from headquarters.

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BACKGROUND

1. **Cyprus has come a long way since the 2013 crisis, and despite delays in completing program reviews, has made significant progress in restoring financial stability and growth.** The recession in the last two years was sharp but milder than expected, and GDP growth was positive in the first quarter of 2015 for the first time in almost four years. The fiscal outturns have exceeded program projections by a large margin. Liquidity and solvency in the banking system have improved significantly, allowing the removal of all payment restrictions. Important structural reforms have been implemented. However, program reviews were held up by delays in establishing a modernized private debt restructuring framework, in particular reformed insolvency and foreclosure regimes, which encountered technical and political challenges.

2. **New insolvency and foreclosure legislation has now been adopted, paving the way for the completion of the fifth, sixth, and seventh reviews under the EFF-supported program.** Central to the success of the program is the need to reduce Cyprus's extremely high level of non-performing loans (NPLs), which reached 59 percent of total loans for the core domestic banks at end-December 2014. However, this objective was hampered by delays in the introduction of the key components of the private debt restructuring legal framework. While the foreclosure law was passed last September by Parliament, it was then suspended, thereby preventing completion of the fifth review under the EFF arrangement. The suspension reflected, in part, concerns in Cyprus that this law would benefit creditors by accelerating foreclosures, but without adequate safeguards in place for vulnerable borrowers in the absence of an updated insolvency framework.[1] In turn, the package of insolvency laws (a structural benchmark for end-December 2014) was delayed due to its technical complexity and lengthy political deliberations. The insolvency legislation was eventually adopted in April, at which point the suspension of the foreclosure law was lifted. The implementing regulations for the foreclosure law—necessary for actually carrying out foreclosures—were then adopted in mid-May. Some provisions introduced during the parliamentary process could weaken the effectiveness of the insolvency and foreclosure frameworks. The frameworks will in any case need to be adjusted over time based on practical experience. Nevertheless, their adoption is a crucial step towards establishing a modern legal framework to deal with the NPLs. The authorities' reform progress in these areas matches the sequence envisaged under the schedule of reviews.

3. **Program performance in other areas has been generally strong.** Economic and fiscal outcomes have been significantly better than expected at the time of the fourth review, reflected in all but one of the performance criteria (PC) being comfortably met.[2] The authorities have made good

[1] The fourth review envisaged that amendments to the foreclosure law would be in place by end-June 2014, with provisions for primary residences entering into effect in December, together with the new insolvency framework.

[2] Due to the delay in completing the reviews, the controlling PCs are those for end-September 2014. Original test dates for the fifth, sixth, and seventh reviews were end-June, end-September, and end-December, respectively.

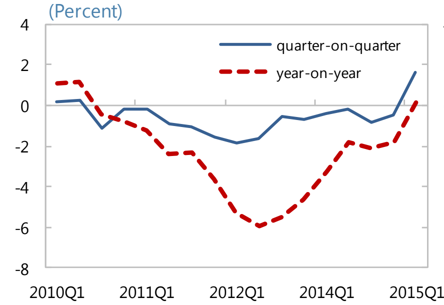
progress on their structural reform agenda, implementing most structural benchmarks, even if with some delays.

4. A difficult political environment could continue to complicate passage of important reforms during the remainder of the program. The authorities' commitment to the program and its objectives remains high. However, with the governing party in a minority position in Parliament and the May 2016 legislative elections already in sight, securing sufficient support will be difficult. This poses challenges for reforms in the areas of privatization and public administration and for further steps to assist clean-up of private sector balance sheets.

RECENT ECONOMIC DEVELOPMENTS

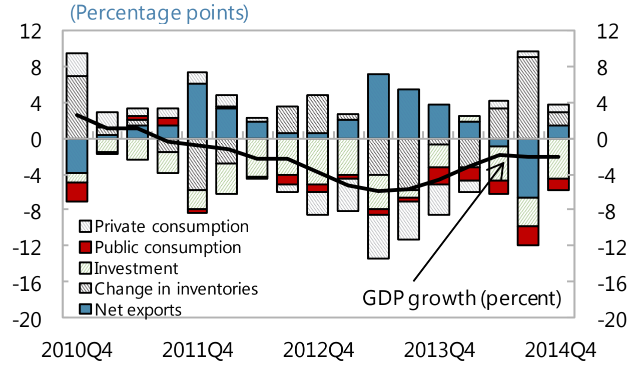
5. Cyprus returned to positive growth in the first quarter of 2015 after almost four years of contraction. Despite a weak second half of 2014 due to headwinds from Russia and uncertainty about the prospects of the authorities' program, the contraction last year was milder than expected. Output declined by 2.3 percent (compared to a 4.2 percent decline envisaged during the fourth review and 3.2 percent projected at the time of the 2014 Article IV Consultation), reflecting more resilient private consumption. On the supply side, construction and financial services contributed most to the contraction (text figure). The preliminary estimate for the first quarter of 2015 indicates that the economy expanded by 0.2 percent year-on-year (1.6 percent quarter-on-quarter) on the back of a positive performance of the service sector, reversing the weakness seen in the latter part of 2014 **(Figure 1)**. The unemployment rate has remained high (15.6 percent in April), but below the fourth review forecast **(Figure 2 and Box 1)**. Deflation accelerated to 1.7 percent in April, reflecting declining energy prices but also still-weak economic conditions, with core inflation at -0.8 percent. The external current account deficit widened in 2014, reflecting a deteriorating trade balance, due mainly to a recovery of imports **(Figure 3)**.

GDP Growth
(Percent)

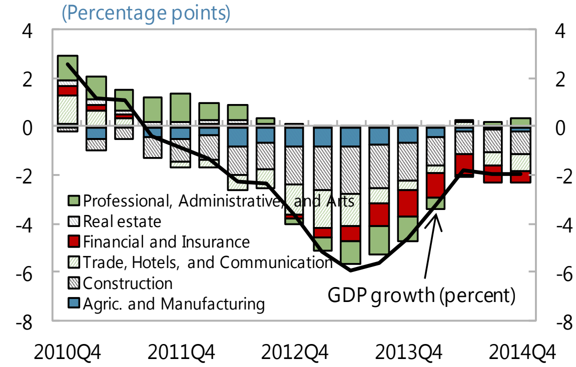


Source: Cystat.

Contributions to GDP Growth-Demand Side
(Percentage points)



Contributions to GDP Growth-Supply Side
(Percentage points)



Sources: Cystat; Eurostat; and IMF staff estimates.

6. The banking system has continued to stabilize, but the high level of NPLs remains a key weakness (Figures 4 and 5):

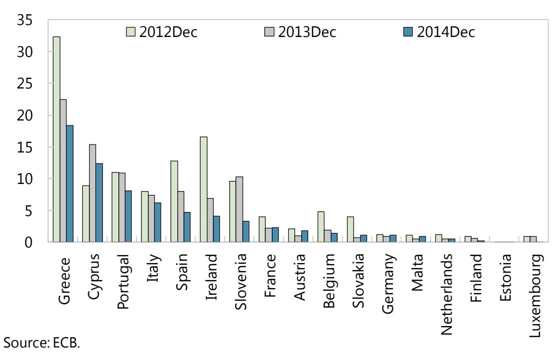
- **External payment restrictions.** The external restrictions introduced in 2013 in the wake of the banking crisis were gradually relaxed starting in December 2014 and were fully eliminated in April.

- **Capitalization.** Banks have been adequately capitalized relative to the adverse macroeconomic scenario of last year's comprehensive assessment performed by the ECB (encompassing an asset quality review and stress tests), including through the injection of €1 billion and €0.2 billion from private sources into Bank of Cyprus (BoC) and Hellenic Bank, respectively. The average core tier 1 (CET1) ratio of the system at end-2014 was 14.2 percent compared to 12.1 percent at end-2013. The adequacy of capital buffers remains contingent on continued progress in resolving NPLs.

- **Deposits.** The banking system as a whole has experienced small deposit inflows this year. Deposits in the core domestic banks have increased, reversing the trend of previous years, although subsidiaries of Greek banks (representing about 14 percent of total deposits) have experienced moderate outflows in recent months. The elimination of external restrictions had no material impact on deposit flows.

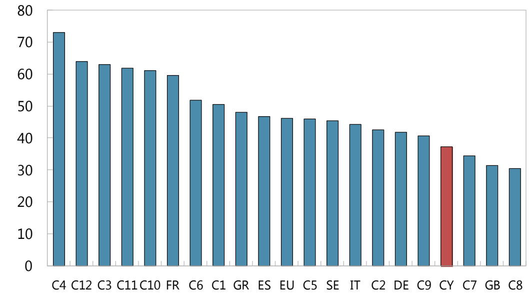
- **Liquidity.** Overall system liquidity has improved significantly. Buffers of domestic banks at end-March were 10 percent higher (€0.9 billion) than at end-2014. In addition, reliance by BoC on ELA has declined by €4.9 billion (about 28 percent of GDP) relative to its peak in 2013Q1, although it remains high at 37 percent of GDP. The Greek subsidiaries remain liquid and maintain only a small exposure to Greek assets and counterparties.

Central Bank Funding as a Share of Credit Institutions Liabilities 1/
(Percent)

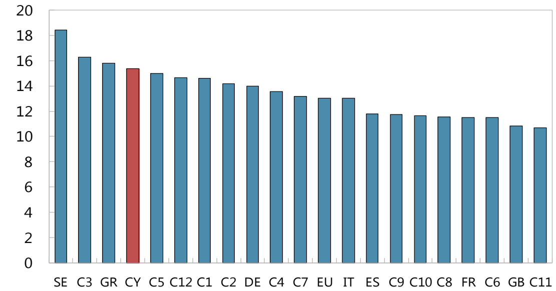


Source: ECB.
1/ Only euro area countries with nonzero central bank funding are represented.

- **Non-performing loans.** The NPL ratio in the core domestic banking system (59 percent of gross loans at end-2014, or 134 percent of GDP) was largely unchanged in the last quarter of last year, and loan restructuring has proceeded slowly across the core banks. Provision coverage of NPLs remained at 37 percent for core domestic banks. While this ratio is lower than the European average of 46 percent, it is in part offset by the higher capital buffers (text chart).

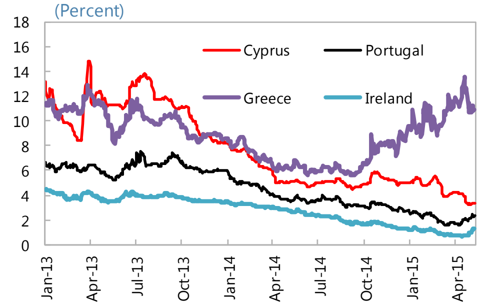


Sources and Notes: European Banking Authority (EBA). EBA discloses name of country if reporting institutions are more than 3.



- **Credit and interest rates.** In line with expected continued deleveraging, credit to the domestic nonfinancial private sector is still falling, although slightly (0.5 percent year-on-year in April). At the same time, in the context of improved liquidity, weak credit demand, and the CBCs decision to decrease the maximum deposit rate by one percentage point, interest rates on loans and deposits have gone down markedly.

7. **Cyprus placed debt in the sovereign market for a second time since the crisis.** In late April, Cyprus raised €1 billion through the issuance of a 7-yearbond at a yield of 4 percent. The proceeds will be used to repay more expensive outstanding debt, resulting in a lower interest bill and a smoother repayment profile over the medium term. Adoption of the insolvency legislation package and its positive implications for resumption of program reviews and the prospect of Cyprus's participation in the ECB's QE contributed to a decline in Cyprus's yields, which have decoupled further from Greece's, but still remain slightly above those of European former program countries. In addition, the T-Bill market has been reactivated, with domestic short-term yields showing significant declines (2.5 percent in the latest auction compared to an average of over 4 percent in 2014).



1/ 10-year government bonds. For Cyprus, longest maturity available
Source: Bloomberg

REPORT ON THE DISCUSSIONS

8. **The discussions focused on the macroeconomic outlook and policy priorities for the last year of the program.** The main focus was on (i) promoting NPL workouts through legal and supervisory measures and supporting bank restructuring; (ii) fiscal policy in 2015 and the medium term; and (iii) structural reforms to ensure fiscal sustainability and support growth.

A. Macroeconomic Outlook

9. **A gradual recovery is expected to take hold in 2015.** Modest growth of 0.2 percent is projected for the current year, with weaker demand from Russia and Greece expected to be offset by

an increase in demand from the EU **(Box 2)**. The regional concerns are expected to weigh on private consumption and investment. Conversely, the effect of lower energy prices on households' purchasing power is expected to support private consumption. Growth is projected to pick up in 2016, and then stay at around 2 percent in the medium term—well below pre-crisis rates of growth. This growth path reflects subdued private consumption and investment growth over the medium-term given the deleveraging needs of the private sector. As discussed in previous reports, the recovery is expected to be credit-less and led by service sectors less reliant on credit, such as tourism and non-financial business services.[3]

10. The unemployment and inflation projections have been adjusted downwards. Consistent with the lower observed level, the unemployment path has been shifted down relative to previous projections, and a gradual decline is projected for subsequent years as employment picks up. Deflation is expected to moderate as the impact of lower oil prices subsides, averaging 0.8 in 2015. Positive inflation is projected from 2016 onwards as domestic demand and wages gradually recover.

Selected Economic Indicators
(Percent change, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020
					Projections			
Real GDP	-5.4	-2.3	0.2	1.4	2.0	2.2	2.1	1.8
Consumption	-5.8	-1.6	0.0	0.8	1.0	1.3	1.2	1.0
Private consumption	-6.0	0.4	0.4	1.1	1.2	1.5	1.3	1.0
Public consumption	-4.9	-8.7	-1.7	-0.8	-0.2	0.8	1.0	1.0
Fixed investment	-17.1	-18.8	-0.9	3.6	4.0	4.5	4.2	3.6
Inventory accumulation 1/	-2.4	2.7	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	4.7	-1.0	0.3	0.3	0.7	0.6	0.6	0.6
HICP (period average)	0.4	-0.3	-0.8	0.9	1.3	1.5	1.8	1.9
Unemployment rate (EU standard; percent)	15.9	16.1	16.1	15.1	13.8	12.5	11.2	10.2

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

11. Risks to the outlook are balanced:

- **Domestic risks.** Slow progress in implementing the new private debt restructuring framework and addressing NPLs could delay balance sheet repair and credit expansion, holding back the recovery and constraining medium-term growth. Persistence of deflation could further weigh on stressed private sector balance sheets. On the upside, some indicators (e.g., consumption related tax collections, market sentiment) as well as the surprisingly strong 2015 first quarter GDP data point to a faster-than-projected pick up of economic activity.

- **External risks.** A protracted period of turmoil related to Greece could affect Cyprus through direct spillovers on the financial system, more general confidence effects, or an impact on EU external demand. Notwithstanding any decisive euro-area wide policy response, it would be difficult for Cyprus to avoid altogether adverse effects of developments related to Greece. A

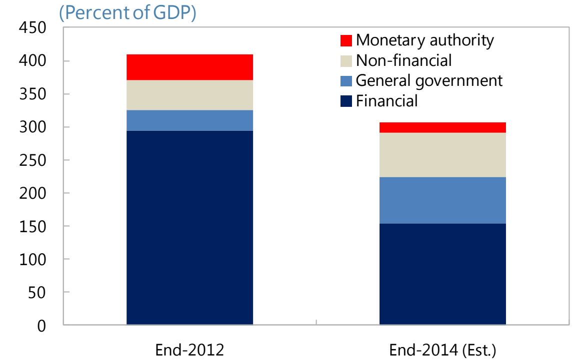
[3] See IMF Country Reports 14/313 and 14/314, including for a discussion on potential growth.

deeper recession in Russia and/or further depreciation of the ruble could affect Cyprus's business and tourism sectors beyond the baseline assumptions. Regarding Greece, while financial links have been significantly reduced, the authorities are monitoring the situation closely. Completing the reviews will be an important step in insulating Cyprus from broader contagion risks by ensuring available financial and liquidity support, and boosting confidence. Upside risks center on more robust external demand or greater compression of yields, for example, due to the positive impact of the ECB's QE, or if the downturn in Russia is milder than foreseen **(Box 2)**.

12. The public debt profile has improved significantly, although risks remain (Annex 2). At end-2014, public debt stood at 107 percent of GDP, compared to the fourth review forecast of 120 percent. The bulk of the improvement derives from (i) a 10 percent upward revision of nominal GDP due to the adoption of the ESA 2010 methodology for national accounts[4] and (ii) deferred ESM disbursements in light of the strong fiscal outturn and lower bank recapitalization needs. Going forward, debt is projected to decline gradually to close to 80 percent of GDP by 2020 (compared to an initial program forecast of 105 percent of GDP), reflecting no further bank recapitalization needs.[5] However, contingent liabilities associated with government guarantees on bank loans (17 percent of GDP), implicit contingent liabilities associated with the banks' reliance on central bank financing (48 percent of GDP), and the non-materialization of privatization proceeds and the debt-to-asset swap (12 percent of GDP) are potential risks.

13. External debt has declined further, but remains a source of vulnerability (Figure 7 and Table 11). It dropped to around 300 percent of GDP at end-2014 from 327 percent of GDP the year before (and a peak of 447 percent of GDP in 2010), largely reflecting the decline in ECB financing to the banking sector. Cyprus's external debt remains sensitive to shocks, in particular to interest rates and growth. The net international investment position (IIP) deteriorated to -84 percent of GDP in 2014 from -78 percent of GDP in the previous year, reflecting mainly a decline in holdings of foreign assets[6].

External Debt
(Percent of GDP)



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

B. Financial Sector Policy

14. Addressing the high level of NPLs remains an urgent priority for a stronger financial system and sustained growth. With NPLs at unprecedented levels and some evidence of strategic

[4] See Country Report 14/313, Supplement 3.

[5] The projection assumes the program buffer will be disbursed toward the end of the program period, after risks have subsided and the need for bank recapitalization has not materialized. It is thus envisaged that the buffer could be used for liability management operations to smooth the medium-term debt profile, which will not lead to an increase in gross debt issuance.

[6] IIP data estimated from CBC BPM6 data excluding special purpose vehicles.

default by borrowers (see Country Report No. 14/313, ¶27), tangible progress on loan restructuring is vital to prevent an erosion of banks' balance sheets and to set the conditions for renewed credit growth and economic recovery (**Annex I** outlines the nature of Cyprus's NPL problem, and assesses the impact of the new private debt restructuring framework). Progress on reaching restructuring solutions has been slow largely due to a lack of incentives for borrowers and lenders to negotiate, including a foreclosure process taking years (resulting in almost no foreclosures to date), banks' capacity constraints and outdated corporate restructuring and personal bankruptcy procedures.

15. The newly-established debt-restructuring framework is a major step forward, but needs to be followed by effective implementation (MEFP ¶3). The new mortgage law streamlines the foreclosure procedure by allowing the sale of loan collateral to be conducted by mortgage creditors, without the involvement of government agencies, to ensure a balanced but swift process. Regarding the new insolvency legislation **(Box 3)**, the new law on personal insolvency provides tools for viable individual debtors to restructure their debt while keeping, where possible, their primary residence. The amended bankruptcy law would provide a "fresh start" to debtors after three years, under certain conditions. Finally, the new corporate examinership law should be conducive to restructuring of viable businesses. Together, these reforms should provide balanced incentives to borrowers and lenders to engage in restructuring discussions as well as the necessary tools to advance deleveraging. Banks are expected to use the foreclosure regime sparingly. To protect vulnerable groups, the recently introduced guaranteed minimum income scheme provides a safety net. The authorities are working on several fronts to address the remaining challenges:

- **Implementation.** With the legislation now in place, an immediate priority is to make the new foreclosure and insolvency frameworks operational. To this end, the remaining administrative acts and regulations needed to ensure the functioning of the insolvency regime will be adopted by end-August 2015 (**new SB**). In particular, the new Insolvency Service should be established and adequately staffed, and the cadre of insolvency practitioners (IPs)—who act as intermediaries between debtors and creditors in various insolvency procedures—should be recruited and licensed. In addition, for the new foreclosure and insolvency procedures to be effective, adequate court capacity and effective procedures are necessary. To this end, the authorities plan to review the civil procedure and court rules (by end-July in the case of foreclosures and end-September for insolvencies) to ensure they do not hinder the implementation of the new procedures. The authorities have also recently established a voluntary mediation process under the auspices of the financial ombudsman, the implementation of which should facilitate a balanced and swift debt-restructuring process. The roll-out of the new framework will take at least several months: while some procedures, such as foreclosures or debt relief orders, may be implemented relatively quickly, personal repayment plans and corporate examinerships will take more time to materialize and are not expected until the end of the year at the earliest.

- **Review and monitoring.** The new insolvency framework draws on the best international practices and cross-country experiences and is generally an important step forward. However, some of the provisions introduced during the Parliamentary discussions deviate from international norms and risk weakening the effectiveness of the new frameworks. For example, provisions allowing debtors who are considered nonviable to apply to court to suspend debt enforcement and bankruptcy procedures for up to six months may result in unjustified delays. Also, the new legislation limits the liability of the guarantors without due regard to their payment capacity. Regarding the foreclosure framework, last minute amendments to the law giving the mortgage debtor a preferential right to buy back the mortgaged property at the foreclosure auction are not commonly found in similar laws in other countries and may weaken payment discipline and lead to strategic behavior by debtors. The authorities have committed to review the legal framework by end-September (**new SB**) with the view to address the identified weaknesses and to make any other necessary adjustments. A comprehensive review of the framework will be conducted in early 2016 based on experience with its implementation.

- **Title deeds.** Procedural impediments and high costs have led to an increasing discrepancy between the economic ownership of real estate and the formal possession of titles. For a large number of transactions, titles have not been issued or transferred to the current owner (e.g., when a real estate developer has purchased a large piece of land and then sold new apartments to individual homeowners). This increases legal uncertainty for buyers and risks for lenders, and opens avenues for abuse. In addition, it complicates loan restructuring and obfuscates collateral quality, while also distorting the real estate market, as untitled properties are difficult to sell. The authorities are tackling the transfer issue from two fronts: first, to deal with the legacy issue, as well as future property transactions, a draft law will be prepared and approved by the Council of Ministers (COM) by end-June 2015 (**new SB**) establishing a rules-based procedure to facilitate the transfer of the title to those buyers that have paid the seller in full; and second, to prevent a re-emergence of this problem, the authorities will also develop statutory and contractual standards that incentivize and facilitate the swift transfer of titles in a property sale. The authorities are also reviewing procedures to streamline the issuance of titles.

16. Supervisory tools to deal with NPLs also need to be strengthened (MEFP ¶4). The program strategy to address the high level of NPLs is centered on strengthening banks' capacity to address problem loans on a case-by-case basis. Significant progress has been achieved, including through the establishment of large-scale internal workout units at banks and sector-wide standards defined in the Arrears Management Framework and the "Code of Conduct". However, making inroads into solving the problem will take time. The adequacy of capitalization and provisioning levels relies on banks being able to meet the restructuring and recovery assumptions underlying the EU Comprehensive Assessment. This will require progress in the following areas:

- **Loan restructuring targets.** The CBC has designed a new framework to incentivize loan restructuring, to enable prompt monitoring of restructuring progress and require corrective action as needed. To this end, the CBC and the banks will agree on forward-looking performance targets. The targets and the banks' performance against them will be published quarterly, for the first time by end-July (**new SB**). To ensure restructuring performance is adequately reflected in banks' financial planning, banks are required to update quarterly their capital budgets and to adjust provisioning levels commensurate with their actual restructuring performance.

- **Sustainability of restructuring solutions.** To ensure that loan restructuring is underpinned by realistic assumptions about the borrower's financial situation (and prevent "evergreening"), the CBC is performing semi-annual bank audits to analyze the sustainability of concrete restructuring cases. Results will be made available to the ECB's Single Supervisory Mechanism (SSM) for the first time by end-June, with a view to implementing any necessary corrective actions.

- **Instruments to facilitate bank asset sales.** The sale of NPLs to other investors would speed up balance sheet clean-up. To enable engagement of non-banks, operational preconditions for servicing loans need to be established. Most importantly, the legal framework needs to be modernized to allow for the sale and securitization of assets and their servicing by third-parties, while providing for adequate risk oversight and protection of borrowers. In particular, by end-June 2015, the COM will approve legislation to enable the sale of loans to non-banks, while retaining the protections of borrowers offered under the Code of Conduct.

17. Efforts to restructure the cooperative credit sector should continue (MEFP ¶5). The cooperative credit sector ("coops") has undergone significant transformation since 2013. 93 individual cooperative credit institutions (CCI) have been merged into 18 entities, and the Cooperative Central Bank (CCB) has become the sector's head office. Going forward, additional steps are needed to: (i) improve the sector's governance and ensure the CCB can fulfill its expanded role; (ii) strengthen the sector's arrears management capacity; and (iii) upgrade the sector's financial management, risk and control functions (now under the CCB). The CCB will prepare time-bound action plans by end-June to address the first two issues and an implementation strategy by end-July to address the third one.

18. Further steps are needed to strengthen banking supervision and finalize the resolution of Laiki Bank (MEFP ¶7).

- **Banking supervision.** The SSM, which is responsible for overseeing the banks in Cyprus, has prepared an ambitious supervisory agenda for 2015, focusing on credit risk and NPLs, as well as the financial control functions of banks. Yet, the CBC will retain important responsibilities. To this end, it has hired additional staff and will, by end-June, further review its capacity needs.

- **Laiki.** The bank has been under resolution for more than two years. Liquidation should commence as soon as possible to allow the payout of creditors. However, the need to preserve value in Laiki's bank holdings abroad and to prudently manage Laiki's large stake in BoC has delayed the process. An advisor has now been appointed to support the sale of Laiki's foreign operations, and by end-June a plan will be presented that covers the liquidation of all assets.

19. The authorities are planning to improve the governance and organization of the central bank. The current governance framework of the CBC has not undergone significant revisions since its inception and warrants updating. In a first stage, the CBC has hired an external advisor to assist in the reorganization of the bank including high-level governance arrangements.

20. The authorities have identified significant deficiencies in the supervision of pension funds and insurance companies (MEFP ¶8). As a first step, a report currently under preparation will outline the future landscape of insurance and pension funds oversight, also providing an inventory of the fragmented pension fund system. Necessary legislation will be submitted to Parliament by the end of the year to implement the report's findings.

21. Progress on the effective implementation of the AML/CFT framework needs to be sustained (MEFP ¶9). The authorities carried out on-site inspections of 11 banks in 2014 and Parliament has adopted amendments to the Company Law to simplify registration and de-registration of non-compliant companies and strengthen the registrar's enforcement powers. The registrar will update corporate data and fully implement the governmental action plan. Further work is required in supervising banks and professions and in enhancing the transparency of companies by reforming their registrar. Banks and professions supervisors will continue bolstering institutional and staff capacity, and regularly coordinating with the relevant prudential supervisor of banks. In relation to the branch of FBME operating in Cyprus, the CBC needs to continue taking any appropriate actions, based on the results of a recent inspection, to minimize reputational and financial risks

C. Fiscal Policy

22. With a cash primary surplus of 2.8 percent of GDP, the fiscal outturn in 2014 was significantly stronger than anticipated (MEFP ¶10). This outcome—relative to the 1.6 percent of GDP deficit targeted during the fourth review—reflects largely permanent factors, although also some one-offs **(Box 4)**. The 2014 outcome represents a 4½ percent of GDP improvement relative to 2013, and was notably achieved despite the contraction of economic activity.

23. The cash primary balance target for 2015 of 1 percent of GDP reflects several one-off factors (MEFP ¶11), and represents a broadly neutral fiscal stance. The one-off factors include (i) high CBC dividends in 2014; (ii) the payment of the remaining compensation to pension funds for losses arising from the deposit bail-in; (iii) a retroactive contribution to the EU budget due to the upward revision of the GDP series; and (iv) upfront costs related to the closure of Cyprus Airways. The target also reflects the adverse impact on revenue of the entry into force of an EU directive changing the taxation of certain services to a consumption-place basis and the payment by the banks of a contribution to the European National Resolution Fund rather than into the budget (text table). Given limited fiscal measures (mostly legislated at end-2012) and negligible automatic stabilizer effects given still-low growth, the targeted balance represents a broadly neutral fiscal stance for 2015 **(Box 5)**, which was deemed adequate given the adjustment already implemented. Automatic stabilizers would be allowed to operate if the economy underperformed relative to the forecast.

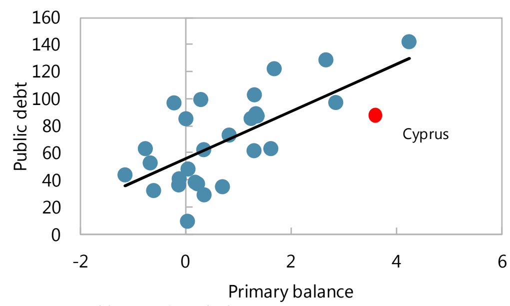
Change in the Primary Balance between 2014 and 2015
(Percent of GDP)

Total	**-1.9**
One-off items	**-1.5**
Unusually high central bank dividends in 2014	-0.4
Compensation of pension funds	-0.4
Upfront Cyprus Airways closure outlays	-0.3
Payment of retroactive EU budget contribution due to increased ESA 2010 GDP	-0.2
Unusually high 2014 company tax revenue due to register clean up	-0.1
Other items	**-0.6**
VAT taxation changed from place of supply to place of consumption	-0.3
Contribution to European National Resolution Fund	-0.2
GMI costs	-0.1
Offsetting factors with favorable impact on the primary balance	**0.2**

Sources: Ministry of Finance; and IMF staff estimates.

24. Consistent with ensuring fiscal sustainability, the authorities will target a long-term primary surplus in a range of 3 to 4 percent of GDP, which will bring debt below 80 percent of GDP in 2020 (MEFP ¶11). The program's fiscal strategy was anchored on reducing the debt-to-GDP ratio to close to 100 percent by 2020, which required sustaining a primary surplus of 4 percent of GDP from 2018 onwards. In view of the revised debt path (as described in ¶12), there was agreement that a long-term primary surplus of between 3 and 4 percent of GDP would still be consistent with ensuring that public debt converges to a prudent level.[7] With this primary surplus target, debt would reach 80 percent of GDP in 2020 and continue declining thereafter. Recognizing that one factor behind the lower debt profile is the upward revision of nominal GDP, which does not alter repayment capacity, debt would remain within the range of what was deemed sustainable at the beginning of the program (i.e., 70–100 percent of GDP) for a country like Cyprus with a large banking sector and significant contingent liabilities. Primary balance targets for 2016–17 were set at 2.4 and 3 percent of GDP, respectively, but could be revised if future events jeopardize the medium-term target.

Primary balance and public debt in the EU, 2018 forecast
(Percent of GDP)



Source: World Economic Outlook.

D. Structural Reforms

25. The authorities will build on the progress to date on their structural reform program, focused on strengthening public finances and supporting growth (MEFP ¶12–16 and Tables 12 and 13):

[7] The precise target will be specified in the 2016-18 budget framework and should be consistent with Cyprus's obligations under the EU's Stability and Growth Pact. For the purposes of the macroeconomic framework, the primary surplus from 2018 onwards is assumed to be 3½ percent of GDP.

- A ***guaranteed minimum income scheme*** (GMI) to support vulnerable groups affected by the crisis was introduced in July of last year (**end-June 2014 SB**). The authorities will carefully monitor the implementation of the new social welfare system including an assessment of targeting accuracy and coverage of the GMI, as well as building a national benefit registry to detect and prevent abuse;

- A new ***public debt management strategy*** to guide the authorities' actions in this area (**end-October 2014 SB**) has been approved by the COM. In addition, to improve the management of fiscal risks arising from guarantees (17 percent of GDP), a database of government guarantees has been completed, initial quarterly risk assessment reports have been prepared, and the institutional framework to manage guarantees has been designed. The authorities intend to adopt the new government guarantee management framework (**new end-June 2015 SB**);

- In line with the ultimate objective of improving the ***efficiency of revenue collections***, senior officials have been appointed to head the new unified tax department, a large taxpayer office has been established (**end-December 2014 SB**), and a new tax debt recovery plan is being implemented, including by exercising (on a pilot basis) new collection enforcement powers. Looking ahead, the authorities will complete the merger of the tax departments, strengthen the large taxpayers office, and develop a new tax procedure code, while making sure that revenue collections are protected during the integration of the tax departments;

- The authorities are proceeding on a reform of the ***public administration*** that ensures the affordability of the public wage bill (once the transitory freeze of wages and hiring limits implemented during the program expire) and addresses distortions in public sector compensation and staffing (**new end-December 2015 SB**);

- Preparations for the ***privatization of state-owned enterprises*** have advanced, including through the appointment of advisors for the privatization of the telecommunications company and the commercial activities of the Limassol port;

- An ***action plan to improve the business environment and promote growth*** is being implemented. The plan, adopted by the COM last February, complements the efforts to restore financial stability and strengthen public finances to set the basis for sustained growth. The plan has two pillars: (i) improving the overall business environment, including through streamlining regulations and cutting red tape; and (ii) addressing bottlenecks impeding growth of the tradable sector.

PROGRAM MODALITIES

26. All but one of the performance criteria were met and compliance with structural conditionality has been broadly on track. All end-September 2014 PCs and continuous PCs have been met, except for the PC on accumulation of general government debt which was missed due to a delay in finalizing the asset swap between the government and the CBC associated with the valuation of the properties involved (MEFP Table 1). The swap is now in its final stages and is expected to be finalized in Q3 of 2015. Most SBs have been implemented, albeit with some delays (Table 10). The SB related to legacy Laiki was missed. As noted in ¶18, a new plan is being designed in this regard.

27. New conditionality and the rephasing of the remaining purchases under the arrangement are being proposed (Table 9 and MEFP Tables 1 and 3):

- **Prior action.** The amended foreclosure law was adopted in September 2014 (Technical Memorandum of Understanding, "TMU", ¶15). Its suspension was lifted in April 2015.
- **Quantitative PCs.** Quarterly PCs through end-December 2015 are proposed.
- **Structural benchmarks.** As outlined in the previous sections, six new SBs are proposed.
- **Rephasing of arrangement.** Given the delays in concluding the reviews, a rephasing of the purchases under the arrangement is proposed. The availability date for the purchase under the eighth review would be set for September 15, 2015, with two more reviews following on a quarterly basis.

28. Risks to program implementation remain:

- **Risks.** Opposition to program policies from political parties and vested interests (bound to further intensify as legislative elections approach) could obstruct pending reforms. In the financial sector, implementation of the new and untested debt restructuring framework could be hampered by legal obstacles and limited capacity, delaying the process of balance sheet repair.
- **Mitigating factors.** The authorities' strong commitment to the program and Cyprus's track record of implementation provide some reassurance about policy implementation going forward. Regarding private sector debt restructuring, the authorities are building the capacity of actors involved, while a full review of the framework to ensure its effectiveness is planned for early next year.

29. Financing assurances for the program remain in place. The program is expected to be fully financed through its completion. Available government deposits of about €0.8 billion at end-April, together with expected proceeds of €0.1 billion from the transfer of the coinage function from the CBC to the Treasury by year-end, expected transfer of €0.1 billion central bank dividends in 2016, expected privatization proceeds (€0.5 billion) during the program period, and undisbursed funds from the ESM/IMF more than cover the €2.7 billion in projected financing needs through May 2016.

30. Capacity to repay the Fund is comfortable, contingent on maintaining the reform path (Table 8). The macroeconomic outlook, public finances and debt outlook are all stronger relative to the fourth review. The return to the capital markets, if sustained, would facilitate repayment to the Fund. Recent debt management operations have reduced immediate post-program financing needs.

Debt service to the Fund relative to GDP and exports remains manageable. Peak exposure to the Fund occurs in 2016 at 563 percent of quota or 6 percent of GDP.

STAFF APPRAISAL

31. **The authorities have made major strides on their reform program, and their strategy is bearing results.** Liquidity and solvency in the banking system have improved, public finances are on a stronger footing, and important structural reforms are being implemented. The economic contraction in the past two years, while severe, was milder than projected and for the first time since mid-2011, growth has turned positive in the first quarter of 2015. The ongoing normalization of the banking system has also allowed the complete removal of external payment restrictions. These encouraging developments reflect improving confidence underpinned by continued progress with policy implementation.

32. **Risks to the program are manageable, but the challenge is to maintain the reform momentum in the face of a difficult political environment.** Political obstacles to adopt the new private debt restructuring legislation were overcome, although at the expense of some deviations from international norms. Going forward, it will be crucial that vested interests and reform fatigue do not derail the reform efforts. Otherwise, this could threaten the recovery and the consolidation of financial stability, and hinder Cyprus's efforts to raise a trajectory of slow growth.

33. **Solving the NPL problem is essential to ensure financial stability and boost growth.** Adoption of the new insolvency and foreclosure legislation is a key step in the right direction, but its effective implementation will be similarly critical. If successful, this will encourage both lenders and borrowers to negotiate and restructure loans on mutually beneficial terms, which in turn will free up new lending, a necessary step to achieve a stronger recovery and boost long term growth prospects. To ensure the framework's effectiveness, it will be important to make the necessary adjustments to correct identified deficiencies and other issues that may arise in practice. Other steps, including easing asset sales restrictions and addressing the backlog of un-issued and un-transferred title deeds, will likewise be essential to facilitate NPL management.

34. **Further efforts to strengthen banking supervision and restructure banks are needed.** Banks and coops should continue to implement their restructuring plans and arrears management frameworks, monitoring their progress on the basis of well defined indicators and addressing any deviations. The CBC should continue to strengthen its supervisory capacity, in partnership with the SSM.

35. **Fiscal performance has been strong, but continued prudence in public finances is warranted.** Fiscal outturns significantly exceeded expectations in 2014, putting Cyprus well ahead on its medium-term fiscal adjustment path. However, with public debt and contingent liabilities still high, there is no room for complacency. Prudent budget execution and efforts to lock in fiscal savings from better-than-expected macroeconomic developments should continue. At the same time, thorough implementation of the new welfare system is important to protect vulnerable

groups, while public investment allocations need to be executed to support economic recovery.

36. The ongoing structural reform program is crucial for public finances and growth. The tax administration and public financial management reforms will help to increase the tax base and support the management and allocation of public resources. The privatization reform will be fundamental to boost efficiency and attract investment. The reform of the public administration should ensure the sustainability of the wage bill after the expiration of the program and enhance government efficiency. The authorities should also move forcefully to address weaknesses in the business environment to support growth prospects.

37. On the basis of the progress achieved under the program and policy commitments going forward, staff supports: (i) the completion of the combined fifth, sixth, and seventh reviews; (ii) the request for a waiver of the nonobservance of a performance criterion as the deviation was temporary and minor; (iii) the establishment of performance criteria through end-December 2015; and (iv) the rephasing of purchases under the arrangement.

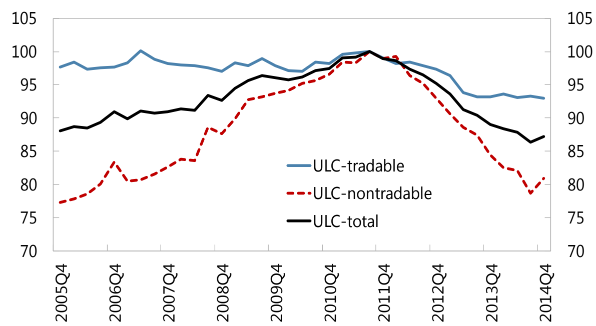
Box 1. Recent Labor Market Developments

The labor market in Cyprus is stabilizing. Two factors have helped—wage cuts cushioned the fall in employment; and other nationals have been leaving the labor force. However, the labor market remains fragile.

The labor market appears to have turned the corner. Following a stabilization in the second quarter of 2014, employment in the fourth quarter picked up by 1.2 percent year-on-year with a slight increase in the labor force participation rate. The unemployment rate has stabilized at 16 percent (see Figure 2).

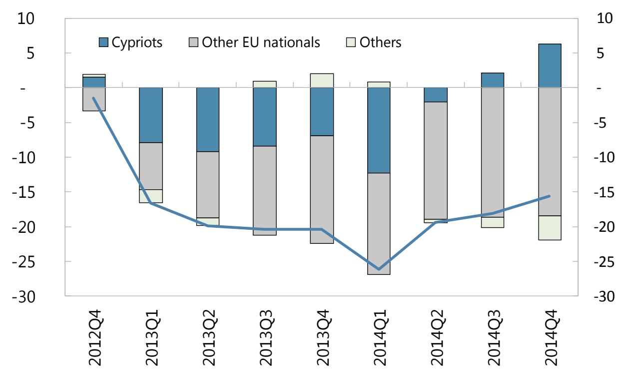
A downward adjustment in labor costs may have helped to mitigate some of the adverse impact of the crisis on jobs. Due to wage cuts, unit labor costs (ULCs) in the last quarter of 2014 were 13 percent below their peak in 2011. This decline was more pronounced in the nontradable sector, driven mainly by public sector wage cuts.

Unit Labor Costs
(2011Q3=100)



Sources: Cystat; ECB; Eurostat; Haver; and IMF staff estimates.
Note: The tradable sector includes agriculture; industry (excluding construction); trade, travel, accommodation, and food; information and communications; financial insurance; and professional services, science, and technology.

Cumulative Employment Change
(Relative to 2012Q3, thousands, NSA)



Sources: Cystat; and IMF staff estimates.

Cypriots fared the crisis better than other EU nationals employed in Cyprus. Almost all the net jobs lost over 2012Q4–2014Q1 were those held by other EU nationals. Their share in employment declined from 13½ percent to 10 percent over this period. As of 2014Q4, Cypriot employment had picked up by 4½ percent year-on-year, while employment of other EU nationals declined by 7½ percent. This could be explained by the large corrections in the construction sector, which prior to the crisis attracted migrants from other EU countries. Incidentally, the less-distressed labor markets for Cypriots may have also supported private consumption.

Notwithstanding the recent increase in employment, the labor market remains fragile. The unemployment rate remains three times its pre-crisis long-run average of 4¼ percent (2000–08). The youth unemployment rate, at 33 percent, is the fourth highest in the euro area, although it has declined from its peak in 2013. The long-term unemployment rate, below one percent prior to the crisis, has climbed to almost 8 percent, highlighting risks for medium term growth.

Box 2. Impact of External Spillovers on the Near-Term Baseline Outlook

The near-term outlook for Cyprus is subject to a set of countervailing external shocks. On one hand, the economy is facing headwinds from Russia and, to a lesser extent, Greece. On the other hand, the outlook is benefiting from the trifecta of lower oil prices, a weaker euro, and a stronger EU recovery compared to the outlook in the 2014 Article IV Consultation. All these factors are built into the baseline outlook, and overall, the estimated net impact of these developments on growth this year is close to zero. Risks to the outlook center on whether these shocks diverge from the baseline assumption.

Russia is an important source of spillovers for Cyprus, primarily through trade and FDI. Cyprus's exports to Russia in 2013 represented about 17 percent of exports (9 percent of GDP), up from 6 percent in 2007. Tourism's dependence on Russian arrivals has increased from 19 percent in 2012 to about 25 percent in 2013–14 (about 4 percent of GDP). The stock of Russian FDI in Cyprus stood at 150 percent of GDP in 2013, of which 90 percent via special purpose enterprises (SPEs) registered in Cyprus. The value-added of services provided to these SPEs amounted to 4 percent of GDP. The recession in Russia and the depreciation of the ruble led to a 20 percent decline of Russian tourist arrivals in September 2014–April 2015 (year-on-year), a sharp reversal from the 17 percent increase in the first eight months of 2014 (year-on-year). A reduction of tourism in 2015 by 20 percent is estimated to reduce growth this year by about ½ppt.

Financial linkages with Russia are also significant. Russians hold a sizable amount of non-resident deposits in Cypriot banks (total non-resident non-MFI deposits stood at 83 percent of GDP at end-March). Deposit repatriation could pose liquidity risks for domestic banks, although as of now there is little evidence of outflows, and banks' liquidity position has improved.

Despite diminishing trade links, Greece remains an important partner. Cyprus's exports to Greece in 2013 accounted for about 6½ percent of exports (3½ percent of GDP), down from 13 percent in 2007. The expected growth slowdown in Greece in 2015 (relative to the October 2014 WEO) is estimated to reduce growth in Cyprus by about 0.1–0.2ppt this year.

Confidence is the main channel of financial spillovers from Greece. Deposits in Cypriot subsidiaries of Greek banks account for 14 percent of total deposits, of which about €2.5 billion (14 percent of GDP) are insured. The subsidiaries are locally financed and their Greek exposures have been significantly reduced. However, they are potentially sensitive to developments in Greece via confidence channels.

The drop in global oil prices boosts domestic demand. Cypriots spend €8 out of every €100 of disposable income on fuel. Accordingly, a €10 decline in global oil prices (sustained for a whole year and assuming that 50 percent of the decline is passed through to lower gasoline prices) frees up disposable income for the equivalent of 0.3 percent of GDP. Next, assuming that half of this is actually spent, the €25 decline in the baseline oil prices for 2015 relative to the Article IV Staff Report would boost GDP by 0.4 percent. However, as half of private spending is channeled to imports, the total impact on GDP from lower oil prices is estimated at 0.2 percent. The oil price decline has a positive impact on the trade balance, as energy consumption depends almost entirely on imported oil products, which account for 20 percent of imports (8 percent of GDP). A €25 decline in oil prices is also estimated to reduce inflation by about 1ppt relative to the Article IV staff report.

A weaker euro and a stronger EU recovery are supportive of growth. The depreciation of the euro against the sterling following the launch of QE enhances Cyprus's attractiveness for UK tourists; arrivals from Britain have increased by 16 percent in the first four months of 2015. In addition, a stronger recovery in the EU (relative to the October 2014 WEO) would boost Cyprus's exports, half of which are shipped to the EU. These two effects combined are expected to raise growth this year by ¼–½ppt.

Box 3. The New Legal Insolvency Framework

To address the high levels of private debt and non-performing loans, the authorities adopted a legislative package to enhance the corporate and personal insolvency frameworks. The new legislation, adopted on April 18 2015 is based on the Reform Strategy adopted by the Government in July 2014, which aimed at modernizing the insolvency framework to provide incentives for repayment and restructuring of debt, allow for speedier and more efficient rescue and rehabilitation of debtors, and recovery of "going concern value". The package consists of five pieces of legislation: (i) amendments to the Company Law to allow for faster and more cost effective liquidation of insolvent, nonviable companies; (ii) a Law on Examinership to facilitate the restructuring and rehabilitation of viable companies; (iii) a Law on Insolvency Practitioners, which establishes a framework for the qualification, licensing and regulation of insolvency practitioners; (iv) amendments to modernize the Bankruptcy Law to allow for a "fresh start" for insolvent debtors; and (v) a Law on Personal Insolvency, which allows for the restructuring of secured and unsecured debts of insolvent individuals, as well as debt relief for individuals with virtually no income or assets.

The new legislation draws on and incorporates some of the best international practices and cross-country experiences on insolvency, but diverges in some areas. During the Parliamentary discussions, amendments were introduced, some of which heavily favor debtors, for example allowing nonviable individual debtors to apply to court for suspension of enforcement, foreclosure or bankruptcy proceedings for up to six months, if the debtor's financial difficulties are considered to be due to the financial crisis. Another amendment introduced the definition of "debt to a financial institution", limiting the default interest rate applicable to that debt to 2 percent. While the full impact of these provisions can be only assessed once experience with the implementation of the new laws is gained, they may undermine incentives for debt restructuring and the effective implementation of the new procedures. The authorities have committed, to closely monitor the roll-out of the new procedures and to review the laws with a view to addressing these and other identified weaknesses, to ensure that the new framework achieves its objectives.

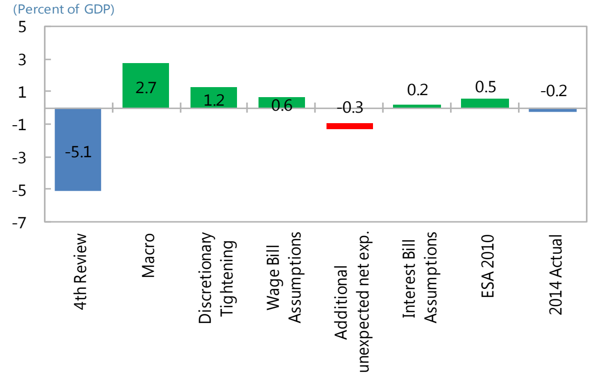
The new legislation also provides a variety of special protections for guarantors. In the run-up to the global financial crisis, personal guarantees were used excessively by financial institutions in Cyprus and, therefore, most loans (including mortgages) are reportedly backed by several guarantees. The repayment capacity of guarantors was often not adequately assessed by lenders. The outstanding stock of guarantees remains exceptionally large. The authorities were therefore concerned that, given that the financial situation of many guarantors has deteriorated during the crisis, enforcement of guarantees may trigger mass insolvencies among the guarantors, with negative social consequences and leading to further increases in NPLs. Special provisions to limit the potential impact on guarantors (limited to guarantees outstanding at the time of the adoption of the law and to loans that are already non-performing) were included in the insolvency legislation. These include: (i) a 3-year prohibition on foreclosure against the guarantor's primary residence in recourse to the liability under the guarantee, (ii) enhanced disclosure obligations towards the guarantor in the repayment plan procedure; (iii) allowing payment of the guarantors' obligations in monthly installments, taking into account the guarantors' reasonable living expenses and their own debt obligations, over a 3-year period from the enactment of the law or over a longer period; (iv) limiting recourse by the creditor to the guarantor to 2 years following approval of the debtor's repayment plan, and by the guarantor to other guarantor(s) and/or the debtor to 3 years following the payment by the guarantor; and (v) limiting the liability of guarantors whose net worth does not exceed a certain threshold for mortgages over primary residences not exceeding a certain threshold. Obligations of guarantors who are natural persons are also limited in the Examinership regime as long as the guaranteed obligations do not exceed a certain threshold.

Way forward. To make the new framework operational, key next steps include the establishment of the Insolvency Service, training and licensing the first insolvency practitioners, educating stakeholders and the general public about the new framework, and adopting remaining acts and regulations.

Box 4. What Explains the Strong 2014 Fiscal Outturn?

The 2014 fiscal outcome was significantly more favorable than program projections. An overall general government cash deficit of 5.1 percent of GDP for 2014 was expected at the time of the fourth review, while a deficit of 0.2 percent of GDP actually materialized. Similarly, a general government primary cash deficit of 1.6 percent of GDP was projected, while the actual primary surplus was 2.8 percent of GDP.

Cyprus: Projected Balance and Actual, 2014
(Percent of GDP)

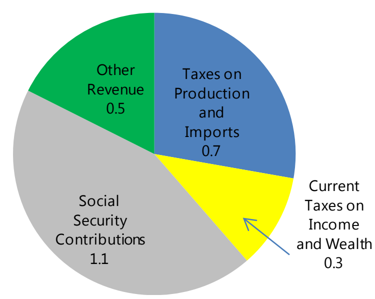


Sources: Ministry of Finance and IMF staff estimates.

Four main factors accounted for the difference in the overall balance:

- **A considerably shallower recession.** Real GDP contracted by 2.3 percent rather than a projected 4.2 percent, which resulted in higher revenues (2.6 percent of GDP) and lower social transfers (0.1 percent of GDP). Stronger real consumption and a more favorable labor market contributed to the better revenue outturn through more robust tax bases and higher government sales (included in other revenue) while lower unemployment and redundancy benefits led to lower outlays. In addition, adverse compliance effects were likely milder than anticipated supporting more favorable tax revenue and social security contributions buoyancy.

Composition of Additional Revenue
(Percent of GDP)



Source: Ministry of Finance.

- **A large additional discretionary tightening.** Discretionary spending was lower by 1.2 percentage points of GDP relative to projections, mainly because of lower goods and services and capital expenditures.

- **Favorable wage bill developments.** The wage bill was 0.6 percent of GDP lower than projected. Key elements contributing to the lower wage bill were a faster reduction in early retirements and general government employment.

- **Higher nominal GDP.** The change in the compilation of the national accounts to the ESA 2010 methodology (done for all Euro-area countries) increased nominal GDP by 10 percent. Given the larger denominator, the balance as a share of GDP declined by 0.5 percentage point.

Several other factors explain the remaining difference. The change to the ESA 2010 methodology also had a small impact through the reclassification of certain revenue and expenditure items. Together with a lower interest bill, this more than offset additional spending on sewerage boards' projects and compensation of pension funds for the impact of the banks' bail in.

Box 5. Fiscal Impulse in 2013–15

Fiscal policy, as measured by the fiscal impulse, had a contractionary impact on the economy in 2013–14, but is projected to be broadly neutral in 2015.

A fiscal impulse estimate is likely to provide a more meaningful measure of the net impact of fiscal policy in a crisis period than one derived from standard structural balance methods. The measure provides an estimate of the impact of discretionary fiscal policy on the economy, abstracting from one-offs and changes in fiscal aggregates caused by cyclical fluctuations. This approach decomposes the actual/projected changes of the primary balance into components that are relatively easier to observe, factors in the impact of automatic stabilizers and simplifies implicit assumptions on the permanent and temporary nature of macroeconomic effects. It is also less subject to output gap uncertainty, unstable elasticities, and omission of non business cycle fluctuations and output composition changes, all of which are especially acute during crisis periods. In particular: the change in the primary balance was decomposed into three components: (i) fiscal adjustment; (ii) the impact of macro developments, (derived by excluding from the fiscal projection the impact of one offs and of measures related to revenue and social transfers; and (iii) other factors (notably, the impact of one-offs, EU directives on revenue collection, and the change in nominal GDP on primary balance ratios (i.e. capturing purely the denominator effect).

Fiscal Impulse Estimates

(Percent of GDP, unless otherwise indicated)

	2013	2014	2015	Total
Change in the Primary Deficit (cash basis, + means reduction) (A=B+C+D)	1.3	4.4	-1.9	3.9
Fiscal Adjustment (B) 1/	6.4	4.4	0.4	11.2
Estimated Impact of Macro Developments (C)	-5.2	-0.8	-0.4	-6.4
Other (D)	0.1	0.9	-1.9	-0.9
Estimated Fiscal Impulse of Automatic Stabilizers (E=C/2)	2.6	0.4	0.2	3.2
Net Estimated Fiscal Impulse (+means contractionary) (B-E)	3.8	4.0	0.2	8.0

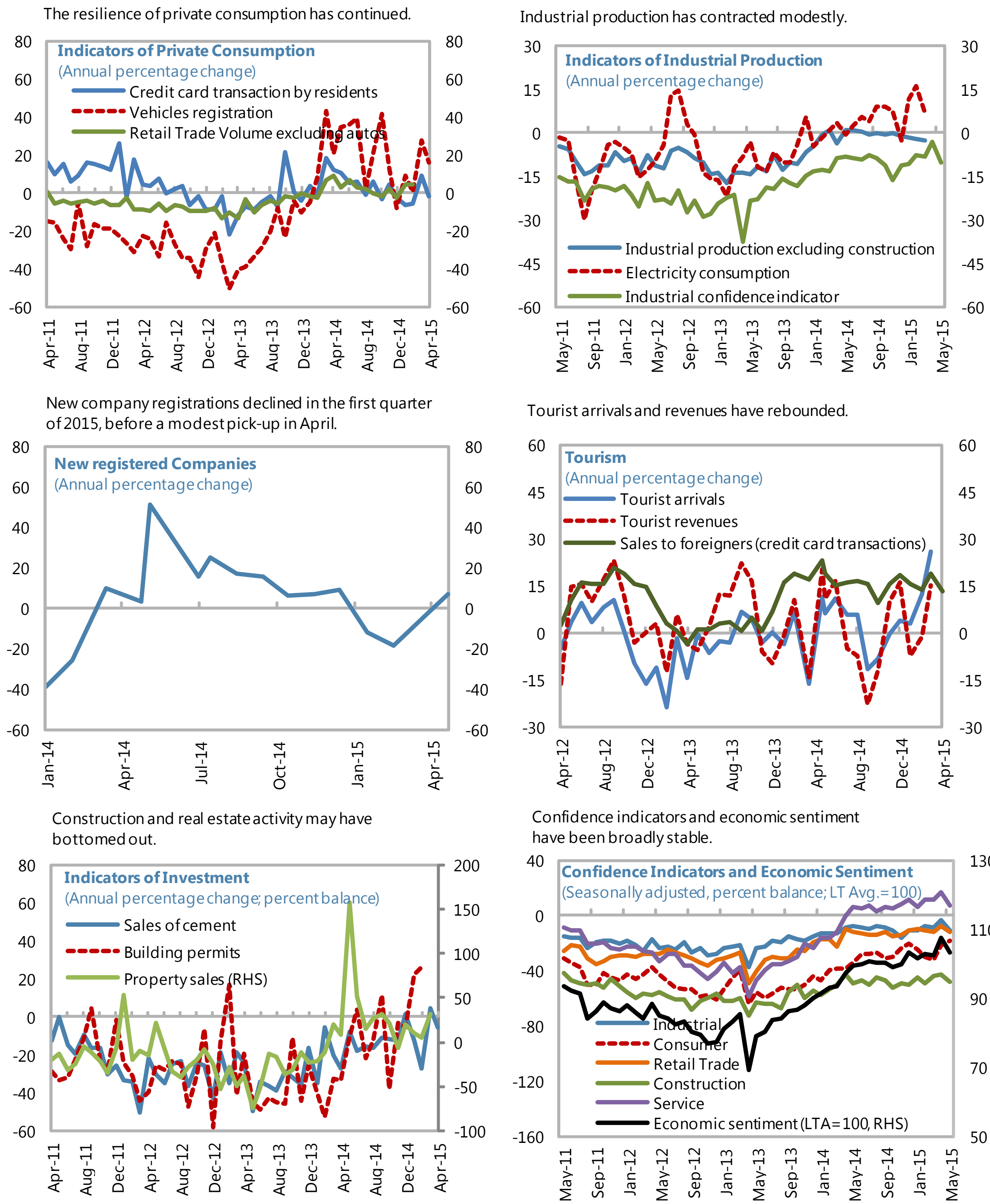
Source: IMF Staff Estimates

1/ Comprises program measures and other tightening including measure related higher than expected social contributions collections in 2014, reductions in the wage bill due to a faster reduction in public employment, early retirements, and/or gratuity payments than anticipated, and unanticipated discretionary reductions in goods and services and capital expenditure.

Estimating automatic stabilizers is an important element in assessing the fiscal impulse. In particular, the contribution of automatic stabilizers is estimated by assuming a fixed percentage of the estimated impact of macro developments on the balance. The percentage reflects the estimated share of the macro impact that is the result of temporary changes in economic activity. In a normal recession, this share is estimated at 70 percent using standard assumptions related to potential output in an advanced economy context. However, in a banking crisis-related recession, a large component of the macro impact can be considered as permanent. Thus, for this exercise, automatic stabilizers capturing the share of non-permanent effects of the recession are assumed to be 50 percent.

On this basis, the negative fiscal impulse is estimated at 4 percent of GDP for 2014, and broadly neutral in 2015. 2014 was marked by a strong tightening, primarily in the wage bill and goods and services on the spending side, and social security contributions on the revenue side. This more than offset higher spending in social transfers due to a more extensive use of safety net benefits, including unemployment insurance, and redundancy and retirement benefits. Automatic stabilizers were limited. For 2015, limited fiscal measures (mostly legislated at end-2012) and negligible automatic stabilizer effects given still-low growth imply a fiscal impulse close to 0. The smaller drag from fiscal policy is one of the factors that could help facilitate the recovery.

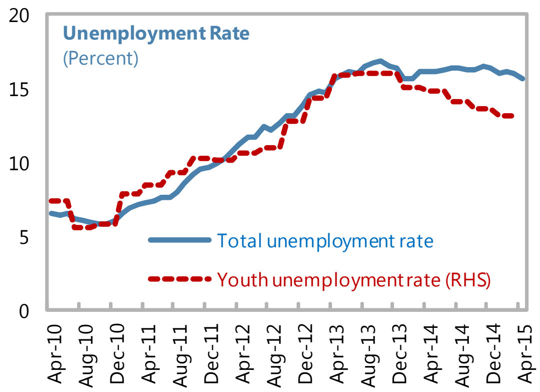
Figure 1. Cyprus: High Frequency Indicators



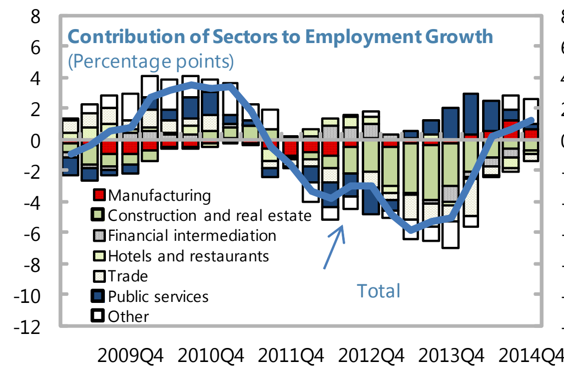
Sources: Cystat; Eurostat; MoF; and IMF staff estimates.

Figure 2. Cyprus: Employment and Inflation Developments

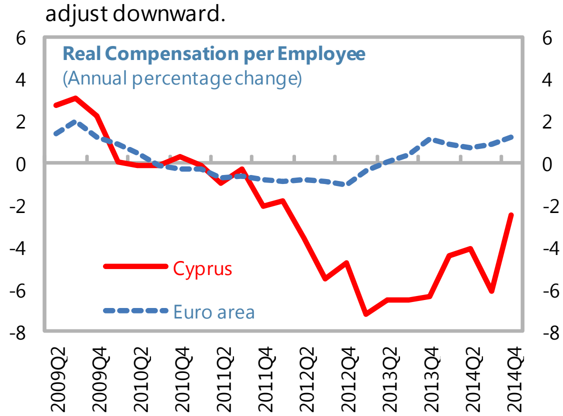
Unemployment remains high.



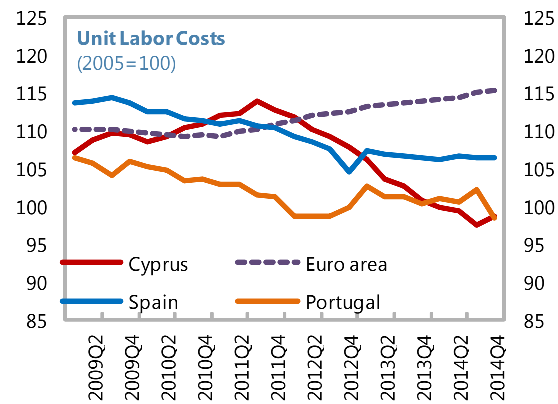
However, employment has started to recover.



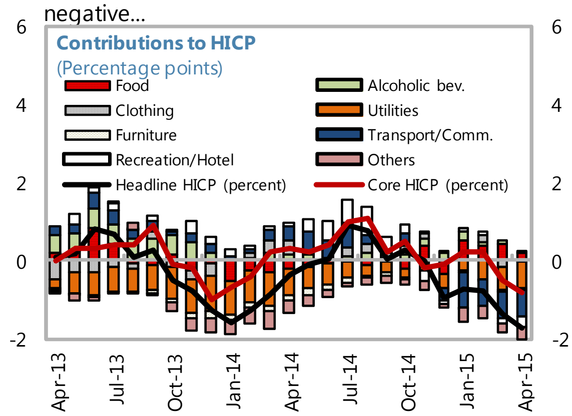
Compensation of employees continues to adjust downward.



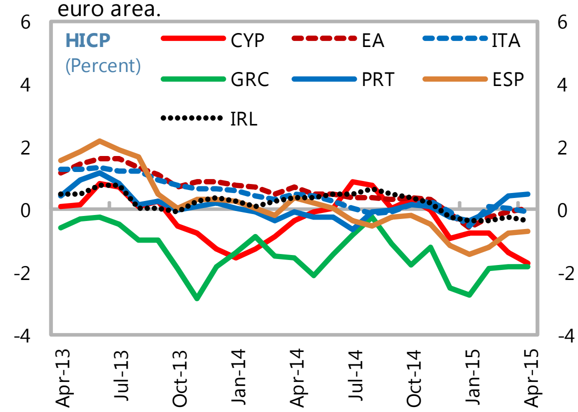
As a result, unit labor costs have declined more than those of most other EA countries.



Driven by lower oil prices, inflation has turned negative...

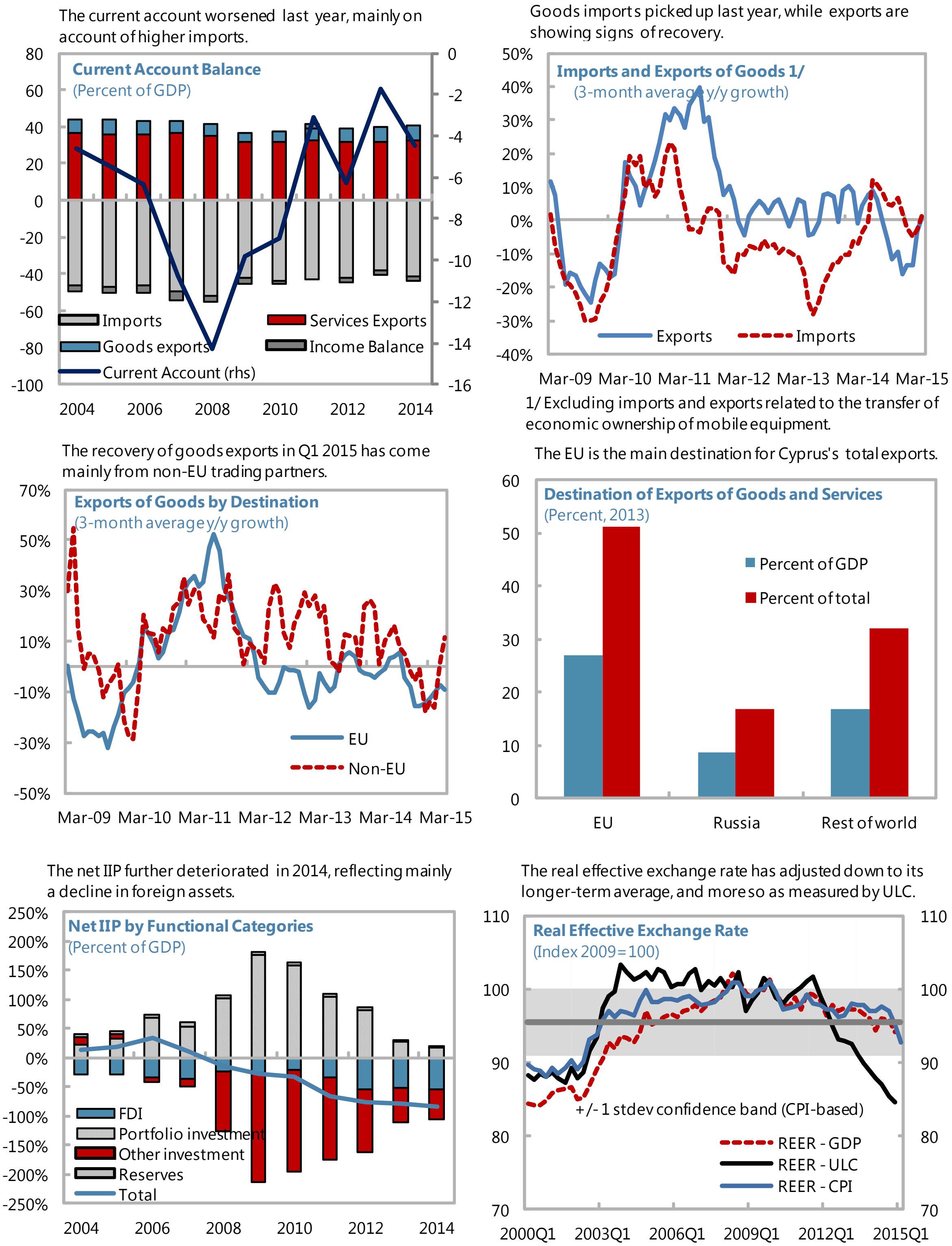


... and lower than in most countries in the euro area.



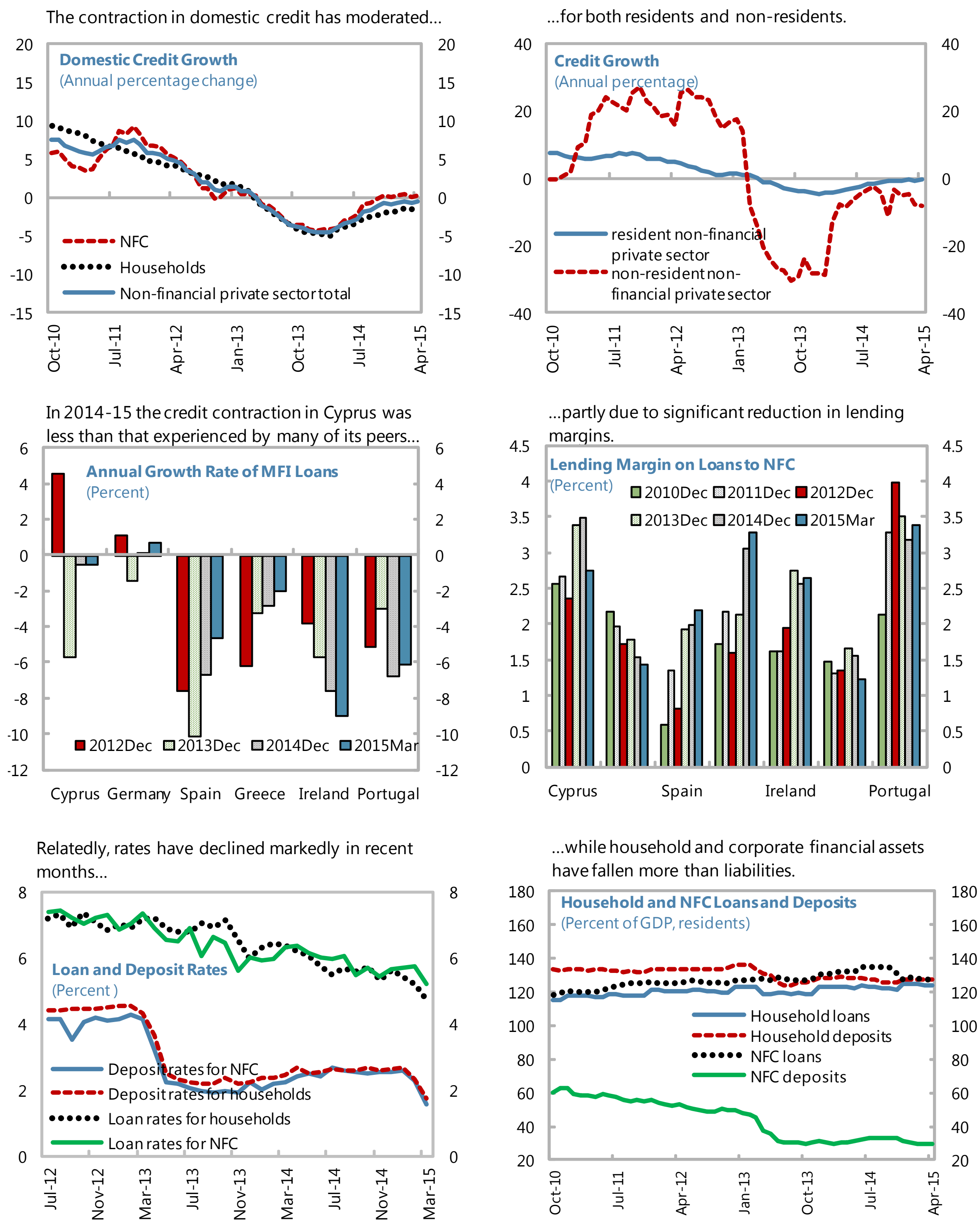
Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

Figure 3. Cyprus: External Indicators



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

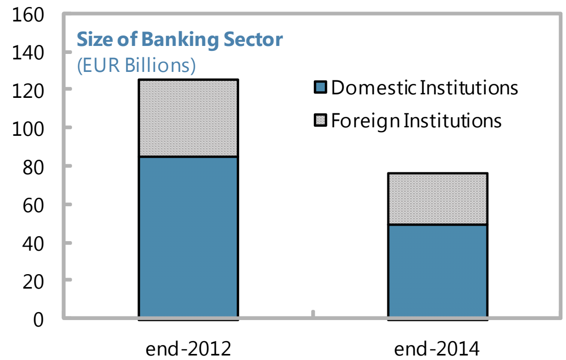
Figure 4. Cyprus: Credit Developments



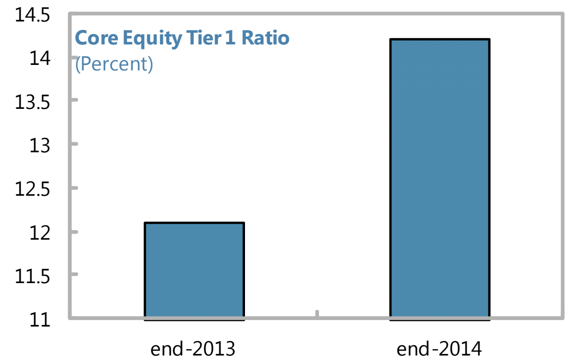
Sources: Central Bank of Cyprus; Cystat; ECB; and IMF staff estimates.

Figure 5. Cyprus: Financial Sector Overview

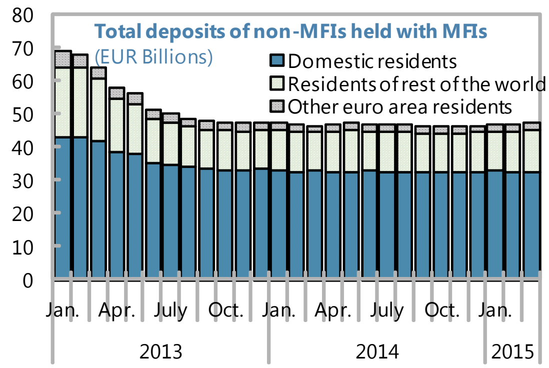
The banking sector has delevered significantly…



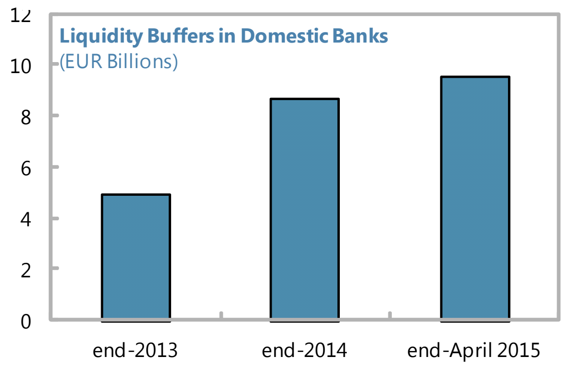
…while the capital position of banks has strengthened.



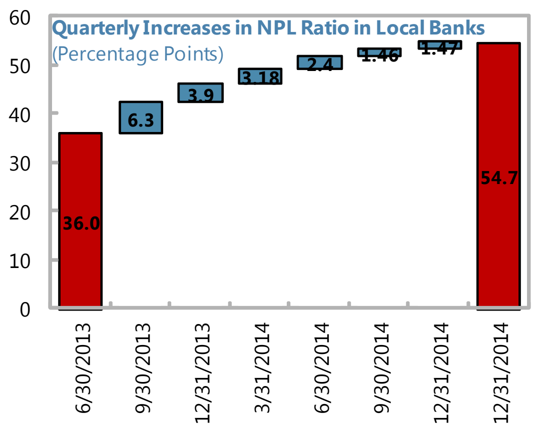
Meanwhile, deposit flows have stabilized for all resident groups…



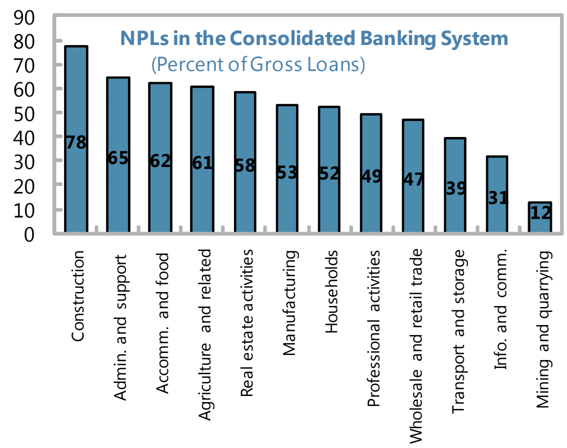
…allowing banks to boost their liquidity buffers.



The increase in NPLs has slowed down.



The distribution on NPLs is uneven across sectors.

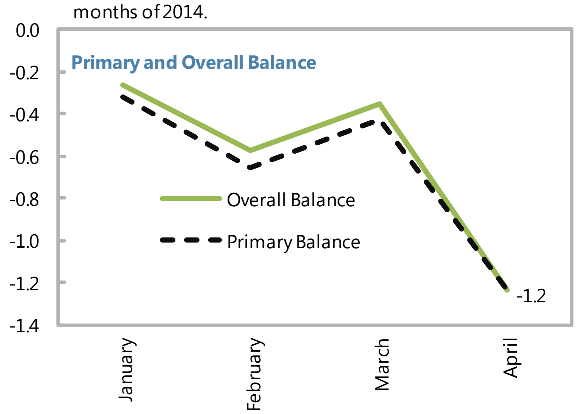


Sources: CBC, ECB; and IMF staff estimates.

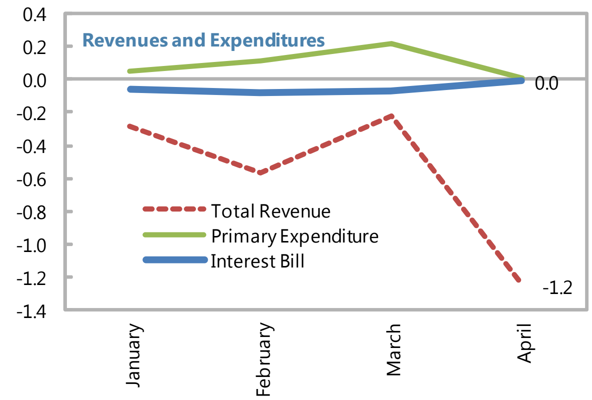
Figure 6. Cyprus: Fiscal Developments in 2015 1/

(Cumulative percent of GDP difference relative to previous year)

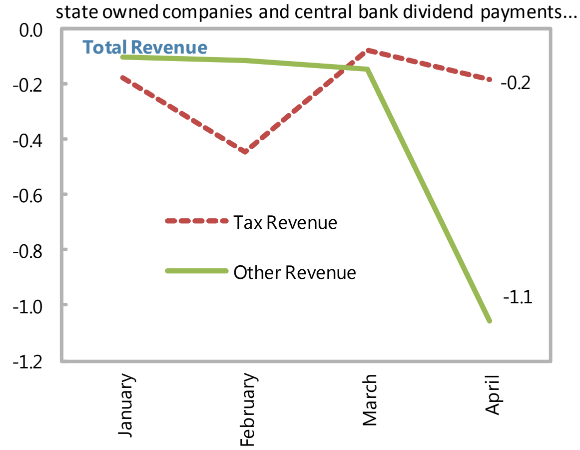
The primary balance has worsened compared to the first four months of 2014.



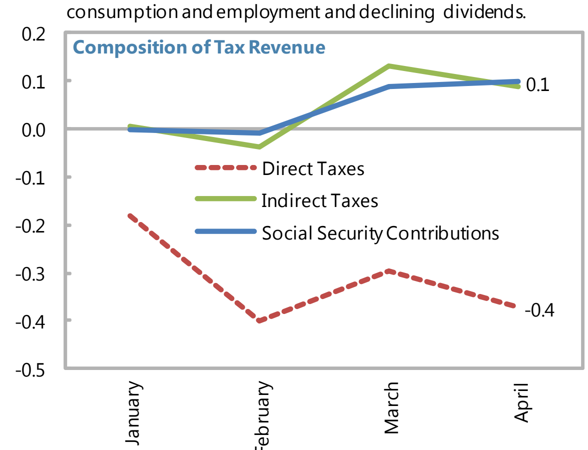
....due to lower total revenue.



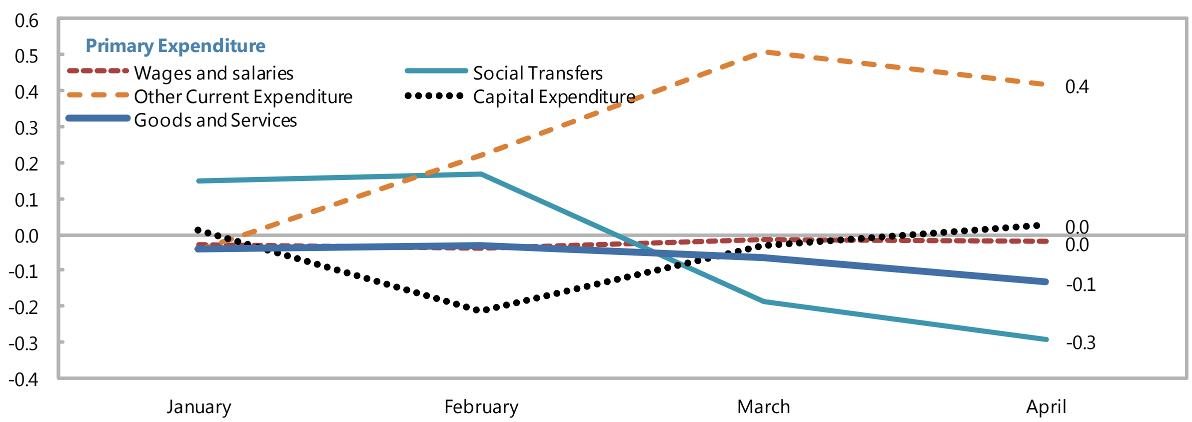
Total revenue has declined mainly due to a different timing of state owned companies and central bank dividend payments...



...as tax revenue composition is shifting, reflecting improving consumption and employment and declining dividends.



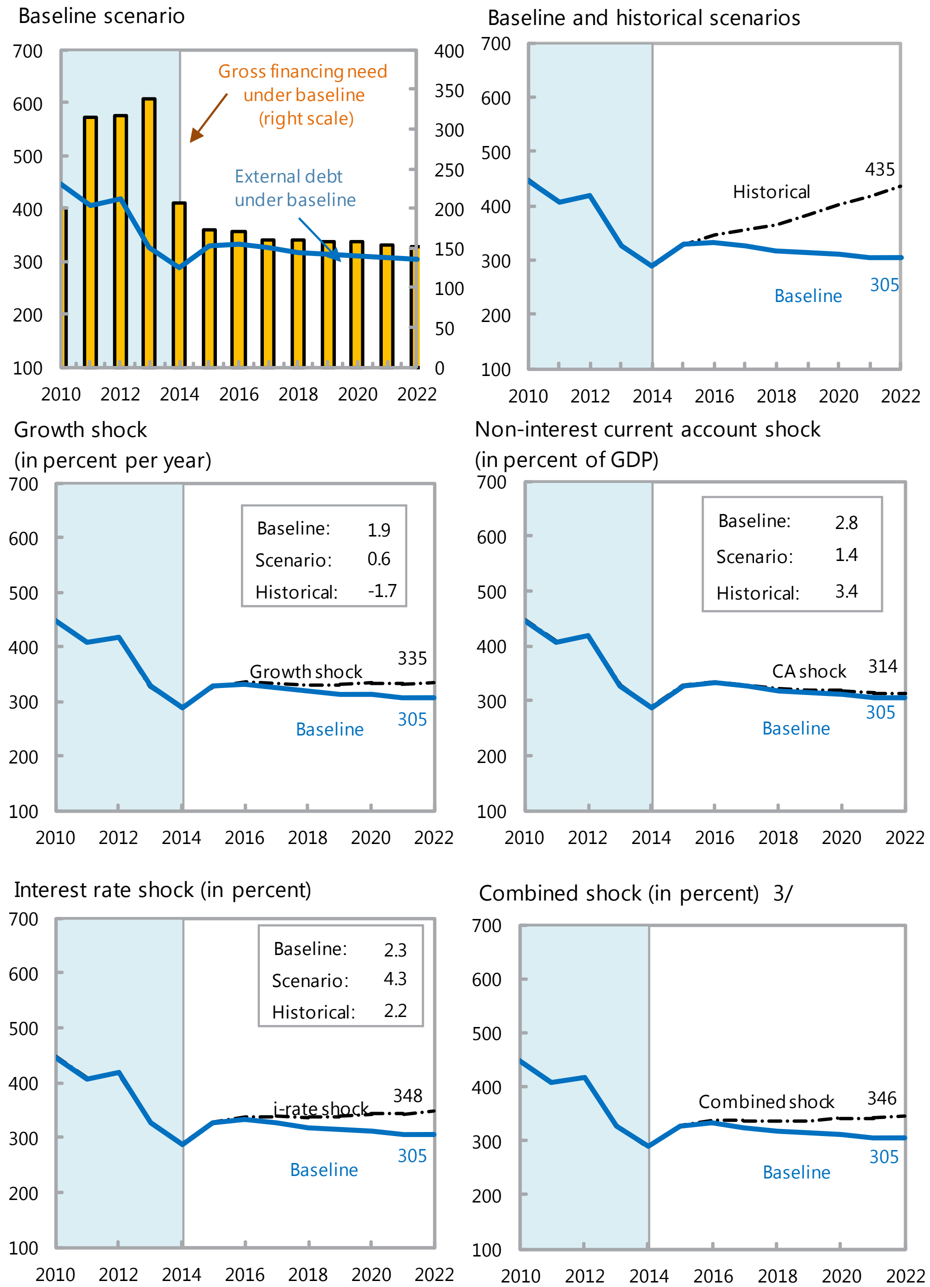
The flat primary spending reflects the payment of most of the remaining compensation to pension funds for bank restructuring (other current expenditure) offset by lower outlays in goods and services and social transfers. The latter reflects falling unemployment and redundancy benefits consistent with a stabilization in the labor market.



Sources: Ministry of Finance; and IMF staff estimates.
1/ ESA 2010, cash basis data.

Figure 7. Cyprus: External Debt Sustainability Analysis—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.

Table 1. Cyprus: Selected Economic Indicators, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Projections						
Real Economy	(Percent change, unless otherwise indicated)										
Real GDP	1.4	0.3	-2.4	-5.4	-2.3	0.2	1.4	2.0	2.2	2.1	1.8
Domestic demand	2.4	-2.1	-3.9	-9.9	-1.3	-0.1	1.1	1.3	1.7	1.6	1.3
Consumption	0.7	1.6	-1.1	-5.8	-1.6	0.0	0.8	1.0	1.3	1.2	1.0
Private consumption	1.3	1.8	-0.7	-6.0	0.4	0.4	1.1	1.2	1.5	1.3	1.0
Public consumption	-1.4	0.7	-2.7	-4.9	-8.7	-1.7	-0.8	-0.2	0.8	1.0	1.0
Fixed investment	-5.1	-9.4	-20.7	-17.1	-18.8	-0.9	3.6	4.0	4.5	4.2	3.6
Inventory accumulation 1/	3.2	-1.4	1.0	-2.4	2.7	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-1.1	2.4	1.7	4.7	-1.0	0.3	0.3	0.7	0.6	0.6	0.6
Exports of goods and services	2.6	4.2	-1.7	-5.0	5.7	0.5	1.5	2.9	3.3	3.2	3.1
Imports of goods and services	4.5	-0.6	-4.6	-13.6	8.1	-0.1	1.0	1.8	2.4	2.3	2.2
Potential GDP growth	1.7	1.5	-1.5	-5.4	-2.2	-0.4	0.4	1.0	1.6	1.9	1.8
Output gap (percent of potential GDP)	-1.2	-2.4	-3.3	-3.3	-3.4	-2.8	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	2.6	3.5	3.1	0.4	-0.3	-0.8	0.9	1.3	1.5	1.8	1.9
HICP (end of period)	1.9	4.2	1.5	-1.3	-1.0	-0.8	0.9	1.3	1.5	1.8	1.9
Unemployment rate EU stand. (percent)	6.3	7.9	11.9	15.9	16.1	16.1	15.1	13.8	12.5	11.2	10.2
Employment growth (percent)	1.4	-1.5	-2.4	-6.1	-0.1	0.0	1.2	1.6	1.7	1.6	1.5
Public Finance	(Percent of GDP)										
General government balance	-4.8	-5.8	-5.8	-4.4	-0.2	-1.7	0.0	0.8	1.5	1.5	1.4
Revenue	37.7	37.0	36.3	37.6	40.2	39.3	39.2	38.8	39.0	39.0	39.1
Expenditure	42.5	42.8	42.1	42.0	40.4	41.1	39.2	37.9	37.5	37.4	37.7
Primary Fiscal Balance	-2.7	-3.6	-2.9	-1.6	2.8	1.0	2.4	3.0	3.6	3.6	3.6
General government debt	56.5	66.0	79.5	102.2	107.5	106.3	98.4	92.3	87.6	82.9	78.7
Balance of Payments	(Percent of GDP)										
Current account balance	-9.0	-3.1	-6.3	-1.7	-4.5	-4.3	-4.1	-4.0	-4.2	-4.3	-4.4
Trade Balance (goods and services)	-5.7	-3.9	-2.8	1.7	-0.6	-0.1	-0.1	0.2	0.3	0.6	0.8
Exports of goods and services	37.7	39.4	39.2	40.0	40.6	40.4	40.7	41.1	41.6	42.0	42.5
Imports of goods and services	43.4	43.3	42.0	38.3	41.2	40.5	40.8	40.9	41.2	41.4	41.7
Goods balance	-24.5	-22.3	-19.9	-16.2	-18.5	-17.3	-17.6	-17.6	-17.7	-17.7	-17.7
Services balance	18.8	18.4	17.1	18.0	17.9	17.1	17.5	17.8	18.0	18.3	18.5
Income, net	-2.0	1.8	-2.3	-2.5	-2.7	-3.0	-2.9	-3.0	-3.4	-3.6	-4.0
Transfer, net	-0.6	-1.0	-1.1	-0.9	-1.2	-1.1	-1.1	-1.2	-1.2	-1.2	-1.3
Capital account, net	0.2	0.2	0.1	1.3	0.8	0.8	0.8	0.8	0.8	0.7	0.7
Financial account, net	8.6	4.0	4.4	-23.9	-3.7	-5.0	-10.3	3.2	3.7	4.0	4.6
Direct investment	0.3	0.7	6.2	0.9	1.8	0.8	7.3	3.0	3.0	4.0	4.0
Portfolio investment	-10.1	29.5	27.5	64.8	11.1	4.3	-7.1	-3.8	-0.3	2.3	2.9
Other investment	17.4	-26.4	-29.6	-89.8	-16.5	-10.1	-10.5	4.1	1.0	-2.3	-2.3
Reserves (- inflow; + outflow)	1.0	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	26.7	7.3	8.5	13.7	0.0	-0.3	-0.5	-0.9
European Union	0.0	0.0	0.0	25.3	6.3	5.5	13.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	1.4	1.1	3.0	0.7	0.0	-0.3	-0.5	-0.9
Errors and omissions	0.2	-1.2	1.8	-2.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance											
National saving	14.2	15.9	10.1	10.4	7.4	7.5	8.0	8.4	8.5	8.8	8.7
Government	0.8	-1.1	-2.0	-1.5	2.7	1.4	3.2	4.1	4.8	4.8	4.7
Non-government	13.4	17.0	12.1	11.9	4.7	6.1	4.7	4.4	3.7	3.9	4.1
Gross capital formation	23.2	19.0	16.3	12.1	11.9	11.8	12.1	12.4	12.7	13.0	13.2
Government	5.5	5.6	5.8	6.5	5.4	6.4	5.4	5.0	4.8	4.8	4.8
Private	17.7	13.4	10.6	5.7	6.5	5.4	6.8	7.5	7.9	8.2	8.4
Foreign saving	-9.0	-3.1	-6.3	-1.7	-4.5	-4.3	-4.1	-4.0	-4.2	-4.3	-4.4
Memorandum Item:											
Nominal GDP (billions of euros)	19.1	19.5	19.4	18.1	17.5	17.4	17.7	18.3	19.0	19.7	20.4

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

1/ Contribution to growth.

Table 2. Cyprus: Fiscal Developments and Projections, 2010–20 1/

(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Projections						
Revenue	37.7	37.0	36.3	37.6	40.2	39.3	39.2	38.8	39.0	39.0	39.1
Current revenue	37.6	37.0	36.2	37.5	40.1	39.3	39.2	38.7	39.0	38.9	39.1
Tax revenue	24.5	24.5	24.0	24.2	25.1	24.7	24.7	24.7	24.8	24.9	24.9
Indirect taxes	14.6	13.9	14.0	13.8	14.8	14.7	14.6	14.8	14.8	14.8	14.8
Direct taxes	9.9	10.6	10.0	10.4	10.3	10.0	10.1	9.9	10.1	10.1	10.1
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
Social security contributions	8.1	8.0	7.8	7.6	8.9	9.0	9.0	9.1	9.2	9.2	9.2
Other current revenue	5.0	4.4	4.5	5.8	6.1	5.7	5.5	4.9	4.9	4.9	5.0
Sales	2.4	2.2	2.5	2.5	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Other	2.6	2.2	2.0	3.3	3.3	2.9	2.7	2.1	2.2	2.1	2.2
Capital revenue	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.5	42.8	42.1	42.0	40.4	41.1	39.2	37.9	37.5	37.4	37.7
Current expenditure	36.9	38.1	38.2	39.0	37.5	38.0	36.0	34.7	34.2	34.1	34.4
Wages and salaries	14.5	14.8	14.6	14.2	13.1	13.1	12.7	12.7	12.7	12.6	12.6
Goods and services	4.5	4.5	4.2	4.2	3.8	3.6	3.5	3.3	3.3	3.3	3.3
Social Transfers	13.1	13.5	13.4	13.9	14.7	14.9	14.7	14.1	13.8	13.9	14.0
Subsidies	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Interest payments	2.1	2.2	2.9	2.8	3.0	2.7	2.4	2.2	2.1	2.1	2.3
Other current expenditure	2.5	2.7	2.7	3.5	2.4	3.2	2.2	1.9	1.9	1.8	1.9
Capital expenditure 2/	5.6	4.6	3.8	2.9	2.9	3.1	3.2	3.2	3.3	3.3	3.3
Overall balance 3/	-4.8	-5.8	-5.8	-4.4	-0.2	-1.7	0.0	0.8	1.5	1.5	1.4
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-4.8	-5.8	-5.8	-4.4	-0.2	-1.7	0.0	0.8	1.5	1.5	1.4
Net financial transactions	-4.8	-5.8	-5.8	-4.4	-0.2	-1.7	0.0	0.8	1.5	1.5	1.4
Net acquisition of financial assets	-0.5	4.9	7.9	13.0	1.9	-3.7	-5.6	-2.2	0.0	0.0	0.0
Currency and deposits	-1.1	4.3	-3.3	4.3	2.1	-0.3	0.0	0.0	0.0	0.0	0.0
Securities other than shares 4/	0.0	0.0	0.0	8.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.7	1.0	1.6	0.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	0.0	9.6	0.4	0.2	0.0	-5.6	-2.2	0.0	0.0	0.0
Other assets	0.0	-0.4	0.0	0.0	0.0	-3.5	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	4.3	10.7	13.7	17.4	2.0	-2.0	-5.6	-3.0	-1.5	-1.5	-1.4
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
Securities other than shares	4.3	7.0	1.6	-8.5	-4.8	-7.0	-18.7	-0.5	2.4	2.8	3.4
Loans	-0.1	3.7	11.6	25.9	6.9	5.0	13.0	-2.6	-4.0	-4.3	-4.8
Other liabilities	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/	-2.7	-3.6	-2.9	-1.6	2.8	1.0	2.4	3.0	3.6	3.6	3.6
Public debt	56.5	66.0	79.5	102.2	107.5	106.3	98.4	92.3	87.6	82.9	78.7

Sources: Eurostat; and IMF staff estimates.

1/ Historical fiscal statistics until 2012 are based on Eurostat and are thus reported on an accrual basis. For 2013 and projections, and to be consistent with the cash basis of the program, the fiscal statistics are reported on a cash basis.

2/ Capital expenditure in 2016 includes payments for guarantees that are expected to be called that year which are recorded as capital transfers under ESA.

3/ The overall balance in 2014 excludes the 1.5 billion euros recapitalization of the cooperative sector. Projections for 2017-18 include unspecified additional fiscal measures. 70 percent are assumed on the spending side and the rest on the revenue side.

4/ The draw down of ESM bonds received in 2013 to recapitalize the cooperative sector in 2014 is excluded from this line consistent with the exclusion of the recapitalization of the cooperative sector in the overall and primary balance.

5/ The primary fiscal balance in 2014 excludes the 1.5 billion recapitalization of the cooperative sector. Primary fiscal balances in 2015 and 2016 include 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

(Millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**5,839.7**	**3,028.1**	**4,266.6**	**4,512.0**	**1,172.7**
Government	3,400.3	2,855.6	4,093.4	1,211.9	772.7
Fiscal deficit ("+" = financing need)	828.0	73.9	305.0	-2.6	-153.6
Debt maturities	2,572.3	2,781.7	3,788.4	1,214.5	926.3
Medium- and long-term	1,596.2	2,031.4	3,064.0	714.5	426.3
Domestic	138.3	1,353.1	2,102.3	438.2	362.2
Foreign	1,457.9	678.3	961.7	276.3	64.1
Short-term	976.0	750.3	724.4	500.0	500.0
Domestic	976.0	750.3	724.4	500.0	500.0
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
Additional Debt Repayments 2/	0.0	0.0	0.0	3,300.0	400.0
Market financing	**776.2**	**1,715.9**	**2,464.5**	**1,087.8**	**772.7**
Government	776.2	1,715.9	2,464.5	1,087.8	772.7
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	776.2	1,715.9	2,464.5	1,087.8	772.7
Medium- and long-term 1/	25.9	991.5	1,964.5	587.8	273
Short-term	750.3	724.4	500.0	500.0	500.0
Net financing requirement	**5,063.6**	**1,312.1**	**1,802.0**	**3,424.2**	**400.0**
Government	2,624.2	1,139.7	1,628.9	124.1	0.0
Fiscal deficit	828.0	73.9	305.0	-2.6	-153.6
Debt maturities	1,796.1	1,065.8	1,323.9	126.7	153.6
Medium- and long-term	1,570.4	1,039.9	1,099.5	126.7	153.6
Short-term	225.7	25.9	224.4	0.0	0.0
Official Financing Sources and Financial Buffers	**5,063.6**	**1,312.1**	**1,802.0**	**3,424.2**	**400.0**
Domestic Financing Sources	**225.7**	**25.9**	**324.4**	**1,000.0**	**400.0**
Use of cash balances	225.7	25.9	224.4	0.0	0.0
Central Bank Dividends/Coinage	0.0	0.0	100.0	0.0	0.0
Privatizations Proceeds	0.0	0.0	0.0	1,000.0	400.0
Official financing sources	**4,837.8**	**1,286.2**	**1,477.6**	**2,424.2**	**0.0**
IMF	252.8	186.2	527.6	124.2	0.0
ESM	4,585.0	1,100.0	950.0	2,300.0	0.0

Source: IMF staff estimates.

1/ Medium and long term market financing in 2013 refers to EIB financing. In 2014, it includes EIB financing and the €850 million issued in May and June of 2014. The 2015 figure includes EIB financing, the April 2015 market issuance, and a second expected issuance in 2015Q3.

2/ Refers to additional debt repayments that would be made with privatization proceeds and a debt management operation in 2016 and with privatization proceeds only in 2017 assuming the full disbursement of the program envelope and the full materialization of privatization proceeds.

Table 4. Cyprus: Balance of Payments, 2010–20 1/

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Est. 2/			Projections			
					(Millions of Euros)						
Current Account Balance	-1,711	-602	-1,217	-310	-783	-752	-736	-728	-800	-838	-905
Trade Balance (Goods and Services)	-1,082	-763	-546	313	-108	-25	-14	35	64	113	162
Goods Balance	-4,665	-4,349	-3,856	-2,941	-3,243	-3,001	-3,116	-3,218	-3,352	-3,484	-3,619
Exports	1,137	1,411	1,440	1,501	1,477	1,526	1,570	1,638	1,715	1,797	1,882
Imports	-5,802	-5,760	-5,296	-4,442	-4,720	-4,526	-4,686	-4,856	-5,067	-5,282	-5,501
Services Balance	3,583	3,585	3,310	3,253	3,134	2,975	3,102	3,253	3,416	3,597	3,781
Exports	6,049	6,262	6,167	5,750	5,634	5,494	5,654	5,897	6,175	6,473	6,777
Imports	-2,468	-2,676	-2,857	-2,497	-2,500	-2,519	-2,551	-2,644	-2,759	-2,876	-2,995
Current Income	-379	357	-456	-452	-468	-528	-519	-549	-637	-709	-812
Current Transfers	-116	-196	-215	-171	-207	-198	-203	-214	-227	-242	-256
Capital Account	36	46	23	244	144	144	144	144	144	144	144
Financial Account	1,647	781	847	-4,333	-647	-870	-1,832	592	710	795	937
Direct Investment	65	132	1,197	169	306	130	1,302	547	569	788	816
Portfolio Investment	-1,934	5,753	5,340	11,734	1,942	749	-1,266	-703	-52	451	586
Financial Derivatives	-59	-261	-870	-55	37	0	0	0	0	0	0
Other Investment	3,372	-4,885	-4,877	-16,211	-2,927	-1,749	-1,868	748	193	-444	-465
Reserves (- inflows, + outflows)	200	43	57	30	-6	0	0	0	0	0	0
Errors and Omission	31	-225	346	-439	0	0	0	0	0	0	0
Program Financing	0	0	0	4,838	1,286	1,478	2,424	-8	-54	-101	-176
					(Percent of GDP)						
Current Account Balance	-9.0	-3.1	-6.3	-1.7	-4.5	-4.3	-4.1	-4.0	-4.2	-4.3	-4.4
Trade Balance (Goods and Services)	-5.7	-3.9	-2.8	1.7	-0.6	-0.1	-0.1	0.2	0.3	0.6	0.8
Goods Balance	-24.5	-22.3	-19.9	-16.2	-18.5	-17.3	-17.6	-17.6	-17.7	-17.7	-17.7
Exports	6.0	7.2	7.4	8.3	8.4	8.8	8.8	8.9	9.0	9.1	9.2
Imports	-30.4	-29.6	-27.3	-24.5	-27.0	-26.0	-26.4	-26.5	-26.7	-26.8	-27.0
Services Balance	18.8	18.4	17.1	18.0	17.9	17.1	17.5	17.8	18.0	18.3	18.5
Exports	31.7	32.1	31.8	31.7	32.2	31.6	31.9	32.2	32.5	32.8	33.2
Imports	-12.9	-13.7	-14.7	-13.8	-14.3	-14.5	-14.4	-14.4	-14.5	-14.6	-14.7
Current Income	-2.0	1.8	-2.3	-2.5	-2.7	-3.0	-2.9	-3.0	-3.4	-3.6	-4.0
Current Transfers	-0.6	-1.0	-1.1	-0.9	-1.2	-1.1	-1.1	-1.2	-1.2	-1.2	-1.3
Capital Account	0.2	0.2	0.1	1.3	0.8	0.8	0.8	0.8	0.8	0.7	0.7
Financial Account	8.6	4.0	4.4	-23.9	-3.7	-5.0	-10.3	3.2	3.7	4.0	4.6
Direct Investment	0.3	0.7	6.2	0.9	1.8	0.8	7.3	3.0	3.0	4.0	4.0
Portfolio Investment	-10.1	29.5	27.5	64.8	11.1	4.3	-7.1	-3.8	-0.3	2.3	2.9
Financial Derivatives	-0.3	-1.3	-4.5	-0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other Investment	17.7	-25.1	-25.1	-89.5	-16.7	-10.1	-10.5	4.1	1.0	-2.3	-2.3
Reserves (- inflows, + outflows)	1.0	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	0.2	-1.2	1.8	-2.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program Financing	0.0	0.0	0.0	26.7	7.3	8.5	13.7	0.0	-0.3	-0.5	-0.9

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

1/ Balance of Payments historical data and projections are presented according to the BPM5 methodology, and thus exclude data related to the operations of Special Purpose Entities (entities without a physical presence in Cyprus).

2/ Estimated based on BPM6 data produced by the Central Bank of Cyprus.

Table 5. Cyprus: External Financing Requirements and Sources, 2012–20

(Millions of Euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Projections					
GROSS FINANCING REQUIREMENTS	**60,086**	**61,881**	**35,404**	**29,956**	**30,491**	**29,426**	**30,515**	**31,288**	**32,111**
Current account deficit ("-" = CA surplus)	1,217	310	783	752	736	728	800	838	905
Medium- and long-term debt amortization	5,800	12,589	3,284	3,247	3,760	2,927	3,649	3,995	4,171
Public sector	593	1,458	383	379	894	64	745	1,045	1,159
Banks	4,380	10,056	1,362	1,345	1,342	1,340	1,351	1,365	1,379
Other private	827	1,075	1,539	1,523	1,523	1,523	1,554	1,585	1,633
Short-term debt amortization	53,069	48,982	31,337	25,957	25,995	25,763	26,012	26,354	26,859
Public sector	8,290	7,494	7,363	2,724	1,635	1,471	1,324	1,192	1,072
Central Bank	7,992	7,494	7,363	2,724	1,635	1,471	1,324	1,192	1,072
General government and SOEs	298	0	0	0	0	0	0	0	0
Banks	43,727	40,414	21,891	21,253	22,381	22,313	22,510	22,768	23,033
Other private	1,053	1,075	2,083	1,979	1,979	1,979	2,177	2,395	2,754
EU and IMF	0	0	0	0	0	8	54	101	176
SOURCES OF FINANCING	**60,086**	**57,043**	**34,118**	**28,478**	**28,067**	**29,426**	**30,515**	**31,288**	**32,111**
Capital account (net)	23	244	144	144	144	144	144	144	144
Foreign direct investment (net)	1,197	169	306	130	1,302	547	569	788	816
CYP investment abroad	219	-232	-306	-261	-355	-550	-569	-591	-612
Foreign investment in CYP	979	402	613	391	1,657	1,096	1,139	1,379	1,428
New borrowing and debt rollover	54,254	35,782	29,621	30,668	28,943	29,183	30,262	31,668	32,529
Medium and long-term borrowing	5,271	4,444	3,665	4,672	3,179	3,171	3,908	4,808	5,092
General Government	2,120	26	910	1,817	326	114	795	1,566	1,779
Banks	1,084	4,334	1,293	1,332	1,329	1,381	1,404	1,419	1,435
Other private	2,067	85	1,462	1,523	1,523	1,676	1,709	1,823	1,877
Short-term borrowing	48,982	31,337	25,957	25,995	25,763	26,012	26,354	26,859	27,438
Public sector	7,494	7,363	2,724	1,635	1,471	1,324	1,192	1,072	965
Central Bank	7,494	7,363	2,724	1,635	1,471	1,324	1,192	1,072	965
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	21,891	21,253	22,381	22,313	22,510	22,768	23,033	23,305
Other private	1,075	2,083	1,979	1,979	1,979	2,177	2,395	2,754	3,167
Other	4,612	20,848	4,046	-2,463	-2,321	-447	-460	-1,312	-1,378
Of which: Net errors and omissions	346	-439	0	0	0	0	0	0	0
FINANCING GAP	**0**	**4,838**	**1,286**	**1,478**	**2,424**	**0**	**0**	**0**	**0**
ESM	0	4,585	1,100	950	2,300	0	0	0	0
IMF	0	253	186	528	124	0	0	0	0
ROLLOVER RATES									
General government 1/	238%	0%	211%	480%	36%	178%	107%	150%	153%
Central bank	94%	98%	37%	60%	90%	90%	90%	90%	90%
Private	89%	54%	97%	104%	100%	102%	102%	103%	103%
Banks	86%	52%	97%	105%	100%	101%	101%	101%	101%
Non-financial corporates	167%	101%	95%	100%	100%	110%	110%	115%	115%

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

1/ Rollover rate does not include EIB loan.

Table 6. Cyprus: Monetary Indicators, 2010–20
(Billions of Euros, unless otherwise indicated, end of period)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)											
Assets	135.0	131.4	128.1	90.3	92.2	96.8	96.7	97.1	98.2	99.1	100.5
Claims on Central Bank of Cyprus	2.3	2.9	3.9	2.7	4.2	4.1	4.2	4.3	4.4	4.5	4.6
Claims on Cypriot resident other MFIs	5.6	5.0	4.6	3.3	4.8	4.8	4.9	5.1	5.2	5.4	5.6
Claims on Cypriot resident non MFIs	54.0	58.2	60.6	55.0	53.6	51.4	50.8	50.6	51.0	50.6	50.9
General government	4.5	5.3	6.5	5.4	4.5	2.8	2.6	2.4	2.4	2.4	2.3
Private sector excluding brass plates 1/	46.5	48.6	49.3	46.5	45.5	45.0	44.6	44.5	44.4	44.6	44.9
Households	22.5	23.5	23.9	22.3	21.9	21.7	21.4	21.2	21.1	21.1	21.2
Non-financial corporations	23.3	24.1	24.4	23.4	22.0	21.7	21.6	21.7	21.8	21.9	22.0
Non-bank financial intermediaries	0.7	1.0	1.0	0.8	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Brass plates	3.0	4.4	4.8	3.1	3.6	3.6	3.6	3.6	3.6	3.7	3.7
Claims on non-residents	69.3	61.3	55.9	25.3	25.8	31.7	32.3	32.9	33.8	34.7	35.5
Other assets	3.8	3.9	3.2	3.9	3.8	4.8	4.5	4.3	3.8	3.8	3.8
Liabilities	135.0	131.6	128.1	90.3	92.2	96.8	96.7	97.1	98.2	99.1	100.5
Liabilities to the Central Bank of Cyprus and Eurosystem	5.5	5.5	9.8	11.2	8.5	7.2	6.4	5.6	5.1	4.6	4.5
Liabilities to Cypriot resident other MFI	5.5	4.9	4.5	3.1	3.6	3.5	3.6	3.7	3.9	4.0	4.2
Deposits of Cypriot resident non MFIs	45.4	43.7	43.3	33.0	32.3	32.1	32.6	33.2	34.2	35.1	35.9
General government	0.5	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Private sector excluding brass plates	36.8	37.4	37.5	29.9	29.4	29.2	29.7	30.3	31.3	32.1	32.9
Households	25.4	26.0	26.4	23.3	22.3	22.2	22.5	23.0	23.7	24.3	25.0
Non-financial corporations	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	4.7	4.6	5.4	2.7	3.2	3.2	3.2	3.3	3.4	3.5	3.6
Brass plates	8.1	5.8	5.3	2.6	2.4	2.4	2.4	2.5	2.5	2.5	2.5
Deposits of non-residents	60.6	56.5	51.3	24.5	24.0	30.1	30.4	30.8	31.2	31.7	32.2
Debt securities	2.4	2.6	1.7	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital and reserves	12.8	11.3	15.1	16.4	21.7	21.7	21.7	21.7	21.7	21.7	21.7
Other liabilities	2.8	7.1	2.4	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Money and Credit											
General government sector credit, net 2/	5.2	5.3	7.2	5.5	4.3	2.5	2.3	2.2	2.1	2.1	2.1
Cypriot resident broad money (M2)	46.6	45.0	44.6	34.5	34.2	34.0	34.1	34.8	35.9	36.8	37.7
Cypriot resident narrow money (M1)	10.6	11.1	11.5	10.4	11.4	11.6	11.8	12.3	12.9	13.3	13.7
					(Percent of GDP)						
General government sector credit, net	27.5	27.0	36.9	30.5	24.3	14.4	12.9	11.9	11.2	10.6	10.1
Private sector credit excluding brass plates	244.0	249.7	253.9	256.8	260.2	258.9	251.6	242.8	234.2	226.2	220.0
Brass plates credit	15.9	22.3	24.6	17.0	20.5	20.7	20.3	19.8	19.2	18.6	18.1
Cypriot resident broad money (M2)	244.2	230.9	230.0	190.2	195.2	195.8	192.2	190.2	189.2	186.6	184.7
Cypriot resident narrow money (M1)	55.9	57.1	59.1	57.4	65.2	66.6	66.8	67.4	67.7	67.3	67.1
					(Annual percentage change)						
General government sector credit, net	-1.6	0.4	36.2	-22.9	-22.8	-41.3	-8.5	-4.9	-2.2	-1.9	-1.3
Private sector credit excluding brass plates	8.8	4.6	1.3	-5.6	-2.1	-1.2	-0.8	-0.4	-0.1	0.3	0.7
Brass plates credit	2.3	44.0	9.9	-35.7	17.0	-0.1	0.3	0.5	0.6	0.6	0.6
Cypriot resident broad money (M2)	10.4	-3.4	-0.8	-22.8	-0.9	-0.4	0.2	2.1	3.1	2.4	2.4
Cypriot resident narrow money (M1)	2.3	4.4	3.2	-9.4	9.8	1.4	2.4	4.2	4.1	3.2	3.2
Memorandum items:											
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	6.5	1.7	0.3	-20.2	-1.6	-0.7	1.4	2.2	3.3	2.6	2.6
Brass plates deposits (y-o-y percent change)	33.8	-28.3	-9.4	-50.4	-7.3	-0.2	0.5	0.8	0.9	1.0	0.9

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

1/ Includes public entities classified outside the general government. 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/ Includes CBC's net claims on general government.

Table 7. Cyprus: Financial Soundness Indicators, 2010-14 1/

(Percent, unless otherwise specified)

	2010	2011	2012	2013	2014
Capital Adequacy					
Overall solvency ratio	12.3	8.6	7.3	13.5	15.3
Tier I capital ratio	10.9	7.4	6.3	12.3	14.6
Core Tier I capital ratio or Common Equity Tier 1 capital ratio 2/	8.8	5.0	4.5	11.7	14.2
Risk weighted assets (billions of euro)	80.2	78.4	69.9	45.0	45.6
Asset Quality					
Non-performing loans to total gross loans 3/	12.4	16.2	25.5	46.2	56.1
Provisions to nonperforming loans	61.2	49.4	47.9	31.0	33.1
Earnings and Profitability					
Return on assets	0.6	-3.4	-3.4	-4.3	-0.6
Return on equity	9.3	-50.9	-69.5	-69.5	-0.1
Cost to income ratio	49.9	49.5	55.6	53.4	40.4
Net interest margin	2.0	2.4	2.3	2.4	2.9
Liquidity					
Liquid assets to total assets	10.7	9.7	8.6	7.0	14.4
Customer deposits to total (non-interbank) loans	113.8	101.1	96.8	73.9	74.9
Market Indicators (end period)					
Cyprus Stock Exchange (CSE) General Index (Mar 2004=1000)	1055.2	295.9	114.9	103.3	84.6
Market capitalization (CSE) (percent of GDP)	29.2	24.4	9.9	8.7	10.8

Sources: CBC; and IMF staff calculations.

1/ These FSIs cover consolidated accounts of domestic and foreign banks operating in Cyprus.

2/ Common Equity Tier 1 capital ratio applies as from the reference date 2014.

3/ As of end 2014, banks report NPLs as per the EU's regulation on reporting NPLs and forborne exposures. The main changes with respect to the previous definition are that the minimum probation period for forborne loans remaining classified as NPLs has increased from 6 to 12 months, and performing restructured loans are now classified as NPLs if they present arrears greater than 30 days.

Table 8. 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	148.5	420.8	99.0	0.0	0.0	0.0	0.0
Stock	0.0	222.8	371.3	792.0	891.0	884.8	841.5	761.1	620.8
Obligations	0.0	1.6	3.8	8.2	16.7	23.9	62.0	99.5	155.5
Repurchase	0.0	0.0	0.0	0.0	0.0	6.2	43.3	80.4	140.3
Charges	0.0	1.6	3.8	8.2	16.7	17.7	18.6	19.1	15.2
Stock of existing and prospective Fund credit									
In percent of quota	0.0	140.8	234.7	500.6	563.2	559.3	531.9	481.1	392.4
In percent of GDP	0.0	1.4	2.7	5.7	6.3	6.1	5.6	4.8	3.8
In percent of exports of goods and services	0.0	3.4	6.5	14.1	15.5	14.7	13.4	11.5	9.0
Obligations to the Fund from existing and prospective Fund credit									
In percent of quota	0.0	1.0	2.4	5.2	10.6	15.1	39.2	62.9	98.3
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.2	0.4	0.6	1.0
In percent of exports of goods and services	0.0	0.0	0.1	0.1	0.3	0.4	1.0	1.5	2.3

Source: IMF staff estimates.

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

Table 9. Cyprus: Revised Schedule of Reviews and Purchases 1/

Availability Date	Amount of Purchase: Millions of SDR	Amount of Purchase: Percent of Quota	Conditions
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
September 15, 2015	99.00	62.58	Eighth review based on end-June 2015 performance criteria
December 15, 2015	99.00	62.58	Ninth review based on end-September 2015 performance criteria
March 15, 2016	99.00	62.58	Tenth review based on end-December 2015 performance criteria
Total	891.00	563.21	

Source: IMF staff estimates.

1/ The 5th, 6th, and 7th reviews are combined, and performance assessed on the basis of continuous performance criteria and end-September 2014 targets.

Table 10. Cyprus: Conditionality for the Combined Reviews

Measures	Timing	Status
Implementation of a new social welfare system	End-June 2014	Implemented in July
Approval by Council of Ministers of the strategy for reforming the debt-restructuring legal framework	End-July 2014	Met
CBC supervisory units to submit to the CBC Board the first quarterly report regarding the coops' performance against selected operational and financial targets	End-July 2014	Met
Appointment of an independent firm and/or international institution to be entrusted with the voting rights of legacy Laiki in BoC	End-September 2014	Not met
Approval by Council of Ministers of the debt management strategy	End-October 2014	Implemented in December
CBC submission of assessment of banks and coops implementation of action plans to address operational deficiencies and potential shortcomings related to compliance with the Code of Conduct and arrears management policies and practices	End-November 2014	Implemented in December
Establishment of an integrated large taxpayers unit	End-December 2014	Implemented in January 2015
Adoption by parliament of legislation to modernize personal and corporate insolvency procedures and to regulate insolvency practitioners assisting in the restructuring process	End-December 2014	Implemented in April 2015
CBC assessment of internal audit on governance of bank debt restructuring	End-January 2015	Met

Table 11. Cyprus: External Debt Sustainability Framework, 2010-2022
(Percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2010	2011	2012	2013	2014 (Est.)			2015	2016	2017	2018	2019	2020	2021	2022	
Baseline: External debt	447.4	406.9	417.8	327.1	288.2			**327.5**	**331.9**	**325.1**	**317.5**	**313.5**	**311.2**	**305.6**	**304.6**	**-6.7**
Change in external debt	152.9	-40.5	10.9	-90.7	-38.9			39.3	4.4	-6.8	-7.5	-4.1	-2.3	-5.6	-1.0	
Identified external debt-creating flows (4+8+9)	14.9	-33.5	29.8	3.3	11.4			2.0	-6.2	-4.5	-5.6	-6.6	-5.6	-5.0	-5.0	
Current account deficit, excluding interest payments	0.9	-5.0	-3.9	-6.8	-2.4			-2.3	-2.7	-3.1	-2.8	-2.8	-2.7	-2.8	-2.9	
Deficit in balance of goods and services	5.7	3.9	2.8	-1.7	0.6			0.1	0.1	-0.2	-0.3	-0.6	-0.8	-1.0	-1.2	
Exports	37.7	39.4	39.2	40.0	40.6			40.4	40.7	41.1	41.6	42.0	42.5	42.9	43.6	
Imports	43.4	43.3	42.0	38.3	41.2			40.5	40.8	40.9	41.2	41.4	41.7	41.9	42.3	
Net non-debt creating capital inflows (negative)	1.7	-6.6	-11.7	-13.9	-4.0			-1.6	-5.9	-2.2	-2.9	-4.5	-4.6	-4.0	-4.0	
Automatic debt dynamics 1/	12.4	-22.0	45.3	24.0	17.8			5.8	2.4	0.8	0.2	0.6	1.6	1.7	1.9	
Contribution from nominal interest rate	8.1	8.0	10.1	8.5	6.9			6.6	6.9	7.0	7.1	7.1	7.1	7.2	7.4	
Contribution from real GDP growth	-4.2	-1.1	10.5	23.2	7.6			-0.8	-4.5	-6.3	-6.9	-6.4	-5.5	-5.5	-5.5	
Contribution from price and exchange rate changes 2/	8.4	-28.9	24.7	-7.8	3.3			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	138.0	-7.0	-18.9	-94.0	-50.3			37.4	10.6	-2.3	-2.0	2.6	3.3	-0.6	4.0	
External debt-to-exports ratio (in percent)	1186.9	1033.4	1066.2	817.3	709.4			811.1	815.5	790.3	763.8	746.9	733.0	711.7	699.3	
Gross external financing need (in billions of US dollars) 4/	50.5	85.3	79.0	81.4	48.4			37.4	38.2	37.2	39.0	40.3	41.7	42.5	43.0	
in percent of GDP	199.5	314.8	316.4	338.2	207.6	5-Year	5-Year	171.9	171.3	159.9	160.1	158.2	156.9	154.2	151.0	
Scenario with key variables at their historical averages 5/								**327.5**	**345.8**	**355.0**	**365.5**	**382.8**	**402.4**	**415.6**	**435.1**	**10.8**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation									
Nominal GDP (US dollars)	25.3	27.1	25.0	24.1	23.3			21.7	22.3	23.3	24.3	25.5	26.5	27.5	28.5	
Real GDP growth (in percent)	1.4	0.3	-2.4	-5.4	-2.3	-1.7	2.6	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9	
GDP deflator in US dollars (change in percent)	-2.8	6.9	-5.7	1.9	-1.0	-0.1	4.8	-6.9	1.2	2.2	2.3	2.4	2.4	1.9	1.5	
Nominal external interest rate (in percent)	2.7	1.9	2.3	2.0	2.0	2.2	0.3	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	
Growth of exports (US dollar terms, in percent)	1.0	12.0	-8.4	-1.5	-1.8	0.2	7.4	-7.2	3.5	5.4	5.7	5.6	5.5	4.9	4.9	
Growth of imports (US dollar terms, in percent)	2.2	7.0	-10.7	-12.1	4.2	-1.9	8.9	-8.3	3.3	4.7	5.3	5.0	4.9	4.4	4.4	
Current account balance, excluding interest payments	-0.9	5.0	3.9	6.8	2.4	3.4	2.9	2.3	2.7	3.1	2.8	2.8	2.7	2.8	2.9	
Net non-debt creating capital inflows	-1.7	6.6	11.7	13.9	4.0	6.9	6.2	1.6	5.9	2.2	2.9	4.5	4.6	4.0	4.0	

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 12. Cyprus Selected Reforms—Measures Completed

Measures	Completion time	Macrofinancial implications
Fiscal Consolidation and 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
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
Adopted the institutional and legal framework to govern the privatization process, including a unit within the Ministry of Finance to implement the privatization plan	March 2014	Provide the legal framework for the privatization process
Integrated by law the two tax authorities into a single Department of Taxation	June 2014	Harmonize procedures and increase efficiency
Adopted a welfare law	July 2014	Reduce poverty and increase efficiency
Implemented a common taxpayer database	September 2014	Improve efficiency of revenue administration
Preapred a report the stock of outstanding guarantees, risks, and how called guarantees have been addressed	September 2014	Address risks arising from government guarantees
Started paying benefits on guaranteed minimum income	October 2014	Reduce poverty and increase efficiency
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
Resolved Laiki bank 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 and consolidated the coop sector	March 2014	Strengthen financial sector stability
Prepared an action plan to strengthen the cooperative credit sector	September 2014	Strengthen financial sector stability
Strengthening supervision and regulation and restructuring private sector debt		
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
Finalized a code of conduct for banks and an arrears management framework	September 2013	Assist debt restructuring
Completed the operationalization of the credit register	September 2014	Allow banks to make informed loan decisions
Enacted amendments to the foreclosure law to streamline the foreclosure process	September 2014	Provide incentives for debt restructurings
Adopted a package of laws to reform the insolvency framework	April 2015	Provide incentives for debt restructurings
Strengthening the AML framework		
Amended legislation to provide the widest possible range of cooperation to foreign counterparts	December 2012	Strengthen business model
Conducted an audit by Deloitte and assessment by Moneyval of AML implementation practices by the banks	August 2013	Strengthen business model
Amended legislation to improve transparency of companies and trusts	September 2013	Strengthen business model
Amended company law in relation with the Registrar of Companies	May 2015	Streamline the process of registration and de-registration of non-compliant companies

Table 13. Cyprus: MEFP Commitments		
Measures	Deadline	Rationale
Financial Sector Policies		
Addressing High NPL Levels - legal framework		
Council of Ministers to adopt legislation ensuring that the ownership of titles reflects the economic ownership of the property at all times **(structural benchmark)**	End-June 2015	Address the problem of immovable properties purchased without proper transfer of title
Authorities to review the relevant civil procedure and court rules related to foreclosure and adopt necessary changes, including legislative amendments	End-July 2015	Facilitate the effective implementation of the foreclosure framework
Authorities to adopt administrative acts and regulations needed to fully ensure the functioning of the Insolvency Regime **(structural benchmark)**	End-August 2015	Start the implementation of the new insolvency regime
Authorities to review the relevant civil procedure and court rules related to insolvency	End-September 2015	Facilitate the effective functioning of the new insolvency processes
Authorities to submit to the Council of Ministers any necessary adjustments to the insolvency and foreclosure frameworks **(structural benchmark)**	End-September 2015	Review the foreclosure and insolvency framework
Authorities to present legal or contractual standards for property sales contracts and connected loan and mortgage arrangements	End-October 2015	Incentivize the swift transfer of title deeds
Authorities to conduct a comprehensive review of the private sector debt restructuring legal framework with an action plan of modifications to the framework	Early 2016	Correct any deficiencies to the foreclosure and insolvency framework
Addressing High NPL Levels - banks' arrears management capacity		
CBC to provide to the SSM its findings and recommendations regarding revision of banks' internal policies and processes for follow-up	End-June 2015	Enforce banks' compliance with arrears management framework and code of conduct
Council of Ministers to approve necessary legislation to enable the sale of loans to non-banks	End-June 2015	Remove existing impediments to the securitization of assets
CBC to publish the aggregate targets and the banks' past performance after each quarter **(structural benchmark)**	End-July 2015	Encourage banks to reduce NPLs and ensure continuous monitoring
CBC to carry out a study of the financial situation of borrowers and to publish the findings	End-July 2015	Ensure the effectiveness of debt resolution policies
Authorities to submit to Parliament necessary changes to the legislative framework related to a secondary market for loans	End-July 2015	Remove existing impediments to the securitization of assets
Restructuring the coop sector		
Authorities to require the coops to submit a time-bound action plan related to arrears management	End-June 2015	Carry out a review of the sector's policies and operational capacity on debt resolution
Streamline responsibilities of the CCB's divisions and enhance the efficiency of the sector's control functions, including by centralizing them at the CCB	End-June 2015	Strengthen the oversight of the CCB over the Cooperative Credit Institutions (CCIs)
Authorities to amend the affiliation directive	End-June 2015	Strengthen the oversight of the CCB over the Cooperative Credit Institutions (CCIs)
CCB to submit an implementation strategy that ensures a smooth transition, including by enabling the CCB to manage the additional responsibilities	End-July 2015	Address deficiencies related to financial control and risk processes
Strengthening financial sector regulation and supervision		
Authorities to determine further staffing needs, also taking into account increased responsibilities in the area of bank resolution	End-June 2015	Ensure sufficient resources are available to carry out the CBC's duties
The resolution authority to finalize a plan for completing the resolution of Laiki	End-June 2015	Complete the resolution of Laiki
Strengthening the AML framework		
Supervisors of lawyers, accountants, and trust and company service providers to adjust risk-based tools	End-June 2015	Maintain financial sector integrity and stability
Authorities to start implementing the reform of the Registrar of Companies	End-July 2015	Streamline the process of registration and de-registration of non-compliant companies
CBC to implement its risk based supervision plan comprising 13 credit institutions (including 4 CCIs)	End-December 2015	Maintain financial sector integrity and stability
Supervisors of lawyers, accountants, and trust and company service providers to implement annual inspection programs	End-December 2015	Maintain financial sector integrity and stability

Table 13. Cyprus: MEFP Commitments (concluded)		
Measures	Deadline	Rationale
Structural Fiscal Reforms		
Implementing a comprehensive welfare reform		
Authorities to prepare plans to consolidate disability and education benefits in line with the adopted welfare reform	End-June 2015	Ensure that the new welfare system is fully in place
Authorities to require recipients of social benefits to declare all the benefits they receive (including non-GMI benefits)	End-September 2015	Ensure that the new welfare system is fully in place
Authorities to finalize an assessment report of the implementation of the GMI	End-September 2015	Ensure that the new welfare system is fully in place
Authorities to build a registry of benefits in line with our new welfare law including the profiles and eligibility of all beneficiaries, cross-checked with other databases	End-December 2015	Ensure that the new welfare system is fully in place
Authorities to re-examine the overall welfare reform to realize efficiency gains from the consolidation of all information on welfare programs	End-March 2016	Ensure that the new welfare system is fully in place
Advancing the tax administration reform		
Authorities to prepare the first quarterly progress report on the tax debt recovery plan specifying targeted groups, collection enforcement measures used, and recovered debt	End-June 2015	Monitor progress on addressing tax arrears and evasion
Authorities to establish a single registration process for all domestic taxes	End-June 2015	Reform the revenue administration
Council of Ministers to establish an integrated legal framework for tax procedures under a new tax procedures code	End-September 2015	Reform the revenue administration
Large Taxpayer Office to be fully functional including taxpayer services, risk assessment and compliance activities	End-December 2015	Reform the revenue administration
Authorities to fully integrate department of taxation	Mid-2016	Improve efficiency of revenue administration
Enhancing the management of fiscal risks arising from government guarantees		
Council of Ministers to approve the institutional framework to monitor and manage existing and new government guarantees **(structural benchmark)**	End-June 2015	Address risks arising from government guarantees
Authorities to improve risk assessment analysis with a view to updating their risk assessment report	End-June 2015	Address risks arising from government guarantees
Council of Ministers to approve the pending FRBSL regulations	End-June 2015	Ensure full implementation of the FRBSL
Parliament to approve the pending FRBSL regulations	End-September 2015	Ensure full implementation of the FRBSL
Taking actions towards the privatization of state-owned enterprises		
Authorities to hire an independent energy advisor to prepare a study for the legal unbundling and ownership structure of EAC as well as the required regulatory review	End-July 2015	Take preparatory steps towards privatizing SOEs
Authorities to adopt legislation to convert CyTA into a limited liability company	End-September 2015	Take preparatory steps towards privatizing SOEs
Authorities to amend the regulatory framework for the privatization of CPA	End-October 2015	Take preparatory steps towards privatizing SOEs
Authorities to implement the legal unbundling of EAC	End-March 2016	Take preparatory steps towards privatizing SOEs
Authorities to privatize CyTA and CPA	End of program	Finalize privatization
Authorities to privatize EAC	Mid-2018	Finalize privatization
Boosting growth prospects and strengthening the public administration		
Authorities to submit to the Council of Ministers a reform package including a revision of the wage setting framework and the opening of promotion posts	End-June 2015	Enhance effectiveness of public administration, while ensuring its affordability
Authorities to prepare an action plan with measures to simplify regulations and licensing requirements hampering the operation of businesses	End-September 2015	Improve the business environment
Parliament to adopt a reform package including a revision of the wage setting framework and the opening of promotion posts **(structural benchmark)**	End-December 2015	Enhance effectiveness of public administration, while ensuring its affordability
Program financing and monitoring		
Authorities to transfer the rights and liabilities associated with coins issuance from the CBC to the MoF and receive additional financing of €100 million	End-December 2015	Secure additional financing

Annex I. The NPL Problem: Assessing the Impact of the New Private Debt Restructuring Framework [1]

This annex discusses Cyprus's nonperforming loans problem, and then presents estimates of the links between private sector debt restructuring, credit growth, and economic activity. Lower private debt could raise credit growth by between 0.6–2.4 percentage points over the medium term.

The NPL problem

Very high levels of private sector debt and the unprecedented levels of NPLs inhibit credit growth and economic recovery. At over 400 percent of GDP, private sector debt in Cyprus is among the highest in the eurozone. In addition, Cyprus's ratio of NPLs over total loans in the domestic banking sector stands at 59 percent, the highest in the region. In this context, credit to the private sector has contracted by about 8 percent in the last two years.

Given limited fiscal space, dealing with the NPL problem can only rely on private sector solutions. High public debt precludes the state from supporting the banks directly or shouldering the risk associated with NPLs**.** Therefore, solutions seen in some other countries (like state-backed asset management companies) are not available to Cyprus (see table below).

A Non-Exhaustive List of NPL Reduction Strategies Around the World

Keeping assets on the balance sheet of the banks			Transferring assets off the balance sheet of the banks		
Writedowns	Guarantee schemes	Internal restructuring units	Insividual SPVs	Private AMCs	State-backed AMCs
Iceland (2009)	U.K. (2009)	Cyprus (2013)	Sweden (1992) Germany (2009)	U.S. (1984) Indonesia (late 1990s) Japan (late 1990s)	Ireland (2009) Spain (2012)

Debt restructuring: a framework for incentives and impact

The strategy in Cyprus has thus focused on enabling a private sector-led approach. It is based on three pillars: (i) building banks' capacity to deal with NPLs, including by setting up internal workout units and procedures; (ii) strengthening the supervisory framework; and (iii) reforming the legal framework for private sector debt restructuring to incentivize banks and borrowers to voluntarily restructure debt, with unilateral measures (such as liquidation) left as an option when the borrower's viability cannot be restored.

The key pillars of the private debt restructuring framework are new foreclosure and insolvency regimes, which are critical for providing adequate incentives. In the absence of a clear and effective legal framework, both banks and borrowers have an incentive to holdout (Figure A1.1), and the high level of NPLs continues to stall credit supply and demand. The revised

[1] Prepared by Ruchir Agarwal, Alejandro Hajdenberg and Oliver Wuensch.

legislation aims at providing incentives for borrowers (i.e. the threat of foreclosure) to re-establish payments if they have the ability to do so, or come to the table to renegotiate, if they can only repay part of the debt. Also banks are incentivized to proactively restructure NPLs, as the banks might otherwise suffer heavier losses if the borrower goes into bankruptcy or liquidation (Figure A2.2).

Figure A1.1. Why Renegotiation Doesn't Happen

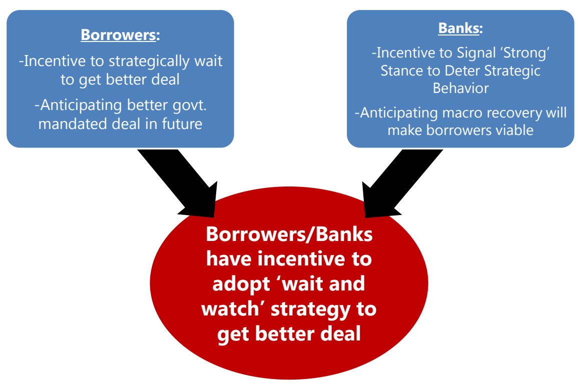
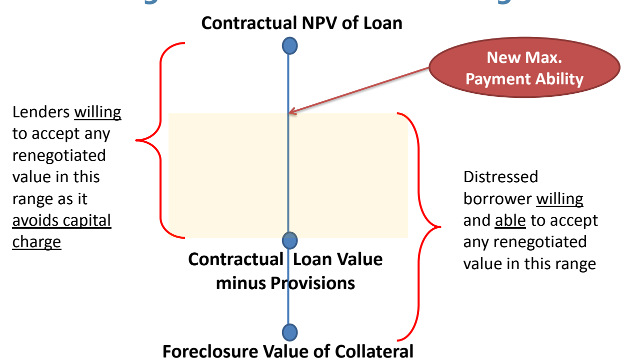
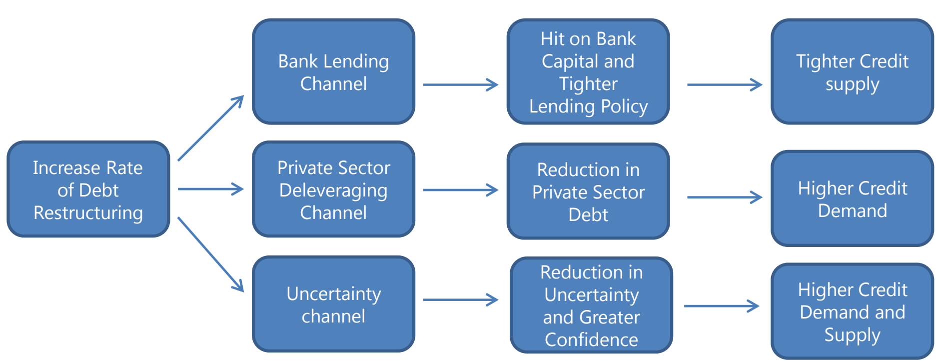


Figure A1.2. Simplified Illustration of Negotiated Debt Restructurnig



Debt restructuring strategies that lead to NPV reduction have opposing effects on credit demand and supply by lowering borrower indebtedness but also adversely affecting bank capital (Figure A3.3). The literature finds that higher private sector debt is associated with lower credit demand, while a tighter capital position of banks is associated with weaker supply. The actual impact on credit is an empirical question, and will depend largely on the net impact of these two channels. An important third channel is through the effect on uncertainty. Successful debt restructurings could reduce uncertainty and support both supply and demand. It should be also noted that the positive impact of a lower debt level would likely take some time to take effect due to the disruptive effects of large scale debt restructuring.

Figure A1.3. Debt Restructuring - Transmission Channels



Empirical estimate of the impact of the private debt restructuring reform on credit growth

A key question is how the new debt restructuring framework will impact credit growth. While the estimation can only be speculative in light of the unprecedented nature of the changes being introduced, this section presents calculations to suggest a range for the potential impact. The computations rely on an assessment that has been performed in the context of the insolvency reform and therefore uses variation in household debt.

The reduction in private sector debt resulting from insolvency could be in the range of 3–12 percent of GDP due to demand factors. The magnitude of the impact depends on various factors including whether borrowers use the "repayment plan" provided under the insolvency regime, the particulars of the eligibility criteria, market value of collateral, repayment rate of modified loans, and the risk that currently performing borrowers see now-greater incentives for restructuring their loans (i.e. strategic default), but also the time needed to manage a high number of cases. Based on an assessment done by the banks, the NPLs that could be eligible for the insolvency process could range between €1–3 billion (6–7 percent of GDP). For the purposes of the calculation, the following parameters were used to generate a range of scenarios: (i) the portfolio at risk of strategic default is either €1 billion or €3 billion (equal to the eligible portfolio for insolvency); (ii) 15 or 30 percent of this at-risk portfolio may actually default; and (iii) as a result of the insolvency process, additional write-downs of 10 or 20 percent could be required beyond the existing provision coverage ratio of 33 percent. The range of estimates from this exercise suggest that the insolvency process could bring about a debt reduction in the private sector of about €0.5–2.1 billion or 3–12 percent of GDP. This corresponds to a €0.2–1.1 billion impact on bank's capital due to additional provisioning under the different scenarios.

Impact of Insolvency: Scenario Analysis

Scenario parameters					Provisions and writedowns			Impact on banks and non-financial private sector	
Nonperforming eligible portfolio	Performing portfolio at risk of strategic default	Current provisions ratio	Additional writedown beyond existing provisions	Strategic default ratio	Existing provisions on non-performing portfolio	Additional writedowns on performing portfolio	Additional writedowns on nonperforming portfolio	Total writedowns beyond existing provisions	Total debt reduction for private sector
(Billions of euros)		(Percent)			(Billions of euros)			(Billions of euros)	
(A)	(B)	(C)	(D)	(E)	(F) = (A × C)	(G) = (A × D)	(H) = (B × E)×(C+D)	(G) + (H)	(F) + (G) + (H)
1.0	1.0	33	10	15	0.3	0.1	0.1	0.2	0.5
1.0	1.0	33	20	15	0.3	0.2	0.1	0.3	0.6
1.0	1.0	33	10	30	0.3	0.1	0.1	0.2	0.6
1.0	1.0	33	20	30	0.3	0.2	0.2	0.4	0.7
3.0	3.0	33	10	15	1.0	0.3	0.2	0.5	1.5
3.0	3.0	33	20	15	1.0	0.6	0.2	0.8	1.8
3.0	3.0	33	10	30	1.0	0.3	0.4	0.7	1.7
3.0	3.0	33	20	30	1.0	0.6	0.5	1.1	2.1

Source: Central Bank of Cyprus and IMF staff estimates.

Lower private debt is then estimated to raise credit growth by between 0.6–2.4 percentage points. Cross-country variation in the euro area during 2000–14 is used to estimate the impact of reduction in private sector debt on credit growth in the subsequent year. The estimate suggests that a 1 percentage point decline in private sector debt is associated with a 0.2 percentage point increase in credit growth. Taking this estimate and applying the range of the estimated write-down (€0.5–

2.1 billion, or 3–12 percent of GDP), the calculation suggests that the impact of the insolvency regime could be associated with an increase of between 0.6–2.4 percentage points in credit growth in the medium term. Note that this calculation makes several strong assumptions. It is assumed that since the banks were adequately capitalized according to the comprehensive assessment exercise, the additional impact on bank capital (estimated to be in the range of €0.2–1.1 billion) will not significantly tighten credit supply. It also implies that there is no mid-term effect of a reduction to corporate debt, as restructured companies are not expected to increase leverage anytime soon.

Any impact from voluntary restructuring would constitute an upside to the estimate in the near term. The program strategy puts priority on enabling voluntary restructuring. However, cross-country experience suggests successful implementation takes time. In Cyprus, during the first three quarters of 2014, credit facilities restructured amounted to 12 percent of NPLs (19 percent of GDP), and a substantial fraction of these solutions are subject to significant risk of re-defaults. Progress is thus expected to remain gradual with limited impact on private debt levels in the short term. A faster pace of voluntary restructuring would therefore constitute an upside.

However, several bank lending factors could dampen credit recovery even if significant private sector deleveraging occurs. These include:

- **Availability of good quality borrowers:** Given the high level of NPLs and uncertainty about the sustainability of already restructured loans, the pool of borrowers with good credit history has shrunk significantly;

- **Sensitvity of bank capital to writedowns:** A large capital impact due to restructuring may inhibit their lending capacity and risk appetite, reducing the benefit of deleveraging;

- **Impact on banks' lending policy:** The new framework is likely to affect banks' lending decisions, although the magnitude and distribution cannot be assessed at this point. For example, in the U.S. context, Gropp et al. (1997) found that more generous bankruptcy terms have a regressive impact on credit allocation and increased lending rates. Other studies (e.g., Jagtiani and Li, 2014), find that filers for bankruptcy have more difficulty re-accessing credit.[2]

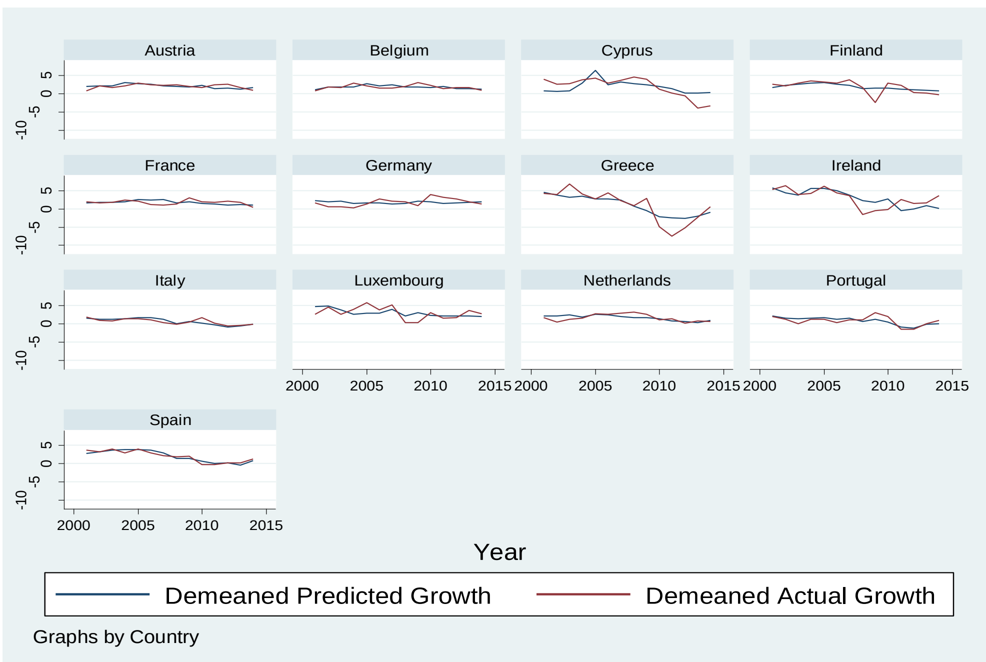
[2] Reint Gropp, et al., "Personal Bankruptcy and Credit Supply and Demand", The Quarterly Journal of Economics, Vol. 112, No. 1 (Feb. 1997); Julapa Jagtiani and Li W., "Credit Access After Consumer Bankruptcy Filing: New Evidence", WP No. 14-25, Federal Reserve Bank of Philadelphia, Aug. 2014.

Linking Credit Growth to Economic Growth

To assess the impact of credit growth on economic growth, a simple model for the euro area countries is estimated. Based on the work of Martin and Philippon (2014), real GDP growth is regressed on the growth of household debt and real government expenditure, controlling for country and time fixed effects. The graphs are demeaned by euro area growth (by differencing out year fixed effects) to examine the idiosyncratic growth experience of each country.

Results suggest that while credit growth is an important determinant of GDP growth in the euro area, in the case of Cyprus other factors may be hindering economic growth. The model fits the performance of euro area countries reasonably well, but in the case of Cyprus (as well as Greece and Ireland) credit growth has a lower explanatory power. The charts below summarize the simulations. Accordingly the results suggest that even if credit growth recovers in Cyprus, effective policies targeting other areas of the economy may be needed.

Credit and GDP Growth: Country Regressions



Annex II. Public Sector Debt Sustainability Analysis

This annex presents an analysis of Cyprus's public debt sustainability. Overall, the public debt profile has improved significantly compared to the Fourth Review and is expected to remain on a sustainable trajectory. However, debt levels remain high and vulnerable to growth and contingent and implicit liabilities shocks. In particular, a combination of shocks scenarios including a growth shock and/or materialization of contingent liabilities could still push debt to very high levels. The non-materialization of privatization proceeds and/or the debt to asset swap are also potential risks.

Cyprus's public debt peaked in 2014 at 107 percent of GDP and is projected to gradually decline to below 80 percent of GDP by 2020. The 2014 debt level represents a significant improvement compared to forecast during the fourth review of 120 percent of GDP (see ¶12). The 2014 level improvement carries forward to the remainder of the debt path. The subsequent medium term debt gradual decline is predicated on the assumptions of continued progress in line with the program towards a 3 to 4 percent long term primary surplus target, a gradual pick-up of economic activity, the utilization of €1.4 billion privatization proceeds in 2016–17 for debt reduction, and a €0.6 billion debt-to-asset swap operation allowing the government to lower its debt by swapping debt for real estate with the CBC.

Debt projections remain vulnerable to shocks (Figure A2.1). The baseline debt level is high and exceeds the benchmark above which the risk of debt distress is assessed as high (85 percent of GDP). Under the adverse shocks, debt could reach between 110 and 125 percent of GDP by 2020.[1] Moreover, external financing needs and the asymmetric fan chart continue to point to risks. However, market perception of Cypriot public debt has significantly improved. In addition, building on the transaction carried out in 2014, further debt management operations in 2015 are expected to continue to smooth the debt maturity profile immediately following the program period. Gross financing needs remain vulnerable to growth and contingent liability shocks.

While forecasting performance has been mixed—given the materialization of unforeseen tail risks—the current macroeconomic baseline remains conservative relative to macroeconomic outturns to date (Figure A2.2). Growth, deflator, and primary balance projection errors appear optimistic relative to other program countries, especially as 2012 and 2013 growth deviations were significantly outside the inter-quartile range. However, these reflected the effects of the power plant accident in 2011 and the banking sector crisis in 2013—exacerbated by the Greek PSI—which could not have been foreseen in the years preceding the events. However, Figure A2.2 does not capture that since the onset of the program, growth and fiscal projections have been consistently more

[1] The parameters of the asymmetric distribution were calibrated to capture potential debt paths under adverse shocks on growth and the primary balance due to a prolonged deleveraging and adjustment fatigue. Consistent with this, upside growth shocks were limited to 1 percentage point and upside primary balance shocks to 2 percentage points.

conservative than the outturns. Medium-term projections also remain conservative relative to other countries that suffered from banking crises and subsequent credit-less recoveries.[2]

Standard indicators suggest that the projected fiscal adjustment is ambitious, although Cyprus's strong fiscal track record thus far provides some assurances (Figure A2.2 continued). The level of cyclically-adjusted primary balance and three year adjustment are considered borderline realistic. However, such large primary balance adjustments are not without precedent including as illustrated by Cyprus' own recent fiscal performance. The authorities' disciplined implementation of adjustment measures in 2013–14 and additional discretionary tightening have led to an almost 3 percent of GDP primary surplus at end 2014, a 4.4 percent of GDP improvement with respect to 2013. Finally, these indicators should be interpreted with caution, given the unusually high uncertainty surrounding the estimation of the output gap and cyclically-adjusted fiscal balances in the current recession.

Debt structure indicators point to vulnerabilities, but there are mitigating factors. The significant external gross financing needs reflect mainly the large amount of foreign deposits, although improved conditions have led to their stabilization and have allowed the removal of external payment restrictions. The large share of public debt owned by non-residents reflects mainly the large official financing in the context of the program, the Russian loan, and loans from the EIB and CEDB. The relatively low and/or fixed interest rate of official liabilities combined with their long term maturity mitigates interest rate and financing risks. Finally, while bond yields and spreads remain higher than in other countries, they have been on a steady decline (see chart in page 7).

Public sector debt remains vulnerable to adverse macro-fiscal shocks (Figure A2.5, top, and Figure A2.5 continued). The main risks analyzed include:

- **Growth risk.** Assuming a decline in growth by two historical standard deviations (i.e. about 7 percentage points) for 2016 and 2017, a corresponding deterioration in non-interest revenue of 0.4 percent per percentage point of growth reduction, recovering to baseline levels in two years thereafter, and a decline of 0.25 percentage points per point of growth of the deflator, the debt ratio would increase to 114 percent of GDP by 2016 and 120 percent by 2020.

- **Primary balance risk**. A shock reducing the planned fiscal adjustment in 2016–18 by 80 percent, capturing the risk of reform fatigue, would increase the debt ratio to 100 percent of GDP in 2016 and to 83 percent of GDP by 2020.

- **Interest rate risk.** While the growing share of official financing in the coming years considerably reduces interest rate risks, ESM financing and new market financing after the program are still a function of market conditions. A shock increasing the real interest rate by 3 percentage points each year during 2016–20 would lead debt to reach 99 percent of GDP in 2016 and slightly above 79 percent of GDP in 2020.

[2] See Box 1 of Country Report No 13/374.

- **Combination of macro-fiscal risks.** A combination of the growth, interest rate, and primary balance shocks above would lead to a debt ratio of 114 percent of GDP in 2016 and 124 percent of GDP in 2020.

- **Deflation** (Figure A2.5, continued): Deflator growth could be lower than envisaged in the baseline if downward wage pressures or oil price pass through to prices is more persistent than anticipated. In this case, debt would increase to 100 percent of GDP in 2016 and 83 percent of GDP in 2020.
- **Slower recovery** (Figure A2.5, continued). A slower and prolonged deleveraging including due to implementation problems of the new public debt restructuring framework could lead to a more sluggish recovery. In combination with a lower deflator (0.25 pt per point of growth), this would lead debt to rise to 100 percent of GDP in 2016 and to 87 percent of GDP by 2020.

- **Risks related to the asset swap and privatization proceeds** (not shown)**.** If the €0.6 billion debt swap were not carried out, debt in 2020 would increase by about 3 percentage points of GDP. If the envisaged privatizations were not implemented, this would increase debt by about 8 percentage points of GDP in 2020.

Contingent liabilities also pose risks to debt sustainability (Figure A.2.5, bottom). A change in the use of the program buffer from the assumed non debt creating debt management operations to debt creating capital injections into the banks would raise public debt. For illustration purposes, a €1 billion bank recapitalization need was assumed. In that case, debt would reach 104 percent of GDP in 2016 and 86 percent of GDP in 2020. The materialization of implicit contingent liabilities associated with the banks' reliance on central bank financing poses similar risks to debt sustainability (not shown). Beyond these contingent liability risks, a full materialization of government loan guarantees (i.e. all €3 billion government guarantees are called) would bring debt to 116 percent of GDP in 2016 and to 101 percent of GDP in 2020.

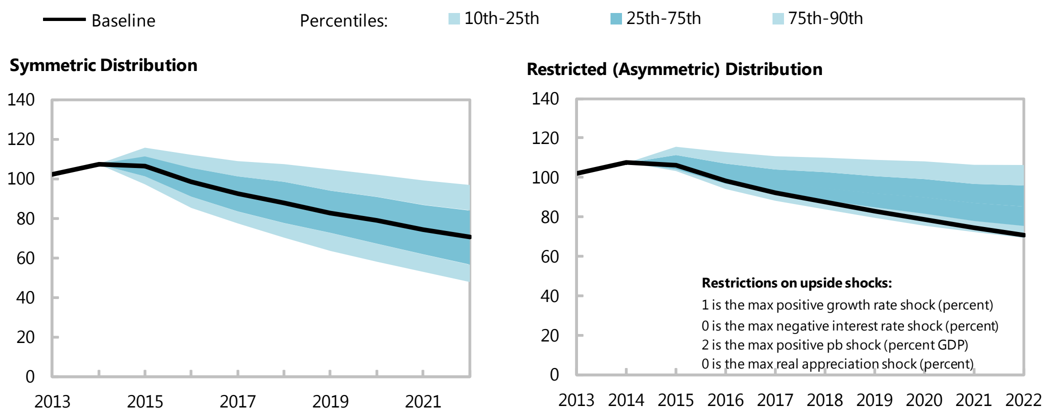
Figure A2.1. Cyprus: Public Debt Sustainability Analysis – Risk Assessment

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

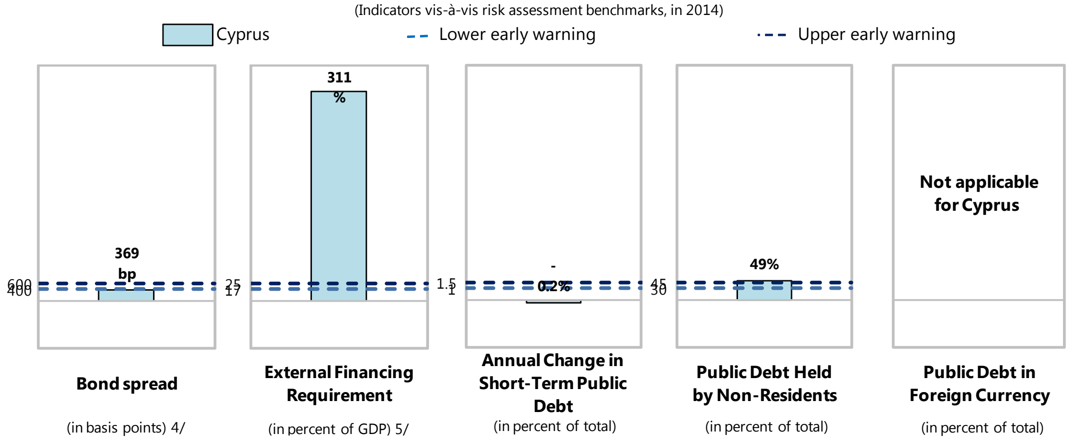
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

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. The baseline debt path and the analysis based on it assume the full utilization of program buffers.

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.

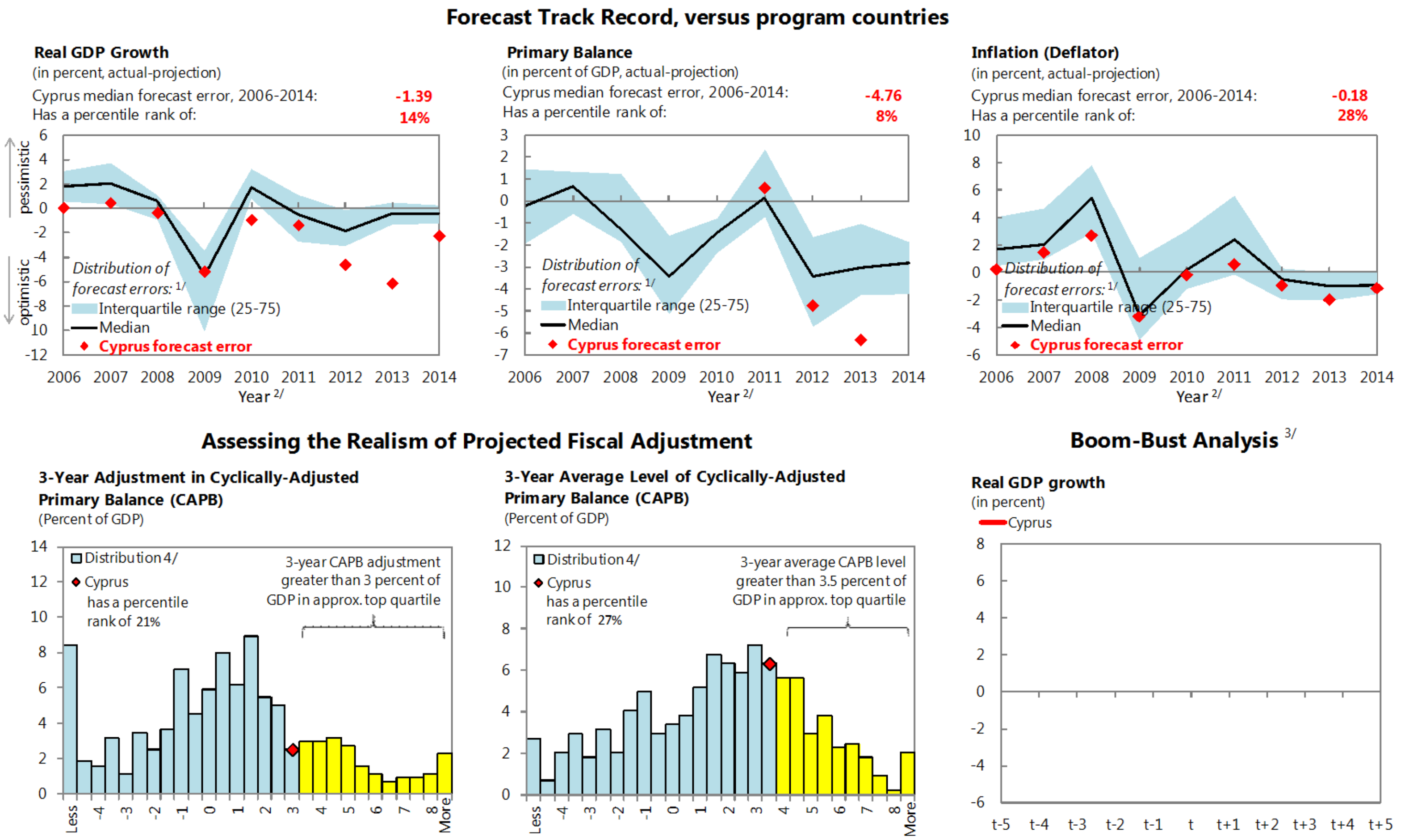
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 20-Feb-15 through 21-May-15.

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 A2.2. 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. The 2012 spring WEO forecast did not factor in extreme tail risks which materialized in March 2013.
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 A2.3. Cyprus: Public Debt Sustainability Analysis – Baseline Scenario

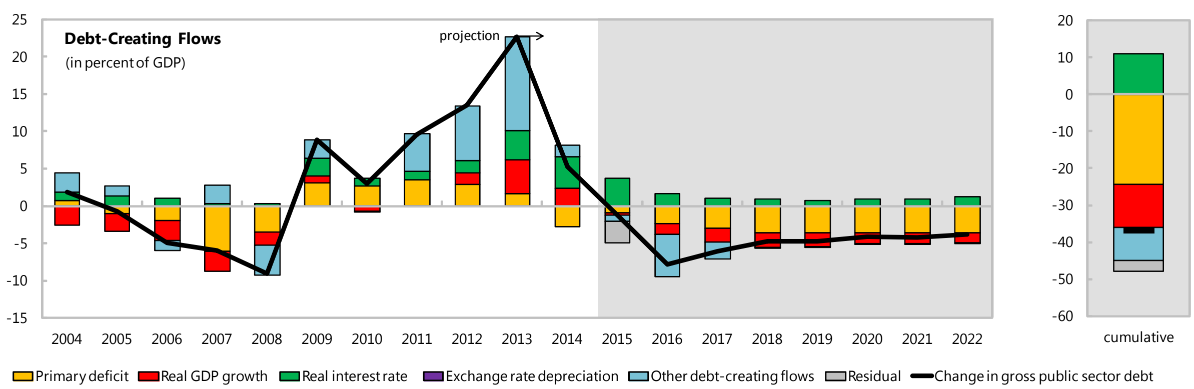
Debt, Economic and Market Indicators [1/]

	Actual			Projections							
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	60.4	102.2	107.5	106.3	98.4	92.3	87.6	82.9	78.7	74.5	70.7
Public gross financing needs	12.4	17.4	16.0	13.3	6.8	4.2	5.6	9.4	11.6	6.5	7.3
Real GDP growth (in percent)	2.1	-5.4	-2.3	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation (GDP deflator, in percent)	2.7	-1.4	-1.2	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Nominal GDP growth (in percent)	4.8	-6.7	-3.4	-0.7	2.1	3.2	3.6	3.8	3.5	3.7	3.4
Effective interest rate (in percent) [4/]	4.9	3.3	2.9	2.5	2.3	2.3	2.4	2.5	2.9	3.1	3.2

As of May 21, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		279
5Y CDS (bp)		419
Ratings	Foreign	Local
Moody's	B3	B3
S&Ps	B+	B+
Fitch	B-	B-

Contribution to Changes in Public Debt

	Actual			Projections									
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.8	22.7	5.3	-1.2	-7.8	-6.1	-4.7	-4.7	-4.2	-4.2	-3.8	-28.8	
Identified debt-creating flows	1.8	22.7	5.3	1.6	-7.8	-6.1	-4.7	-4.7	-4.2	-4.2	-3.8	-25.9	
Primary deficit	0.0	1.6	-2.8	-1.0	-2.4	-3.0	-3.6	-3.6	-3.6	-3.6	-3.6	-17.2	-0.2
Primary (noninterest) revenue and grants	37.9	37.6	40.2	39.3	39.2	38.8	39.0	39.0	39.1	39.0	39.0	234.4	
Primary (noninterest) expenditure	38.0	39.2	37.4	38.4	36.8	35.8	35.4	35.3	35.5	35.4	35.4	217.1	
Automatic debt dynamics [5/]	0.0	8.4	6.6	3.4	0.2	-0.9	-1.1	-1.1	-0.5	-0.5	-0.1	0.1	
Interest rate/growth differential [6/]	0.0	8.4	6.6	3.4	0.2	-0.9	-1.1	-1.1	-0.5	-0.5	-0.1	0.1	
Of which: real interest rate	1.1	3.9	4.2	3.7	1.7	1.0	0.9	0.7	1.0	0.9	1.2	8.9	
Of which: real GDP growth	-1.2	4.6	2.4	-0.3	-1.5	-1.9	-2.0	-1.8	-1.5	-1.4	-1.3	-8.8	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.8	12.6	1.5	-0.8	-5.7	-2.2	0.0	0.0	0.0	-0.1	0.0	-8.7	
Net privatization/asset sales proceeds (negative)	0.0	0.0	0.0	-0.6	-5.6	-2.2	0.0	0.0	0.0	0.0	0.0	-8.4	
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	1.8	12.6	1.5	-0.3	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	-0.3	
Residual, including asset changes [8/]	0.0	0.0	0.0	-2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-2.9	

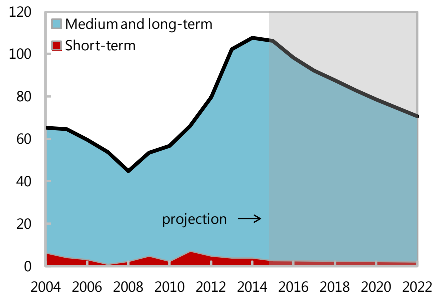


Source: IMF staff estimates.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) 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 refects the Euro 0.6 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.

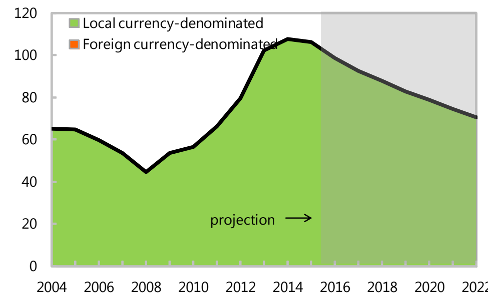
Figure A2. 4. Cyprus: Public Debt Sustainability Analysis – Composition of Public Debt and Alternative Scenarios 1/

Composition of Public Debt

By Maturity
(in percent of GDP)



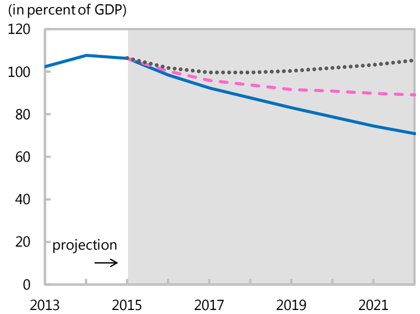
By Currency
(in percent of GDP)



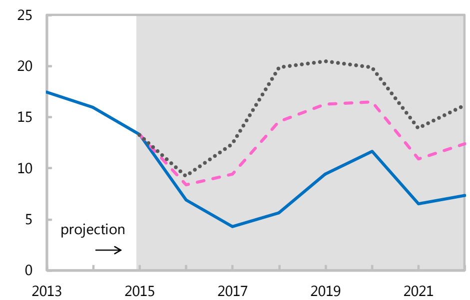
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(Percent)

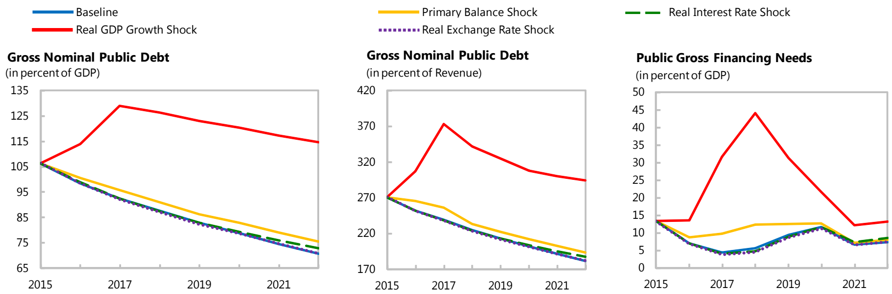
Baseline Scenario	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary Balance	1.0	2.4	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.3	2.3	2.4	2.5	2.9	3.1	3.2
Constant Primary Balance Scenario								
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary Balance	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Effective interest rate	2.5	2.4	1.9	2.0	2.3	2.9	3.3	3.2

Historical Scenario	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP growth	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary Balance	1.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	2.5	2.4	2.0	2.1	2.6	3.4	3.9	3.9

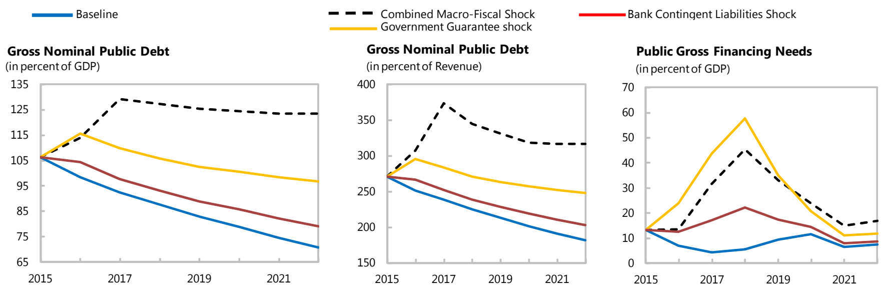
urce: IMF staff estimates.
Inflation in the tables refer to GDP deflator growth.

Figure A2.5. Cyprus: Public Debt Sustainability Analysis – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

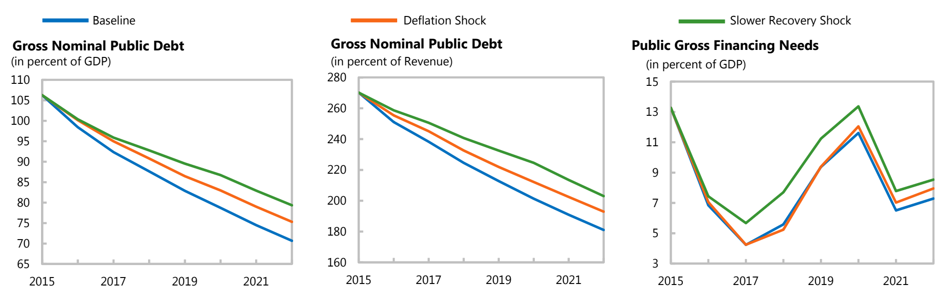
(Percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	0.7	1.3	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	1.9	2.0	2.2	2.8	3.2	3.1
Real Interest Rate Shock								
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	2.4	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	1.9	1.8	2.1	2.9	3.7	3.8
Combined Shock								
Real GDP growth	0.2	-5.7	-5.1	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	-1.1	-0.6	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	-3.2	-8.2	1.6	2.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	2.2	3.1	3.9	4.9	5.7	5.9
Bank Contingent Liabilities Shock								
Real GDP growth	0.2	1.4	2.4	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	-3.2	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	2.1	2.2	2.6	3.3	3.7	3.6

Source: IMF Staff Estimates

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP growth	0.2	-5.7	-5.1	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	-1.1	-0.6	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	-3.2	-8.2	1.6	2.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	2.1	2.4	2.9	3.6	4.0	3.9
Real Exchange Rate Shock								
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	1.0	1.2	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	2.4	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	1.7	1.8	2.0	2.5	2.8	2.7
Government Guarantee shock								
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	0.7	1.2	1.4	1.7	1.6	1.9	1.5
Primary balance	1.0	-14.6	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.3	2.5	3.0	3.7	4.6	5.0	5.0

Additional Stress Tests



Underlying Assumptions

(Percent)

	2015	2016	2017	2018	2019	2020	2021	2022
Deflation Shock								
Real GDP growth	0.2	1.4	2.0	2.2	2.1	1.8	1.8	1.9
Inflation	-0.9	-0.7	-0.1	0.5	1.2	1.3	1.7	1.5
Primary balance	1.0	2.4	3.0	3.6	3.6	3.6	3.6	3.6
Effective interest rate	2.5	2.4	1.9	1.8	2.0	2.6	2.9	2.7

	2015	2016	2017	2018	2019	2020	2021	2022
Slower Recovery Shock								
Real GDP growth	0.2	0.4	0.8	1.0	1.2	1.5	1.8	1.9
Inflation	-0.9	0.4	0.9	1.1	1.5	1.6	1.9	1.5
Primary balance	1.0	2.0	2.5	3.2	3.2	3.1	3.5	3.7
Effective interest rate	2.5	2.4	1.9	1.9	2.1	2.7	3.0	3.0

Source: IMF staff estimates.

Appendix I. Cyprus: Letter of Intent

Nicosia, May 29, 2015

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), we describe progress and policies toward the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Recent developments have been encouraging. The output contraction in 2014 was less than projected, and we expect a return to positive economic growth in the second half of 2015. Our financial system is recovering as demonstrated by the Comprehensive Assessment carried out by the European Central Bank, and more recently, by a stabilization of our deposit base and increasing banking system liquidity. This allowed us to remove the remaining external payment restrictions on April 6, 2015. Our access to market financing has improved, as reflected in the successful debt issuance on international capital markets in April, the second one since the 2013 crisis. The Cypriot economy is now much more resilient to regional and global economic shocks.

We remain fully committed to the reform program, and fiscal performance has continued to exceed expectations. We achieved a primary surplus of close to 3 percent of GDP in 2014 (excluding the recapitalization of the cooperative sector), easily surpassing the program projections and signaling that our fiscal adjustment effort is well ahead of schedule. Fiscal performance has been in line with expectations in the first part of 2015. All quantitative performance criteria (PC) for end-September 2014 and indicative targets for end-December 2014 were observed, with the exception of the PC on the ceiling on the stock of general government debt at end- September 2014. This target was missed due to a delay in completing the debt-asset swap between the government and the Central Bank of Cyprus. The delay was temporary, and we are finalizing the swap.

We have made significant progress on the structural reform agenda of the program, and most of the structural benchmarks (SB) were met. However, the political environment has remained challenging, in particular with the governing party holding a minority in the Cypriot House of Representatives. As a result, reforms to the private debt restructuring framework were delayed, which led to difficulties in completing program reviews. Notably, we regret that delays in the entry into force of the amendments to the foreclosure law resulted in the cancellation of the 5th review. In addition, preparing the insolvency legislation and the implementing regulations for the foreclosure legislation took longer than originally planned. However, all these elements are now in place and Cyprus has now established a modernized private sector debt restructuring legal framework. This is a key step to addressing the high level of non-performing loans (NPLs) in the banking system, which is critical to getting credit flowing again in support of the economic recovery and job creation.

Looking forward, in support of our program objectives,

- In the financial sector, we will continue to prioritize addressing the high level of NPLs. Following on the reforms to date, we will make the private debt restructuring framework fully operational, including by tackling the current backlog of unissued and un-transferred title deeds, monitoring the implementation of the new insolvency and foreclosure frameworks on an ongoing basis and further improving them as needed. We will also continue to strengthen financial sector supervision and build the capacity of the banking system to restructure loans in a sustainable manner.
- We will continue to pursue a prudent fiscal policy.
- We will advance on our structural reform agenda, notably on tax administration, the management of fiscal risks, and public administration reform. We will also move forward on critical growth-enhancing reforms, including the privatization program.

Financing of our program remains adequate, and based on the above, we request the following:

- Completion of the fifth, sixth, and seventh reviews under the EFF arrangement and three purchases under this arrangement in the amount of SDR 74.25 million each.
- Waiver for non-observance of the end-September 2014 PC on the ceiling on the stock of general government debt.
- Establishment of new quantitative PCs for end-June 2015, end-September 2015, and end-December 2015 (Table 1).
- Re-phasing of the remaining undisbursed amount evenly over three reviews instead of four as per the original schedule to take into account the delays in the reviews.

We are fully committed to the policies set forth in the attached MEFP, which we believe are sufficient 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	Chrystalla Georghadji Governor of the Central Bank of Cyprus

Attachment I. Cyprus: Memorandum of Economic and Financial Policies

A. Recent Developments and Outlook

1. **The recession moderated last year.** Output contracted by 2.3 percent in 2014 compared to the fourth review forecast of 4.2 percent and to 5.4 percent in 2013, as the resilience of domestic demand more than compensated for the deterioration of the external balance due to import growth. The labor market has shown signs of stabilization reflecting wage adjustment and a reduction in the foreign labor force, but unemployment remains high. The banking sector has continued on its path to recovery, with deposits stabilizing and liquidity increasing, while private sector credit continued to contract. In April, we lifted all remaining external restrictions and successfully tapped the international bond market for a second time since the banking crisis.

2. **Our economy is expected to start recovering during 2015, despite headwinds from external developments.** After almost four years, growth in the first quarter has been positive and we envisage growth of 0.2 percent for the year. We expect that a decline in demand from Russia will be more than offset by higher private consumption, reflecting improved purchasing power from lower energy prices. For the following years, we have kept our growth projections broadly unchanged, continuing to expect output to expand at a moderate pace, supported by a gradual recovery of private consumption and investment. Average inflation is expected to decline further this year, reflecting the pass-through of lower global oil prices. Risks to this outlook remain broadly balanced. On the external front, a stronger contraction of the Russian economy could negatively affect our exports while the depreciation of the euro could be an upside risk. Direct spillovers from Greece are expected to be manageable due to diminished trade and financial links but we remain vigilant to any possible impact from adverse shocks. On the domestic front, slower than anticipated progress in addressing NPLs could delay balance sheet repair and hold back credit growth, thereby postponing the recovery and constraining medium-term growth.

B. Financial Sector Policies

Addressing High NPL Levels

3. **Addressing the high level of NPLs in our banking system is a central priority.** The NPL ratio reached 59 percent for the core domestic banking sector at end-December 2014. To address this problem, we are focused on strengthening the legal framework and supervisory tools for arrears management. The establishment of functional foreclosure and insolvency regimes is expected to provide incentives to creditors and debtors to negotiate voluntary debt restructurings and expedite the clean-up of balance sheets.

Legal Framework

- **Foreclosure framework.** We have enacted amendments to the foreclosure law to streamline the foreclosure process. The changes should provide incentives for creditors and debtors to negotiate voluntary debt restructurings. To make the amended foreclosure law fully operational, we have adopted the necessary regulations. We are currently reviewing the relevant civil procedure and court rules and will adopt, by end July 2015, necessary changes, including legislative amendments if warranted. These changes will facilitate the effective implementation of the foreclosure framework and will enable the courts to process cases on a timely basis.

- **Insolvency framework.** In mid April parliament adopted a package of laws to reform our insolvency framework.

    - **Legislation.** The new legislation represents significant progress towards modernizing our corporate and personal insolvency legislation in line with our July 2014 strategy. The framework provides incentives for repayment and restructuring of debt while allowing for speedier and more efficient rescue and rehabilitation of debtors. The adopted package consists of five pieces of legislation: (1) amendments to the Company Law to allow for faster and more cost effective liquidation of insolvent, nonviable companies; (2) a Law on Examinership to facilitate the restructuring and rehabilitation of viable companies; (3) a Law and regulations on Insolvency Practitioners which establish a framework for the qualification, licensing and regulation of insolvency practitioners; (4) amendments to modernize the Bankruptcy Law to allow for a "fresh start" for insolvent debtors through their discharge after three years of bankruptcy, subject to proper safeguards; and (5) a Law on Personal Insolvency, which allows for the restructuring of secured and unsecured debts of insolvent individuals, as well as debt relief for individuals with virtually no income or assets.

    - **Implementation.** We are now taking steps to establish and launch the new Insolvency Service which will centralize the administration of the new insolvency framework. Most of the legal and institutional arrangements are in place in order to start the implementation of the new insolvency regime. Administrative acts and regulations needed to fully ensure the functioning of the Insolvency Regime will be adopted by end-August 2015 **(new structural benchmark)**. The implementation of the new laws will also require substantial capacity building for the actors responsible for its implementation, including the courts. We will prepare an action plan with that objective in mind. Finally, we plan to review by end-September the relevant civil procedure and court rules to ensure that they facilitate effective functioning of the new insolvency processes and reduce the courts' workload to increase court capacity to process cases on a timely basis.

    - **Monitoring.** We will continuously monitor implementation of the new insolvency framework, with a view to identify possible deviations from international best practices and to enhance its effectiveness. In particular, explicit provisions allowing debtors to apply to the court for suspension of enforcement, without any obligation on the part of the debtor, could weaken incentives for non viable debtors to promptly pursue debt restructuring. In addition, provisions have been added that could shield guarantors from payment obligations without due regard to their payment capacity. To ensure that the new insolvency framework achieves its objectives, we will monitor its performance on a continuous basis.

- **Review of the framework.** In consultation with program partners, we will submit to the Council of Ministers by end September 2015 any necessary adjustments to the insolvency and foreclosure frameworks, including legislative changes **(new structural benchmark)**. Moreover, we will conduct a comprehensive review of the private sector debt restructuring legal framework by early 2016, with an action plan of modifications to the framework to correct any deficiencies.

- **Title deeds.** We are taking steps to address the problem of immovable properties that were purchased without proper transfer of title to ensure, *inter alia*, smooth functioning of the foreclosure and debt restructuring processes. By end-June 2015, the Council of Ministers will adopt legislation ensuring that the ownership of titles reflects the economic ownership of the property at all times **(new structural benchmark)**. The legislation will enable swift transfer of titles and the release of encumbrance while providing safeguards against abuse. It will cover future property transactions as well as legacy cases. For legacy cases, it will provide for a rule-based mechanism aimed at treating buyers, sellers, and holders of collateral in an equitable manner taking into account compliance with their obligations related to the property transaction and enabling adequate compensation if available. The legislation will be informed by a financial sector impact assessment performed by the CBC in close cooperation with the Ministry of Interior. By end-October 2015, we will present to program partners legal or contractual standards for property sales contracts and connected loan and mortgage arrangements. We will also propose further legislative and administrative measures necessary to incentivize the swift transfer of title deeds.

Banks' arrears management capacity

4. We are strengthening the capacity of the banking system to restructure loans in a sustainable manner. We are now focused on boosting incentives for banks to step up their restructuring efforts according to the following priorities:

- ***Revision of the Arrears Management Framework and Code of Conduct.*** We have adopted a revised Arrears Management Framework and Code of Conduct, limiting protections to individuals as well as small and micro-enterprises—all up to a pre-determined threshold—and covering issues related to the treatment of guarantors and consistent with the insolvency framework. Also, to increase borrowers' awareness of their rights and obligations, the CBC will make available on its website a comprehensive and user-friendly guide to the restructuring process under the Code of Conduct.

- ***Sustainable restructuring solutions.*** We will closely monitor and enforce banks' compliance with the arrears management framework and the code of conduct. To this end, the CBC will assess the appropriateness of restructuring solutions, including by relying on the semi-annual sustainability audit that is available since end-May 2015 for the first time and will be repeated twice yearly. By end-June 2015, the CBC will provide to the SSM its findings and recommendations regarding revision of banks' internal policies and processes for follow-up.

- ***Debt resolution targeting framework.*** To encourage banks to reduce NPLs and ensure continuous monitoring, the CBC will agree with banks on institution- and portfolio- specific targets for the various phases of the restructuring process for at least the following two quarters, on a rolling basis. The CBC will publish the aggregate targets and the banks' past performance after each quarter, for the first time by end-July 2015 (**new structural benchmark**), explaining discrepancies between targets and actual performance, as well as any revisions of targets. The data quality and coverage of our supervisory reporting framework for NPLs and restructuring will be improved by requiring banks to submit data in line with revised requirements starting with the third quarter of 2015.

- ***Financial situation of borrowers.*** A comprehensive understanding of the borrowers' financial situation is critical to ensure the effectiveness of debt resolution policies and to assess the magnitude of strategic defaults. For this purpose, the CBC is carrying out a study of the financial situation of borrowers and will publish the findings by end-July 2015.

- ***Banks' capital planning and budgeting.*** The CBC has required core banks to submit updated condensed capital and funding plans, based on updated and consistent economic assumptions, including on the resolution of non-performing assets. These plans will be updated on a quarterly basis.

- ***Secondary market for loans.*** A task force is currently evaluating necessary actions to promote the development of a secondary market for distressed assets by facilitating the transfer of existing loans. Necessary changes to the legislative framework to remove existing impediments to the securitization of assets, including removal of the requirement to obtain prior consent of borrowers, will be submitted to Parliament by end-July 2015. Moreover, by end-June 2015, necessary legislation will be approved by the Council of Ministers to enable the sale of loans to non-banks, while retaining the protections of borrowers offered under the Code of Conduct.

Restructuring of the Cooperative Credit Sector

5. We are continuing to restructure the coops sector. The sector has already undergone a thorough restructuring and has successfully passed the ECB's Comprehensive Assessment. Measures have been taken to strengthen its executive management, and the sector's information technology provider has been put under the control of the Cooperative Central Bank (CCB). Nevertheless, more efforts are needed to strengthen the sector's capacity. Progress with loan restructuring has been slow, in part due to operational, staffing, and information technology deficiencies. We are focusing on three main areas:

- ***Arrears management*:** We have carried out a review of the sector's policies and operational capacity on debt resolution. We have required the coops to submit by end June 2015 a time-bound action plan outlining how identified deficiencies will be addressed on a timely basis and how the arrears management capacity of the sector can be strengthened through external operational support.

- ***Governance*:** By end June 2015, we will streamline responsibilities of the CCB's divisions and enhance the efficiency of the sector's control functions, including by centralizing them at the CCB to the extent possible. To strengthen the oversight of the CCB over the Cooperative Credit Institutions (CCIs), we will amend the affiliation directive by end-June.

- ***Financial control and risk processes*:** The CCB has carried out an independent audit of financial control and reporting processes, including of management information systems. It also submitted to responsible supervisors in March a time-bound action plan to address identified deficiencies in a timely manner. To this end, by July 2015, the CCB will submit an implementation strategy that ensures a smooth transition, including by enabling the CCB to manage the additional responsibilities.

Normalizing Financial Flows

6. We will continue to ensure adequate liquidity in our banking system. Following the full liberalization of deposits and external flows, the CBC continues to monitor conditions and stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. Although liquidity has improved, additional government guarantees in line with state aid rules for the issuance of bank bonds could be used as collateral against liquidity, but only if necessary to safeguard financial stability.

Strengthening Financial Sector Regulation and Supervision

7. We will continue strengthening banking supervision. To this end, we have two near-term priorities:

- ***Transition to the SSM***. The CBC has presented a supervisory work plan of its involvement in the SSM supervisory activities in 2015. To ensure sufficient resources are available to carry out its duties, the CBC has hired ten additional staff. We will determine further staffing needs by end-June 2015, also taking into account increased responsibilities in the area of bank resolution.

- ***Resolution of Laiki***. The resolution authority will finalize in June 2015 a plan for completing the resolution of Laiki. The full implementation of the plan will be completed without delay.

8. We are reinforcing insurance and pension fund supervision. By end-September 2015, we will present a report with proposals to improve the capacity and governance of the insurance and pension fund supervisors in line with international best practice. The report will set priorities for the next steps and will provide a comprehensive inventory of pension and provident funds. The corresponding legislative proposal will be submitted to Parliament by end-December 2015.

Strengthening the AML Framework

9. We are strengthening the implementation of the AML/CFT framework. We continue working on the following areas:

- ***AML/CFT supervision of banks***: To maintain financial sector integrity and stability, the CBC implemented in 2014 a new risk-based AML/CFT supervision methodology. The CBC completed the remaining onsite inspections reports from the 2014 supervisory plan in March 2015 and will apply, as needed, appropriate supervisory measures. The CBC has adopted its risk based supervision plan comprising 13 credit institutions (including 4 CCIs) that will be implemented by end December 2015. The CBC also took swift action to put the local branch of FBME Bank Ltd. under resolution after its designation by the US authorities as a financial institution of primary money laundering concern and will continue taking appropriate supervisory actions.

- ***AML/CFT supervision of professions:*** The supervisors of lawyers, accountants, and trust and company service providers will adjust the risk-based tools by end June 2015. These will be used to develop comprehensive annual inspection programs that will be implemented by end December 2015.

- ***Registrar of Companies:*** Parliament adopted the amendments to the company law in mid-May to streamline the process of registration and de-registration of non-compliant companies and strengthening the Companies Registrar enforcement powers. Following the adoption of the legislation by the House of Representatives, we will start implementing its reform by the end of July 2015.

C. Fiscal Policy

10. The cash primary surplus—excluding the recapitalization of the cooperative sector—was 2.8 percent of GDP in 2014, exceeding our target by a large margin. This outcome reflects (i) stronger than anticipated economic activity which led to higher tax revenues and social security contributions; (ii) a faster than expected reduction in the number of early retirements, which lowered our wage bill; and (iii) containment of discretionary spending which led to lower outlays on intermediate consumption and capital expenditure.

11. We have revised our primary balance target for 2015 to reflect the 2014 over-performance and the downward revision to growth. We will target a cash primary balance of 1 percent of GDP. This will lock in some of the fiscal savings from 2014 while accommodating (i) a loss of revenues due to the implementation of European directives on changes to the VAT place of supply for certain services; (ii) the contribution to the National Resolution Fund; (iii) lower central bank dividends; and (iii) several one off factors including a retroactive contribution to the EU budget arising from the ESA 2010 GDP revision, compensation payments to pension funds related to bank restructuring, and other specific outlays. We have also revised our 2016 and 2017 cash primary balance targets to surpluses of 2.4 and 3 percent of GDP respectively to take into account the better than anticipated 2014 outcome and the largely one off nature of the main factors triggering the reduction in the primary surplus in 2015 with respect to 2014. With bank capitalization and fiscal needs less than projected and a consequently improved debt path, we are targeting a primary surplus in a range of 3 to 4 percent of GDP in 2018 and thereafter instead of 4 percent previously, which is sufficient to maintain our debt on a clear downward path.

D. Structural Reforms

12. We are implementing a comprehensive welfare reform that ensures a guaranteed minimum income (GMI) for all those in need. We have set up a fully staffed unit to monitor progress with implementation of the reform and have started paying out benefits. Looking forward, we will take actions to ensure that the new welfare system is fully in place and that outcomes are promptly analyzed in order to determine possible refinements:

- By end-June 2015, we will prepare plans to consolidate disability and education benefits in line with the adopted welfare reform.
- By end-September 2015, we will require recipients of social benefits to declare all the benefits they receive (including non-GMI benefits). We will also finalize in the same timeframe an assessment report of the implementation of the GMI, including main outcomes, the number of applications, fiscal costs, targeting accuracy, and coverage. The assessment will also discuss possible refinements going forward.
- By end-December 2015, we will build a registry of benefits in line with our new welfare law including the profiles and eligibility of all beneficiaries, cross-checked with other databases.[1]
- By end March 2016, and with the registry in place, we will re-examine the overall welfare reform to realize efficiency gains from the consolidation of all information on welfare programs.

13. We are advancing our tax administration reform. We have passed legislation integrating the two tax authorities into a single Department of Taxation and to enhance tax collection enforcement powers. Our efforts are concentrated on two fronts:

- ***Addressing tax arrears and evasion***: In line with the newly adopted collection enforcement powers, we have finalized our tax debt recovery plan, which will form part of our wider compliance improvement strategy. On that basis, we have started implementation of our tax debt recovery plan including through the use of bank garnishing powers on a pilot basis. To monitor progress, we will prepare quarterly implementation reports specifying targeted groups, collection enforcement measures used, and recovered debt. The first quarterly progress report will be prepared by end-June 2015.

[1] The registry of benefits will entail establishing a single view of social benefits for each beneficiary via an interface which will link three registries: Ministry of Labor, Welfare and Social Insurance, the Ministry of Education and Culture and the Ministry of Interior.

- ***Reforming the revenue administration***: In January, we established the new large taxpayer office (LTO) covering 40 percent of our total revenue collections. Going forward, we will establish a single registration process for all domestic taxes by end-June 2015, and by end-December 2015, the LTO will be fully functional including taxpayer services, risk assessment and compliance activities aiming to expand coverage to 50 percent of total revenue collections. In line with this goal, we will allocate appropriate human resources. We will also establish an integrated legal framework for tax procedures under a new tax procedures code, to be approved by the Council of Ministers by end September 2015.

14. We are enhancing the management of fiscal risks arising from government guarantees and finalizing the implementation of the Fiscal Responsibility and Budget Systems Law (FRBSL). The stock of government guarantees (20 percent of GDP) may pose risks to our public finances. With a comprehensive guarantee database now in place, the Council of Ministers will approve by end June 2015 the institutional framework to monitor and manage existing and new government guarantees **(new structural benchmark)**. The framework will define clear responsibilities for the MoF and other line ministries, as well as guidelines and procedures for the issuance of new guarantees, the management of existing guarantees based on their assessed risk, and the restructuring and recovery of called guarantees. We will also improve our risk assessment analysis with a view to updating our risk assessment report by end-June 2015. In order to ensure the full implementation of the FRBSL, the public investment guidelines have been finalized and submitted to the Council of Ministers. The Council of Ministers will approve the guidelines by early June. The pending FRBSL regulations will then be approved by the Council of Ministers by end-June 2015 and by the Parliament by end-September 2015.

15. We are taking actions towards the privatization of state-owned enterprises. Privatization is expected to improve economic efficiency, help to reduce our public debt, and encourage foreign direct investment. We have established a privatization unit which is now operational. We have also selected advisors for the privatization of the telecom company (CyTA) and the commercial activities of the ports authority (CPA) in the Limassol port. Looking forward, legislation will be adopted to convert CyTA into a limited liability company by end-September 2015 and the regulatory framework will be amended as necessary for the privatization of the CPA, by end-October 2015. By end July 2015, we will hire an independent energy advisor to prepare a study for the legal unbundling and ownership structure of the electricity company (EAC) as well as the required regulatory review. The legal unbundling will be implemented by end-March 2016.

16. We are continuing reforms in other areas aimed at boosting growth prospects and strengthening the public administration.

- We are implementing the Action Plan for Growth for which a key aim is improving the business environment. To this end, we will develop a time-bound action plan to strengthen the enforcement of contracts, including streamlining judicial procedures. We will also prepare, by end-September 2015, an action plan with measures to simplify regulations and licensing requirements hampering the operation of businesses.

- To enhance the effectiveness of our public administration, while also ensuring its affordability, by end-June 2015, a reform package including a revision of the wage setting framework and the opening of promotion posts to the wider civil service, will be submitted to the Council of Ministers for adoption by Parliament by end-December 2015 (**new structural benchmark**). Salary and employment decisions will be consistent with a public wage bill as a share of GDP on a descending path over the medium term. We will complement this with reforms to enhance staff mobility to promote the efficient allocation of human resources.

E. Program Financing and Monitoring

17. Financing for our program is assured. In line with the practice in most other European countries, we will transfer the rights and liabilities associated with coins issuance from the CBC to the MoF and receive additional financing of €100 million associated with this transfer by end-December 2015. In addition, the CBC is expected to transfer an additional €100 million in central bank profits to the government during 2016, in line with CBC duties under the Treaties and the Statute. We intend to issue additional debt in the international markets in the second half of this year to smooth maturities and minimize refinancing risk after the program, in line with our debt management strategy, market conditions permitting.

18. Despite delays in completing the reviews, fiscal outturns have been very strong, and we have largely caught up with reforms. In view of this performance, we request completion of the combined fifth, sixth, and seventh reviews under the Extended Fund Facility Arrangement, and a disbursement of SDR 222.75 million. We also request that the remaining amount under the EFF (SDR 297 million) be re-phased in three equal disbursements over the remainder of the arrangement.

19. 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 defined in Tables 1 and 2 and in the Technical Memorandum of Understanding (TMU). There are also continuous performance criteria on the non-accumulation of external payment arrears, on non-imposition of restrictions of payments and transfers for current international transactions, and on non-introduction of multiple currency practices.

20. We authorize the IMF to publish the Memorandum of Economic and Financial Policies, its attachments, and the related staff report.

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

	Performance Criteria			Indicative Targets			Performance Criteria		
	Sep-14			Dec-14			Jun-15	Sep-15	Dec-15
	Target	Adjusted target 4/	Actual	Target	Adjusted target 4/	Actual			
Floor on the general government primary balance 2/	40	29	552	-253	-265	493	-71	232	167
Ceiling on the general government primary expenditure 2/	4,784	4795	4,499	6,864	6,876	6,539	3124	4654	6670
Ceiling on the stock of general government debt 5/	18,172		18,393	18,994	18,914	18,819	19966	18833	18473
Ceiling on the accumulation of new general government guarantees 2/	207		124	312		165	40	91	131
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0		0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		-0.1	0		-0.1	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		9	10		8	33	33	33

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ The primary balance and primary spending targets were adjusted down and up, respectively, by €10.8 million in September and by and €12.2 million in December to reflect compensation payments to pension funds.
5/ The December 2014 debt target was adjusted down by €80 million as only 20 million of the expected 100 million disbursement of the Cyprus Entrepreneurship Fund loan was received in Q4.

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	
		Target	Actual	Target	Actual	Target	Actual
Number of comprehensive field audits of large taxpayers 1/	0	2	2	4	4	6	6
Number of comprehensive field audits of high risk taxpayers 2/	0	8	6	16	16	24	22

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: Proposed Conditionality

Measures	Timing
Prior Actions for the Combined Reviews	
Adoption by Parliament of amendments to the Foreclosure Law	Before Board Meeting
Structural Benchmarks	
Adoption by the Council of Ministers of legislation ensuring that the ownership of titles reflects the economic ownership of the property at all times	End-June 2015
Adoption by the Council of Ministers of the institutional arrangements to monitor and manage government guarantees	End-June 2015
Publication by the CBC of the targets of loan restructuring, and banks and coops' aggregate performance against them	End-July 2015
Adoption of administrative acts and regulations needed to fully ensure the functioning of the insolvency regime	End-August 2015
Submission to the Council of Ministers of necessary adjustments to the insolvency and foreclosure frameworks	End-September 2015
Parliamentary approval of reform package including a revision of the wage setting framework	End-December 2015

Attachment II. 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. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.1221 dollar, €1 = 134.90 Japanese yen, €1.25403= 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 2010 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 2010.
- *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 2010*. 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 2015 targets will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €4.5 million.

- The 2015 targets will be adjusted upwards by the dividends received from the CBC in excess of €133 million and in excess of €58 million from the semi-government organizations.

- The 2015 targets will be adjusted downwards by the dividends received from the CBC below €133 million and below €58 million from the semi-government organizations.

- The 2015 targets will be adjusted downwards by the payments to cover called government guarantees up to €80 million.

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.

- The 2015 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 €4.5 million.

- The 2015 ceilings will be adjusted upwards by the payments to cover called government guarantees up to €80 million.

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

8. The general government debt constitutes total outstanding gross liabilities as defined by ESA 2010. This includes the debt of all institutions included in the general government as defined above and other ESA 2010 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.

9. 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-December 2014 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 €20 million for 2015.

- 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 2015 budget under the National Strategic Reference Framework.

- Upwards by €600 million if the debt-to-asset swap between the government and the central bank is not finalized according to the current timeline.

- Upwards by the size of the revision of the stock of general government debt due to methodological changes in the definition of the government sector.

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

10. 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 December 2014 was €2.95 billion. For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.

11. 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 2015 relative to the amounts presented in Table 1 of the MEFP. The annual provision of guarantees cannot exceed €131 million.

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

12. 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-December 2014 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

13. Domestic expenditure arrears are defined as unpaid invoices that have past the due date by 90 days by the budgetary central government, extrabudgetary funds, semi-government organizations, and local governments excluding village communities. 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 2014 was €9.6 million. Increases below €1 million will not be considered a breach of the performance criterion.

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

14. 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-December 2014 was €117.3 million. The stock of VAT refund arrears shall not exceed 150 million euros.

B. Monitoring of Prior Actions, Structural Benchmarks and MEFP Commitments

15. Adoption by parliament of amendments to the Mortgage Law ("Foreclosure Law", prior action)

Specification. The new foreclosure procedure will include the following elements:

a) The only condition for the initiation of the foreclosure procedure will be a default on payment of more than 120 days past, while acknowledging that the mortgage creditor may be otherwise stayed from pursuing enforcement of its remedies by operation of other laws or rules;

b) It will contain swift procedures for obtaining market valuation of the property by independent valuators;

c) It will allow for an initial auction with a reserve price at 80% of the market value, with a subsequent lowering of the reserve price to no less than 50% after three months of the initial auction, and a new valuation after 12 months of unsuccessful auctions or sales after the initial auction, maintaining, a reserve price of no less than 50% of this new valuation;

d) It will contain precise deadlines for all procedural steps and respective preclusive periods for appeals;

e) It will contain provisions to safeguard the integrity of the foreclosure process, including through transparency and anti-fraud provisions.

Regulations issued pursuant to the new law will facilitate a swift and transparent sale process without delays or hurdles.

16. AML supervision's implementation:

- On a quarterly basis, in the context of program reviews, 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 2015 annual inspection program, onsite supervision missions will start in the first quarter and step-up during the year. 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.

17. 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

18. 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 provided 30 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 arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Treasury Department.	15 days after the end of the month
Stock of VAT refund arrears	Quarterly	Tax Department.	15 days after the end of the quarter
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

Statement by Mr. Menno Snel, Executive Director for Cyprus, and Mr. Ektoras Kanaris, Advisor to the Executive Director June 19, 2015

We thank staff for their constructive assessment of the fifth, sixth and seventh reviews under the Extended Arrangement for Cyprus. The paper appropriately captures the economic developments since the last review and covers topics of relevance for future reforms.

The set of reviews comes after a pause in the program's flow due to a single, yet extensive and crucial, reform. This relates to the modernization of the private debt restructuring framework which, after more than a year of deliberations due to its technical and political complexity, was eventually legislated and enacted. We feel it is important to highlight at the outset that despite the review process being hinged on this complicated reform, the bulk of the program's objectives continued to be met resolutely, per the timelines prescribed in the associated reviews. This is well corroborated by the report, and further supported by the dramatically improved market sentiment throughout this time.

Program performance remains well on track with all but one performance criteria observed with considerable margins, with the remaining one on track to be completed in Q3 2015. Despite an ambitious structural reform agenda, the requirements of structural conditionality are also being faithfully adhered to. Even as minor delays in some were inevitable, the requirements for all relevant structural benchmarks for the combined reviews were observed, while one of them was rendered obsolete and is being redesigned.

As we elaborate further on, Cyprus has indeed come a long way since the 2013 crisis. The financial sector is stable and on the mend, the public finances are on a very healthy footing and there are clear signs that the underlying economic fundamentals have changed for the better. Among the most notable developments is the country's return to economic growth in the first quarter of 2015, after 14 consecutive quarters of deep recession. The authorities have also tapped into the international bond markets for the second time since the crisis, further establishing the conditions for a smooth program exit. The sustained effort and determination continue to be recognized by all major rating agencies as the ratings/outlook have undergone several upgrades over the last year. Moreover, all capital controls have been abolished earlier this year, and the transition to unrestricted capital flows has been smooth despite the volatile regional environment. Finally, the authorities note and welcome staff's recognition that the program buffers will not be needed for bank recapitalization needs. This has in turn led to a steep downward shift in the country's baseline debt profile, which should further nourish the positive market sentiment.

Macroeconomic developments

Recent GDP numbers have been very encouraging. In the first quarter of this year Cyprus returned to growth for the first time since it slipped into recession in 2011, expanding by 1.5 percent on a quarter-on-quarter basis (0.2 year-on-year). Compared with the previous quarter, this was among the highest growth rates recorded among EU Member States. For 2014, the growth also surprised on the upside, contracting by almost 2 percentage points less than the fourth review estimate. These developments happened during a period of significant regional headwinds from – particularly to Cyprus – important economies, and reaffirm the economy's resilience exhibited since the onset of the program. The lower oil prices, euro depreciation, the ECB's asset purchase program and the European Commission's Investment Plan are also expected to foster stronger growth over the short term. Like the Fund forecasts, the authorities assume a modest rebound in 2015. They also concur that the main risk to the macro outlook stems from regional headwinds which could hurt the service sector in particular. Staff makes a valid point that completion of the reviews would further insulate Cyprus from broader contagion risks.

Several other developments point towards a promising outlook. For example, the business operating environment shows signs of stabilization given that lending to non-financial corporations is marginally positive and interest rates are in decline. The economic sentiment indicator increased by 4 points in April 2015 compared to the previous month and continues to run above its long-term average. This came about largely due to the improvement in the business climate in all sectors and the strengthening of the consumer economic confidence. Notably, exports of goods increased by 45.5 percent in January-March 2015 compared to January-March 2014. Tourism results point towards another strong year, as arrivals increased by 13.7 percent in January-April 2015 compared with the same period last year.

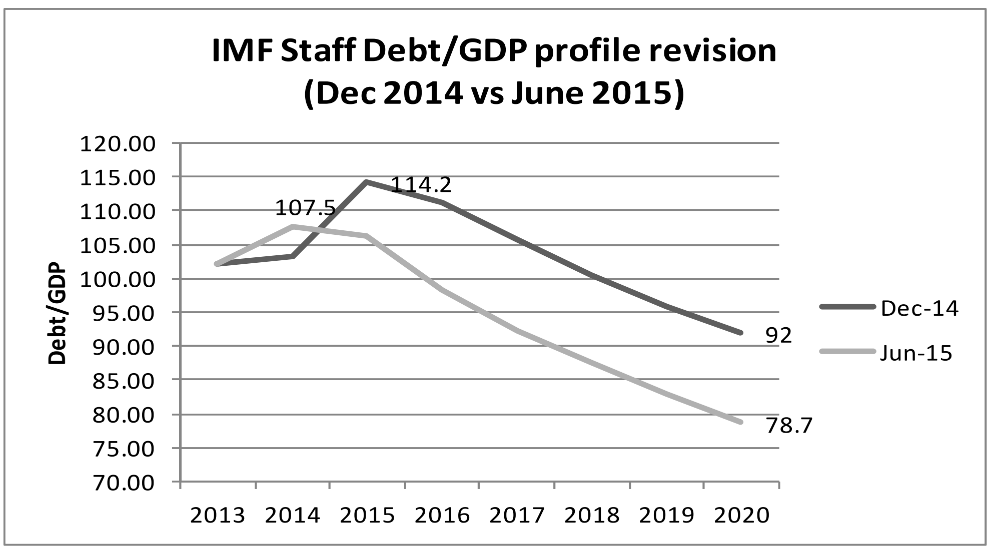
Finally, while unemployment still remains high, it appears to be on a declining trend since its peak in 2013. The unemployment rate in April 2015 stood at 15.6 percent, down from 16.0 percent recorded in March 2015. Compensation per employee in 2014 declined by around 4.7 percent compared to 2013, the steepest correction in the EU, contributing to a decline of nominal unit labor cost and improving cost competitiveness further. This is expected to diffuse any remaining unemployment pressures.

Fiscal

In spite of the recessionary environment over the last four years, the program's fiscal targets have consistently been met with considerable margins. In 2013, for example, Cyprus delivered a primary deficit of 1 percent of GDP against an original target of 3.3 percent of GDP. In 2014, a surplus of 2.8 percent of GDP was recorded against an originally targeted deficit of 2 percent of GDP. Underlining the authorities' commitment to do whatever it takes to adhere to the quantitative conditionality, the savings relative to the targets were prudently locked in throughout the program. Moreover, as staff confirms, these outcomes reflect largely permanent factors. For the period until April 2015, the primary balance remained in surplus in the order of 0.6 percent of GDP. From a broader perspective these developments, in the context of the recent increase in activity, signify that fiscal consolidation can coexist with GDP growth.

For 2015, a primary balance target of 1 percent of GDP is envisaged, despite considerable negative one-off factors amounting to almost 2 percent of GDP. These are detailed in the staff report. Should downside risks to growth materialize, we note staff's view that flexibility may be required. Nevertheless, there remains an unwavering commitment to keep up with the strong track record for 2015 and the coming years.

Public debt and broader financing and sustainability developments have been among the most positive. Long-term bond yields continued to drop in April and May, largely attributable to the enactment of the foreclosure and insolvency legislation which set expectations for completion of the reviews and possible access to the ECB's asset purchase program. Taking advantage of the improved conditions, Cyprus successfully placed a new seven-year Eurobond on April 2. As in the past, the amount will be used to repay more expensive outstanding debt, resulting in a lower interest bill and a smoother repayment profile over the medium term. Finally, debt sustainability has improved markedly upon the recognition, inter alia, that the program buffers – about 12 percent of GDP – are now unlikely to be used for new financing. This has led to a steep downward shift in the debt profile relative to the last staff update. More importantly, already as of this year, debt is on a declining trajectory and a year earlier than what the program envisaged.



Financial Sector

Notwithstanding the marked improvement in the economic environment, the authorities deem the program's level of success to ultimately run through the financial sector's revival. Following two years of deep-rooted reforms the sector's recovery was epitomized by three events.

First, the conclusion of the ECB's comprehensive assessment verified that no further bank recapitalization by the State was necessary. With one of the highest average core tier 1 capital levels in Europe (14.2 percent at end 2014) the banking system is able to withstand significant headwinds. Moreover, the Q1 2015 reporting season marked all three major credit institutions' return to profitability.

Second, on the back of the positive outcome of the ECB's comprehensive assessment and a sustained improvement in liquidity and funding conditions, the authorities abolished all capital controls on April 5 2015. Even though this was done in a period that the regional economic environment was faltering, the level of deposits has increased since then. Notably, this was achieved just over two years since the bail-in of unsecured deposits and the imposition of the controls.

Lastly, despite several political and technical hurdles, the Foreclosure Law, the Insolvency Framework and the relevant Regulations, which are vital for addressing the Non-Performing Loans, have been enacted by the House of Representatives on April 17 2015. This was the product of a momentous effort by the authorities, in close cooperation with our program partners, establishing the legal and regulatory infrastructure capable of effectively addressing arrears, accelerating sustainable restructurings and advancing the banks' deleveraging process. While certain provisions introduced during the Parliamentary discussions may weaken its efficiency, under no circumstance should they diminish the significance and value of these new legislative tools. In addition, the authorities will implement and monitor the performance of the insolvency and foreclosure frameworks and have agreed to make adjustments, if necessary.

The authorities have also been working on other measures to speed up the resolution of the NPLs, notably with regards to the sale of loans(facilitating the resolution of non-performing loans by permitting banks to sell part of their distressed assets portfolio to investors and specialized companies) and to the transfer of issued title deeds (this will enable buyers to obtain a legal title to the property rapidly and will enhance NPLs management and the practical implementation of foreclosure and insolvency frameworks). Draft legislation has recently been submitted to the program partners. In the meantime, the Central Bank is creating a framework that monitors NPL management and incentivizes banks to expedite and improve their processes and policies with a view to increasing the pace of restructurings.

Structural reforms

The authorities have always seen the crisis as a window of opportunity to lay the foundation for a viable and sustainable growth model. Much has already been done, inter alia, widely ranging from the goods and services market, public administration review, public financial management, housing market, health, tourism and energy. With the economy

stabilized and its urgent needs having been addressed, the attention is now shifting towards the remaining structural reforms that will address longstanding inefficiencies that historically hampered growth, reduced productivity incentives and fostered imbalances in the labor conditions.

Having already implemented a ground shifting reform of the welfare system, the government sees as priority the completion of the public administration reform which will permanently ensure the affordability of the public wage bill and address any remaining distortions in public sector compensation and staffing. Within these priorities, privatizations and reform in the corporate governance of state-owned enterprises remain high on the list, not for their cash-raising merits, but for the associated benefits such as increased competitiveness and foreign investment. While this is proving to be more politically challenging than hoped for, the authorities are determined to pursue this, starting with the telecoms, ports and the state lottery. The Privatization Unit has appointed all relevant investment advisers for the telecom privatization and has made progress on its corporatization law. The authorities are aiming for the law to be adopted by the Council of Ministers in the next few weeks and by Parliament soon after the summer.

Conclusion

Two years into a difficult adjustment program, the economy is at last signaling that the authorities' efforts and the people's sacrifices have not been in vain. Notwithstanding this generally supportive backdrop, the authorities are aware that significant challenges remain. With this in mind, the authorities wish to reiterate that the recent economic uptick does not in any way signify that the problems are over. On the contrary, it provides the impetus to keep working meticulously through the remaining challenges that will cement the island's promising prospects.

Despite the delays in bringing these reviews to the Board, the report clearly shows that overall program performance has been strong. While some setbacks have proved inevitable, these were associated with the difficulty in navigating an ambitious reform agenda with a minority government. The authorities wish to express their appreciation to their international partners for the understanding and constructive help that has been demonstrated throughout this process.