INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/125

CYPRUS

May 2013

REQUEST FOR ARRANGEMENT UNDER THE EXTENDED FUND FACILITY

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

- **Staff Report** on the request for an arrangement under the Extended Fund Facility, prepared by a staff team of the IMF, following discussions that ended on April 3, 2013, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 30, 2013. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Supplement** of May 10, 2013 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 15, 2013 discussion of the staff report that completed the request.
- **Statement by the Executive Director** for Cyprus.

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

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

*Also included in Staff Report

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

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International Monetary Fund
Washington, D.C.

CYPRUS

REQUEST FOR ARRANGEMENT UNDER THE EXTENDED FUND FACILITY

April 30, 2013

KEY ISSUES

Fund-supported arrangement: The Cypriot authorities have requested a three-year Extended Fund Facility arrangement in an amount of SDR 891 million (563 percent of quota, about €1 billion), with equally phased purchases. The European Stability Mechanism is expected to contribute about €9 billion in 2013-16. The first Fund disbursement will amount to SDR 74.25 million (about €86 million).

Background: Cyprus built significant internal and external imbalances in the run up to the global crisis. These were exacerbated by an oversized and weak banking sector (with assets of over 800 percent of GDP) heavily exposed to Greece, which posed large contingent liabilities onto the sovereign. The Greek debt restructuring, together with realized and prospective loan losses in both Cyprus and Greece, resulted in an assessment that the two largest banks were insolvent, triggering a loss of confidence and culminating in a banking crisis. The authorities responded through bold and unprecedented steps to address the banking problems upfront. Troubled banks were resolved or restructured and recapitalized through participation of bank creditors, including uninsured depositors. This helped to ensure burden sharing and minimize fiscal costs. Nevertheless, these actions required the imposition of temporary administrative controls to preserve financial stability. A deep recession of about 13 percent is thus expected, and time will be needed for the economy to adjust to the deep structural changes to its financial sector and adapt its business model.

Main elements of the program:

- **Financial sector policies**: These aim to restore financial stability and resumption of credit to support economic activity. The program builds on the recent actions to complete the financial sector restructuring and recapitalization process, gradually restore normal financial flows, deal with private sector debt restructuring, reform bank and cooperative supervision and regulation, and strengthen the AML framework.

- **Fiscal policy**: The program entails an ambitious and well-paced fiscal adjustment that balances short-run cyclical concerns and long-run sustainability objectives, while protecting vulnerable groups. The consolidation will be anchored in a long-run primary fiscal surplus target of 4 percent of GDP needed to achieve a debt level of close to 100 percent of GDP by 2020. This requires the upfront implementation of 2¼ percent of GDP of measures in addition to 5 percent of GDP already underway for 2013-15, and a further effort of 4¾ percent of GDP to be implemented during 2015-18. Structural fiscal reforms to budget frameworks, revenue administration, and pensions will complement the adjustment, and a privatization program will help to reduce financing needs.

- **Risks:** Macroeconomic risks remain unusually high, given the uncertain impact of the banking crisis and fiscal consolidation on economic activity and the adaptation of the business model. Financial sector risks to the program are particularly acute, including lingering concerns about the high reliance of the largest bank on central bank support, the system's rising non-performing loans, and the future impact of administrative restrictions, but also the potential consequences of their premature lifting. Political resolve to implement all aspects of the policy program could falter, adding to risks. Materialization of these risks could lead to a higher debt trajectory and the need for additional financing measures to ensure debt sustainability. Program design—including additional financing buffers and equally-phased Fund disbursements—help to contain risks for the Fund.

Approved By

Ajai Chopra and James Roaf

Discussions were held in Nicosia during March 18-April 2. The mission met with the President, the Minister of Finance, the Governor of the Central Bank of Cyprus, other Cabinet Ministers, among others. Staff worked in conjunction with representatives from the European Commission and the European Central Bank. The IMF team comprised Delia Velculescu (head), Luis Cortavarría, Katja Funke, Vincenzo Guzzo, Alejandro Hajdenberg, Annamaria Kokenyne, Uffe Mikkelsen, François Painchaud, David Parker, Jiri Podpiera, Stephanie Segal, Alejandro Simone, Mario Tamez and Oliver Wuensch. Mr. Kanaris (OED) attended some of the meetings.

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BACKGROUND

1. **Cyprus accumulated large imbalances in the run-up to the global financial crisis**. Sizeable non-resident inflows attracted by the low corporate tax regime led to a rapid increase in the size of the banking sector to over eight times GDP. These inflows helped to finance large current account deficits, which peaked at 15 percent of GDP in 2008, and contributed to a worsening of Cyprus' international investment position. They also facilitated fast domestic credit growth, fueling a housing boom and an increase in household and corporate sector gross indebtedness to one of the largest levels in the euro area. Loose fiscal policies following Cyprus' entry in the eurozone in 2008 contributed to a rapid rise in fiscal deficits and public debt (Figure 1).

2. **Tight sovereign-bank links exacerbated these imbalances as the crisis intensified.** Cyprus developed deep financial links to Greece: by end-2011, bank loans to Greek residents and holdings of Greek government bonds reached 130 and 30 percent of Cyprus' GDP, respectively. As the Greek crisis unfolded, Cyprus' sovereign debt spreads soared, and it lost market access by mid-2011 (its public debt was under 70 percent of GDP). The economy fell into recession in late 2011, exacerbating the correction of the housing market that had started in 2009. This, together with the Greek PSI, devastated banks' balance sheets. Negative feedback loops further weakened public finances, and public debt climbed to 86 percent of GDP in 2012.

3. **To support their efforts to address these imbalances, the authorities have requested a 3-year Extended Fund Facility arrangement from the Fund.** The authorities' macroeconomic adjustment program aims to restore the health of the banking sector and place public finances on a sustainable footing. The requested support from the Fund amounts to SDR 891 million (563 percent of quota, about €1 billion), with SDR 74.25 million (about €86 million) to be made available upon Board approval, and a similar amount to be disbursed in eleven installments, subject to quarterly reviews. Additional financial support is being provided by the European Stability Mechanism (ESM) in the amount of about €9 billion. Program monitoring will be conducted by the Fund and the European Commission (EC) and European Central Bank (ECB), according to respective understandings under the Memorandum of Economic and Financial Policies (MEFP) and Memorandum of Understanding (MoU).

RECENT ECONOMIC DEVELOPMENTS

4. **The recession has deepened** (Figure 2). Output contracted by 2½ percent in 2012, with the decline accelerating toward the end of the year, as economic uncertainty intensified. Private demand led the decline: investment plunged by 23 percent, and consumption fell by 2.7 percent. A fiscal consolidation package introduced in 2011 imposed an additional drag. The foreign balance, however, contributed positively to growth, given falling imports in line with domestic demand. The unemployment rate reached 14 percent in February, while inflation declined to 1.3 percent in March,

on the back of lower energy prices, with recent increases in excise taxes preventing a more rapid adjustment.

5. **The current account deficit deteriorated.** The trade deficit narrowed to 2.5 percent of GDP in 2012 from 4 percent of GDP in 2011 (down from 11.4 percent of GDP in 2008) on the back of sharp import compression. Nevertheless, the current account deficit increased to close to 12 percent of GDP, as the net income balance moved from an exceptional surplus of 0.6 percent of GDP in 2011, reflecting lower dividends and losses incurred by foreign companies, to a deficit of 8.2 percent of GDP in 2012, given large losses recorded by Cypriot bank branches in Greece. The deficit was financed by FDI, government borrowing, and a drawdown of portfolio assets abroad. Cyprus ranks above average on structural competitiveness indicators (Figure 3).

6. **The fiscal deficit narrowed and was financed increasingly by short-term paper.** Despite the recession, the deficit declined to an estimated 5.6 percent of GDP in 2012 from 6.3 percent of GDP a year earlier. Revenues increased slightly, driven by extraordinary dividends and one-off tax amnesty proceeds, while higher VAT rates helped to offset tax base erosion due to the weakening economy. A contraction in capital spending given maturing projects more than offset higher public pension outlays due to early retirements in anticipation of pension reforms. With no access to international markets, the government financed itself with remaining disbursements from a €2.5 billion Russian loan contracted in 2011 and with t-bills purchased by banks and pension funds of state-owned enterprises (SOEs).

7. **The banking system came under intense pressure** (Figure 4). Since early 2012, the banking system lost 10 percent of domestically raised deposits, with the second largest bank (nationalized in mid-2012) having lost 1/3 of deposits. This trend started in mid 2011, accelerated during the June 2012 Greek elections, and continued as uncertainty grew about the solvency of some banks and the potential timing and scope of official financing for Cyprus. The outflows were accommodated by increased provision of Emergency Liquidity Assistance (ELA) by the Central Bank of Cyprus (CBC), which reached 60 percent of GDP in late 2012 (largely concentrated in one bank). An independent bank due diligence exercise assessing asset quality completed in February 2013 by PIMCO revealed capital needs for the banks of around 60 percent of GDP, which added to the stress.

8. **The authorities have taken unprecedented steps to address insolvent banks upfront** (Box 1). These involved the resolution and restructuring of the two largest and insolvent banks (assets of 400 percent of GDP). To this end, a bank resolution law was passed in mid-March 2013, under whose auspices three key steps were taken : (i) the Greek branches of Cypriot banks were sold to a Greek bank; (ii) Cyprus Popular Bank (CPB) was intervened and its insured deposits, ELA, and enough assets to meet regulatory limits were transferred to Bank of Cyprus (BoC), while uninsured deposits and other assets were left in a run-off unit; and (iii) BoC was intervened and recapitalized with participation of bank creditors, including uninsured depositors, to attain regulatory limits, with a cushion in case of further balance sheet deterioration. All insured deposits were protected. As a result of these actions, the banking system shrunk by about 200 percent of GDP. Market reaction has been limited (Box 2).

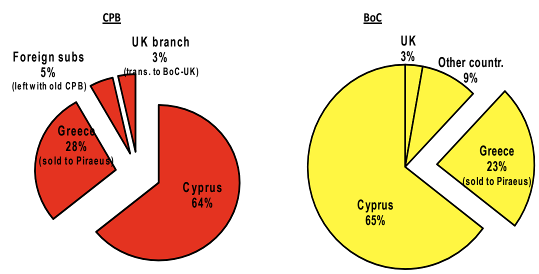
Box 1. Dealing with the Problem Banks

Issue. *According to the PIMCO due diligence analysis, the two largest Cypriot banks were economically insolvent.* Relative to other financial institutions in Cyprus, Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB) were both projected to accumulate large losses through 2015 and reported a high level of insolvency under the baseline scenario. These losses were expected to be significantly larger under a stress scenario envisioned at the time to involve recession of close to 10 percent in 2012-14 and an implicit increase in non-performing loans (NPLs) to nearly 70 percent of gross loans by 2015 and provisioning of 50 percent. To achieve a Core Tier 1 (CT1) capital ratio of 6 percent under the stress scenario, these banks needed a total of 44 percent of GDP (close to €8 billion). However, these funds were not available in the private sector and a government capital injection was also not tenable, as such public support would have rendered public debt unsustainable.

Percent of GDP (unless otherwise noted)	**BoC**	**CPB**	**HB**	**Foreign subs and branches**	**Coops**	**Total**
Assets (net)	201	171	49	221	98	739
Loans (net)	146	126	27	132	73	504
Liabilities	190	165	46	210	89	701
Deposits	159	100	43	103	84	489
Central bank liabilities	21	56	0	NA	0	76
CT1 2015 (percent of RWAs)						
PIMCO baseline scenario	-4.7	-5.8	9.5	18.7	3.0	-1.1
PIMCO adverse scenario	-16.3	-15.7	-1.5	10.8	-4.1	-11.1
Capital shortfall (PIMCO adv.)	22.2	21.5	1.9	0.8	3.3	49.8

Note: CT1 and capital shortfalls for foreign subs and branches and coops only for those included in due diligence. Data on assets and liabilities are September 2012 data.

Strategy. *The Cypriot authorities took decisive, upfront steps to resolve, downsize, and recapitalize the two banks at no additional fiscal cost.*[1] On March 25, the Central Bank of Cyprus intervened CPB and BoC, and the following actions were taken:



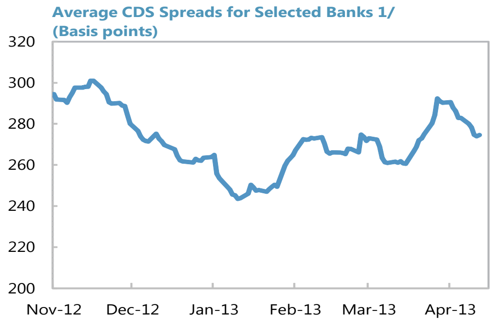
- **Sale of the CPB and BoC Greek operations to Greece's Piraeus bank**. At the time of the sale, both Greek branches had a positive net asset position. Failure to reach agreement could have been disadvantageous both for Greece and Cyprus. The sale reduced the size of the balance sheets of the two banks by 1/3 and also contingent liabilities of the Cypriot government to cover almost €9 billion of insured Greek deposits.
- **Transfer of deposits of CPB's UK branch to the UK subsidiary of BoC.** In return, the BoC subsidiary received an equal amount of cash which the CPB branch held as reserves at the Bank of England.
- **Resolution of CPB by transferring assets, insured deposits, interbank liabilities, and ELA to BoC.** CPB was not viable as a standalone institution, having limited collateral buffers for its large ELA funding (about €10 billion), given deteriorating asset quality. Therefore, it was decided to transfer part of it to BoC. The value of the transferred assets exceeded the value of the liabilities, such that the transferred CPB balance sheet had a CT1-ratio of 9 percent under PIMCO's stress scenario. Uninsured deposits and remaining assets were left in CPB under liquidation. In exchange for the positive net asset position in the transfer, the unit under liquidation will receive BoC shares.
- **Recapitalization of BoC with participation of bank creditors, including uninsured depositors.** The recapitalization was done under the auspices of the new bank resolution law, which required participation of bank creditors in the order of seniority. Creditors' claims were converted into equity, as follows: uninsured deposits were converted into A-shares, senior debt into B-shares, subordinated debt into C-shares convertible capital instruments into D-shares, and rights of ordinary shares were suspended. Until holders of A-shares have recovered their full initial capital investment plus interest through dividends, other shares will not collect dividends nor have voting rights. This structure implied a preliminary 37.5 percent conversion ratio on uninsured deposits[2]. Of the remaining 62.5 percent, a further 22.5 percent were frozen until completion of an independent valuation of BoC's assets and liabilities. Withdrawals on the last 40 percent are subject to restrictions to be lifted gradually.

1\ Transferred assets and capitalization were made on the basis of PIMCO's stress scenario.

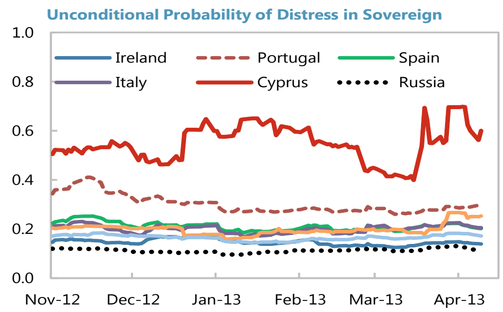
2\ The 37.5 percent ratio is based on a preliminary valuation of the assets based on PIMCO's stress scenario.

Box 2. Spillovers from Economic and Financial Developments in Cyprus

Spillovers from Cyprus have been limited in magnitude. Although the latest developments in Cyprus triggered a flight to safety and a sell-off in some euro area bank stocks, the adverse market reaction has been limited. Spillover effects have varied across markets, with the strongest impact recorded in those assets more directly exposed to developments in Cyprus – notably Greek government bonds, Greek and Russian bank stocks, subordinated debt in some periphery country banks, and, to some extent, Slovenian government bonds. However, other financial assets remained largely unscathed.



Source: Bloomberg.
1/ Average of selected banks in industrialized countries.



Source: Moody.

Market reaction has been of temporary nature so far. Weak financial institutions across Europe will likely remain vulnerable to external shocks, and the risk of long-term spillovers from Cyprus cannot be dismissed. However, following the initial sell-off, most markets appear to have stabilized and, in some cases, they have even regained ground. For instance, prices in peripheral government bonds have posted gains compared to their lowest point at month's end. Dynamics in peripheral bank stocks have been more sluggish, although it is difficult to disentangle the impact of the Cypriot crisis from other drivers.

Several factors may explain the muted market response. Market participants may have viewed the circumstances in Cyprus as unique. An outsized banking system relative to fiscal capacity funded by a large share of non-resident uninsured deposits is not common, suggesting that the approach taken in Cyprus may not be repeated in other European countries. Moreover, the large inventory of tools now available to European policymakers to mitigate risks of widespread bank and sovereign funding stress may have also played a role. For instance, beyond the possibility of further monetary support through rate cuts and/or generalized quantitative easing, the ECB could: i) relax collateral eligibility rules, ii) announce another wave of LTRO, or; iii) activate the OMT facility.

9. **Safeguarding financial stability required the introduction of capital controls and restrictions on deposit withdrawals**. A 6-day "bank holiday" was in effect while the bank restructuring strategy was being clarified and implemented. During this period, it became clear that once banks reopened a run on deposits would be inevitable. Faced with this prospect, the authorities decided to temporarily freeze uninsured deposits in BoC and impose restrictions on all bank cash withdrawals and transfers within the country and across borders (Box 3).

Box 3. Temporary Administrative Measures

Following the resolution and recapitalization of the two largest banks, the liquidity position of the banking system had to be protected after expiration of bank holidays. Temporary restrictions are aimed to allowing market participants to become familiar with the new banking environment and regain confidence in the authorities' banking strategy.

Restrictions were imposed on both domestic as well as cross-border transactions. Some of these measures give rise to current international restrictions under the Fund's Article VIII (Annex III). These measures have been gradually relaxed since initial imposition. As of April 24, main measures include:

- *Cash*: Restrictions on cash transactions aim to manage withdrawals of funds from banks, as well as uncontrolled export of capital. Accordingly, withdrawals of cash are currently limited to a maximum of €9,000 per month. The export of bank notes abroad is restricted to €2,000 per person and journey.
- *Checks, credit, and debit cards*: Checks play a significant role in the daily business transactions taking place in the Cypriot economy. While the cashing of checks is prohibited to prevent circumvention of cash restrictions, checks can be used for payments and transfers within Cyprus in line with the rules applicable for wire transfers. Credit and debit cards can also be used for domestic payments and transfers to the same extent as wire transfers. However, usage abroad is currently restricted to €5,000 per accountholder per month in order to prevent excessive capital export.
- *Wire-transfers***:** Restrictions apply to prevent outflows that might destabilize the liquidity situation of a bank or the banking system as a whole. Wire-transfers of businesses not exceeding €300,000 for domestic and €20,000 for cross-border payments are exempt from restrictions. Payments exceeding these limits are subject to the approval of the Restrictions Committee (including members from the CBC and the MoF) after verification that the payment is consistent with the normal business activities of the payer. Individuals may transfer up to €3,000 and legal persons up to €50,000 for any purpose to another domestic bank. Salary payments are not subject to any restrictions.
- *Prohibition to open new accounts*: To reduce the risk of deposit migration that could undermine banks' liquidity, banks may not open accounts for new customers, except for funds received from abroad or with the approval of the Committee.
- *Extension of term deposits*: To further stabilize banks' liquidity, maturing term deposits are extended for one month, except for an amount of €5,000 or 20 percent of the deposit. Term deposits may also be used to offset existing loans within the same bank to prevent the increase of nonperforming loans.

PROGRAM STRATEGY

10. **The authorities' program focuses on two key objectives aimed at achieving sustainable long-run growth:**

- **Restoring financial sector stability:** The authorities' policy actions aim to place the banking system on a sustainable footing so as to restore financial intermediation and support economic activity. The program builds on the recent actions to deal with the two troubled banks to complete the financial sector recapitalization process, gradually restore normal financial flows, and reform the sector's supervision and regulation.

- **Achieving sustainable public finances:** The program entails an ambitious and well-paced fiscal adjustment that balances short-run cyclical concerns and long-run sustainability objectives, while protecting vulnerable groups. Policies under the program will complement the fiscal adjustment under way. Structural fiscal reforms will support these efforts, with privatization and reforms to the public wage indexation mechanism also helping to strengthen the economy's efficiency and competitiveness.

11. **Alternative strategies were either unavailable or undesirable (or both)**. Recapitalization of the insolvent banks with public money was not tenable, as it would have led to an unsustainable debt, peaking at close to 150 percent of GDP, with significant risks of increasing further. This would have overburdened the Cypriot taxpayer and maintained the large size of the banking sector, posing continued contingent risks onto the state. Non-debt creating strategies, such as direct recapitalization of the banks by the ESM, ELA restructuring, or outright sale of the troubled banks, were not available. The alternative of exit from the euro-zone would only partially address Cyprus' problems and would have deeply affected all market participants through devaluation and default, leading to large losses for taxpayers and insured depositors. Finally, a proposal to impose a large one-off levy on both insured and uninsured deposits in all banks operating in Cyprus did not differentiate between solvent and insolvent institutions and conflicted with the aims of deposit insurance. Subsequent opposition and the change in strategy have reinforced the protected status of insured deposits and an institution-based approach to bank resolution.

12. **Official financing will support the authorities' strategy**. Time is needed to allow the economy to correct its imbalances, adjust to the deep structural changes to its financial sector, and rebuild a sustainable business model. With no prospects for access to international debt markets, Cyprus' financing needs over the next few years will need to be covered mainly through official sources. The program is designed to cover sizeable needs associated with debt amortization falling due, financing of the fiscal deficit, and the recapitalization of banks other than the two institutions being restructured, with buffers from both official sources and bank creditors to help to cover residual risks. Compliance with the program is expected to allow a gradual rebuilding of market access at reasonable terms over the long run.

MACRO ECONOMIC FRAMEWORK

13. **Activity will contract sharply in 2013-14 and is expected to recover modestly in the medium term**. The forecast reflects the distress in the banking sector following the resolution and restructuring of the two largest banks and a significant fiscal consolidation. It is subject to unusually large uncertainty. Specifically:

- **Negative growth of about 9 and 4 percent is projected for 2013 and 2014**, consistent with other banking-crisis episodes. The conversion of uninsured deposits into equity will severely affect private sector balance sheets, impairing consumption and investment. The administrative restrictions are likely to disrupt the payment system, hampering activity. The banking sector deleveraging will compress financial and related services, further constraining credit. Finally, fiscal consolidation underway will have a strong negative impact, as fiscal multipliers tend to be larger during recessions (Box 4).

- **A gradual recovery is expected starting in 2015**, driven by a normalization of private consumption and a rebound of investment from a low basis. However, the crisis is likely to have a lasting impact on professional services, hampering growth until the economy adapts its business model. The prolonged fiscal consolidation will remain a drag on activity, and external demand is expected to stay subdued. In this context, growth is projected to stabilize at 1¾ percent by 2020, much lower than the 4 percent average over the past 30 years. The authorities expected a somewhat higher long-run growth, driven by investments in gas exploitation, but agreed to revisit the forecast once investment prospects crystallized.

Cyprus: Selected Economic Indicators
(Percent change, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8
Consumption	-11.5	-5.1	0.8	1.9	2.5	2.5	2.2	2.2
Private consumption	-12.3	-5.6	1.6	2.9	3.4	3.3	2.6	2.4
Public consumption	-8.9	-3.7	-1.7	-1.3	-0.6	-0.1	0.9	1.5
Fixed investment	-29.5	-12.0	2.3	3.5	5.5	4.3	4.2	4.0
Foreign balance 1/	5.2	1.6	0.2	-0.1	-0.3	-0.3	-0.4	-0.4
HICP (period average)	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	15.5	16.9	14.6	13.7	12.9	12.0	11.1	10.2

Source: IMF staff estimates.
1/ Contribution to growth.

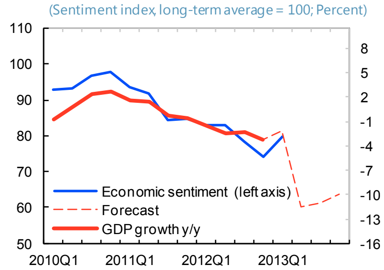
14. **Inflation will decline below the euro area average**. Core inflation is projected to decline to 0.4 percent due to the depressed activity. But increased excise taxes will keep headline inflation close to 1 percent. A negative inflation differential with the euro area over the next few years will contribute to a small improvement in Cyprus' competitiveness. While structural competitiveness indicators have not indicated serious problems, adapting the business model could require enhanced competitiveness looking forward; if so, this would likely involve a more negative inflation differential.

Box 4. Cyprus: Impact of the Crisis on Economic Activity

The crisis is expected to have a large negative impact on economic activity. While a precise quantification is highly uncertain, the banking crisis combined with fiscal consolidation are expected to lower growth in 2013-14 through the following channels:

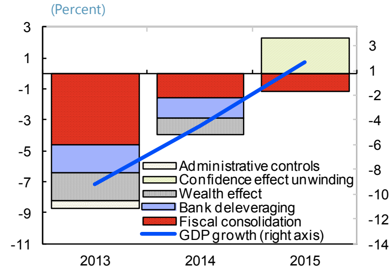
- **Fiscal adjustment will reduce domestic demand.** A frontloaded consolidation of 6.6 percent of GDP in 2013-14 is expected to significantly affect growth. Recent literature and experience from other program countries suggest that fiscal multipliers are higher in recessions. Staff has therefore assumed a one-for-one impact of fiscal consolidation measures on growth.[1/]
- **Financial sector restructuring will constrain both consumption and investment.** Resident households and corporates are expected to take losses on uninsured deposits following the resolution and restructuring of the two large banks. In line with the permanent income hypothesis, households will gradually rebuild the lost wealth over the long run by reducing consumption, suppressing aggregate demand and output. In the corporate sector, lost capital buffers and working capital will likely lead to downsizing and bankruptcies, weakening economic activity and increasing unemployment. Overall, the deposit-to-equity swap is estimated to cut growth by about 3 percentage points. Moreover, banks' deleveraging through loss recognition, non-renewal of loans, and provisioning against future losses is expected to reduce growth by about 2.8 percentage points in 2013-14, assuming that a 100 percent decline in bank's assets results in a 2.5 percent reduction in GDP growth. Finally, administrative controls on payments and withdrawals create frictions in day-to-day transactions and are expected to lower growth in 2013-14 by about half a percentage point.

Growth projection, 2013
(Sentiment index, long-term average = 100; Percent)



Sources: Haver Analytics and IMF Staff estimate.

Impact on growth
(Percent)



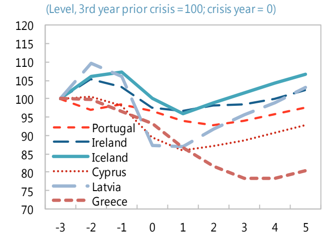
Sources: IMF Staff estimates.

Registered companies and professional services
(Percent; Thousands, right axis)

Sources: Registrar of Companies, Haver, and IMF Staff estimate.

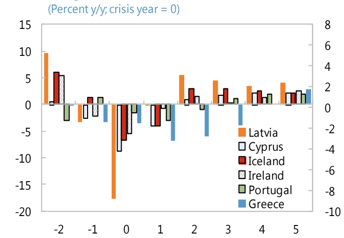
Compared to recent crisis episodes, Cyprus's output loss is expected to be larger than most except Greece over the long run. As in most other cases (except Greece) the recession is expected to last two years, with a mild recovery taking hold thereafter. The depth of Cyprus' slump is predicated on the large shock to the main source of growth in recent years. But, given that the key problems are addressed upfront, a large drag on growth is expected to be lifted, facilitating long-run growth. Still, the cumulative output loss relative to trend for 2013-16 is estimated at around 50 percent of potential output, larger than the 20-30 percent 4-year average estimates from other banking crises reported in the literature.[2]

GDP level
(Level, 3rd year prior crisis = 100; crisis year = 0)



Sources: IMF staff estimates.

GDP growth
(Percent y/y; crisis year = 0)



Sources: IMF staff estimates.

1/ "Coping with High Debt and Sluggish Growth", WEO, October 2012 and "Growth Forecast Errors and Multipliers", IMF Working Paper 13/1.
2/ Resolution of Banking Crisis: The Good, the Bad, and the Ugly, IMF Working Paper 10/146 and "Systemic Banking Crises: A New Database," IMF Working Paper 08/224.

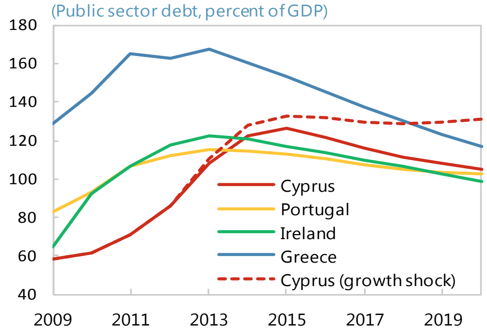
15. **Significant external adjustment is expected in the short term.** The current account deficit is projected to narrow to close to 2 percent of GDP in 2013, largely due to continued import compression as domestic demand contracts, and a correction in the net income balance as income received on FDI abroad normalizes following the sale of loss-making bank branches in Greece. While exports of financial and other business services are expected to be severely affected by developments in the banking sector, tourism receipts are expected to remain resilient, as capacity has been sold in advance. The deficit is expected to stabilize at around 2 percent of GDP in the long term. Official funds are expected to be the largest source of external financing, although FDI is also projected to receive a boost once privatizations materialize; the private sector, on the other hand, will continue to draw down holdings of foreign portfolio assets to meet its financing needs.

16. **Risks to the outlook are substantial and tilted to the downside**. Notably, the impact of the banking crisis and fiscal consolidation on both real GDP and the deflator is highly uncertain. The contraction in professional business and financial service exports could be deeper if foreign banks and large deposits relocate to other destinations in greater volume or faster pace than assumed. On the domestic side, given the size of the banks having been resolved, the losses faced by uninsured resident depositors, temporarily frozen corporate accounts, and the need to impose payment restrictions, the economic slump could result in a vicious circle of bankruptcies, further correction in real estate prices, delay in lifting restrictions, bank losses, and unemployment. These, together with the effects of the fiscal consolidation on the economy could also lead to a deeper recession than anticipated, with negative feedback loops on fiscal accounts, including public debt. On the upside, if banks are seen as having stabilized, confidence could be rebuilt sooner, allowing for the earlier removal of controls and a faster recovery of activity. In addition, some support may come from larger investments in the energy sector.

DEBT SUSTAINABILITY

17. **Given substantial downside risks to the outlook, full implementation of the program is essential to achieving sustainable debt dynamics.** The debt-to-GDP ratio is expected to peak at 126 percent in 2015, given continued fiscal deficits and weak growth. Thereafter, debt dynamics are expected to improve as growth resumes and the primary surplus improves. With full implementation of policies under the program, the debt ratio is projected to continue to fall, reaching around 105 percent of GDP by 2020. While these dynamics could be considered sustainable in the baseline scenario, macroeconomic risks are unusually high, and a worse-than-expected macroeconomic outlook or implementation slippages would have profound adverse implications for the debt trajectory (Annex I). Should these risks materialize, additional financing measures may be needed to preserve debt sustainability.

Debt sustainability
(Public sector debt, percent of GDP)



Source: IMF staff estimates.

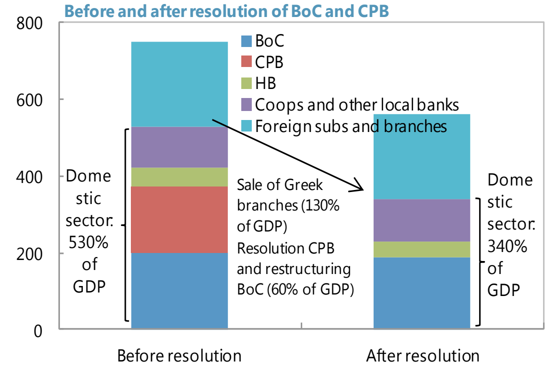
18. **High external debt will also prevail over the program period.** Given the outsized financial sector, Cyprus' external debt, including deposits by non-residents, was estimated at close to 450 percent of GDP at end-2012 (the net international investment position was -90 percent of GDP). In 2013, external debt is expected to fall to under 330 percent of GDP, mainly reflecting the divestment of Greek branches, but also losses incurred by non-residents on uninsured deposits in the two intervened banks. Over the long term, the external debt-to-GDP ratio is expected to continue to decline to under 275 percent of GDP, as growth rebounds, the non-resident deposit base continues to shrink, and Cyprus registers sizeable non-interest current account surpluses (Annex II).

POLICY DISCUSSIONS

A. Financial Sector Policy

19. **Upfront action has addressed immediate concerns, but restoring the health of the financial system will require additional measures**. The resolution, restructuring, and recapitalization of the two largest insolvent banks with contribution from bank creditors, including uninsured depositors, has averted a collapse of the system. It has also reduced contingent liabilities on the sovereign, with the domestically-owned sector already downsized from 550 to 350 percent of GDP, close to the euro area average. Nevertheless, short-term risks are high, as restrictions remain in place, the deep recession is expected to take a toll on banks' balance sheets, and depositor uncertainty remains. The authorities and staff agreed that firm steps are needed to complete the restructuring and recapitalization process so as to rebuild confidence in the viability of the banking system, normalize financial flows, and set the conditions for sustained growth. Restructuring is also expected to further reduce the size of the banking sector. Moreover, measures will be needed to facilitate private debt restructuring, enhance banking supervision and regulation, and strengthen anti-money laundering (AML) practices.

Cypriot Banks' Assets:
Before and after resolution of BoC and CPB



Recapitalizing and restructuring the financial sector

20. **The recapitalization strategy makes a clear distinction between solvent and insolvent institutions**. This has important implications for depositors. All insured depositors are protected under the strategy. However, in the two insolvent banks that were intervened, part of uninsured deposits has been converted into shares to ensure adequate capitalization, in line with the new resolution law. Looking forward, to address potential additional capital needs following an

independent asset valuation in BoC, an additional uninsured deposit buffer has been set aside and could be used if needed. Staff has cautioned against exemptions from conversions into equity, which could lead to unequal treatment among uninsured depositors. In the rest of the private banks and the coop sector (assessed as a whole given its mutual-guarantee structure), which have been found solvent overall, uninsured depositors will not be expected to participate in the recapitalization of their institutions. Such recapitalization will be done through private or public funds.

21. **The authorities agreed to complete the restructuring of the new BoC.** According to the new bank resolution law, an independent fair value assessment of BoC and CPB's assets and liabilities will need to be conducted (MEFP ¶9, structural benchmark for end-June 2013). This will help to finalize the new balance sheet based on most recent information and determine whether additional capital is required to ensure a CT1 ratio of 9 percent by end-program. To this end, in addition to the 37.5 percent of BoC uninsured deposits converted into equity, a further 22.5 percent will remain frozen and subject to potential conversion after completion of the valuation process. BoC could then re-access normal Eurosystem refinancing facilities and resume normal activity in line with its new business plan (structural benchmark for end-September).

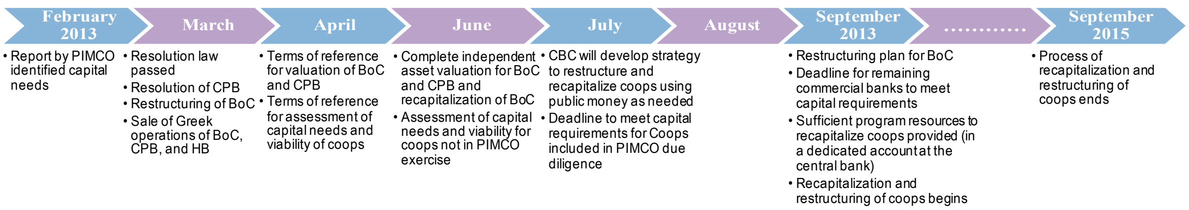
22. **Other viable commercial banks will be recapitalized within six months** (MEFP ¶10). The process will be guided by the capital needs identified under PIMCO's adverse scenario. Staff and the authorities agreed to allow time for viable but undercapitalized institutions to raise capital and preserve private ownership. However, if new capital is not forthcoming, viable banks will be recapitalized by the state according to state aid rules involving dilution of existing shareholdings and junior debt holdings, but without contributions by depositors. Banks recapitalized with public funds will also be asked to submit business plans with clear downsizing targets, including divestiture of non-core activities and reduction of operational costs.

23. **The credit cooperative sector will also be restructured and recapitalized**. The sector is comprised of about 100 Credit Cooperative Institutions (CCIs), which provide credit to residents, are covered by mutual guarantees, and are supervised on a consolidated basis by an independent supervisory agency (other than the CBC). The sector's NPLs averaged 38 percent at end-June 2012. PIMCO identified a capital shortfall of around €600 million for a sample of 17 CCIs (more than half of the sector's assets), with some CCIs' capital needs exceeding 15 percent of own assets. Given that the sector is viable in the aggregate, the authorities agreed to address its weaknesses as follows:

- An assessment of capital needs for individual CCIs not covered by the PIMCO exercise will be finalized by end-June 2013 (structural benchmark);
- CCIs will be given an opportunity to raise capital in the market;
- All CCIs which could not access sufficient private capital will be orderly and gradually restructured and recapitalized with public funds, without contribution by depositors (a restructuring strategy is a structural benchmark for end-July). Public funds will be made available

subject to compliance with minimum governance and operational criteria to guarantee the viability of the sector.

- To maintain confidence in the sector, sufficient official funds to cover recapitalization and restructuring costs will be disbursed in a special account at the time of the first review, to be drawn on over time as the CCIs are being restructured.



Normalizing financial flows

24. **Discussions focused on the tradeoff between freeing payment flows and preserving financial stability.** The authorities were particularly concerned about the significant costs to economic activity posed by the restrictive measures. These related to the inability of working capital to flow freely not only within the economy, but also outside, as the small island is heavily dependent on imports. But they also pertained to subjecting the international banks to the overall restrictions, which was seen as detrimental to other business services affiliated to the offshore activity of these banks. Nevertheless, it was recognized that eliminating restrictions too abruptly could lead to disruptive outflows and liquidity problems in the banking sector.

25. **The authorities agreed to relax restrictions gradually, based on close monitoring of trends and of banks' liquidity buffers**. The overall strategy focuses on lifting restrictions on domestic transactions before lifting those on international payments as conditions continue to ameliorate. While exempting offshore operations of foreign banks from restrictions could help with preserving affiliated business services, staff raised concerns regarding the effectiveness of ring-fencing these. Failure to prevent outflows from domestic to foreign banks could give rise to domestic liquidity pressures. Completing the restructuring process is expected to lead to a resumption of confidence and a gradual stabilization of funding. For the time being, availability of euro-system liquidity will be critical. Sufficient availability of ELA and a resumption of ECB counterparty status for BoC will be needed to allow for a lifting of restrictions.

Enhancing preparedness to deal with troubled borrowers

26. **The framework for debt workouts will be enhanced to facilitate the cleanup of banks' portfolios** (MEFP ¶19). Given already high and likely rising NPLs, having in place tools to address overdue loans expeditiously helps both the banks and their borrowers. It was agreed that the CBC will assess and modify existing frameworks with the aim to facilitate out-of-court debt workouts according to international best practice. On this basis, banks would develop strategies to deal with

NPLs of viable, but temporarily troubled borrowers, while minimizing moral hazard. These would need to be carefully monitored. The authorities also agreed to consider an ombudsman-type institution to mediate between borrowers and banks and to the use of tax exemptions related to voluntary discounts on loan repayments.

Enhancing regulation and supervision

27. **The authorities have identified a number of measures to strengthen the supervisory and regulatory framework for credit institutions** (MEFP ¶17 and ¶18)**.** Discussions highlighted deficiencies in the existing framework that allowed the rapid expansion of the banking sector and buildup of risks that led to the recent crisis. These pertained to the monitoring of credit quality (including use of nonstandard NPL definitions excluding fully collateralized loans), lack of an early supervisory framework for banks, and heterogeneous supervisory standards and responsibilities related to banks and CCIs. In this context, to prevent risks from materializing in the future, it was agreed that the regulatory framework would be strengthened along the following dimensions:

- **Credit quality monitoring.** The authorities agreed to measures ensuring that going forward the banks will: (i) report NPLs timely and adequately, based on internationally-recognized definitions; (ii) comply with materially enhanced risk-management practices, including proper underwriting and loan-collection standards, as well as appropriate collateral valuation and provisioning practices; and (iii) be able to obtain credit information from individuals and corporates from a credit register that will need to be established to effectively monitor large exposures and troubled borrowers (structural benchmark for end-September 2013).

- **Early corrective actions.** The aim is to empower the CBC with sufficient supervisory tools (including the ability to impose penalties, remove bank managers, and suspend dividend payments) to timely address bank vulnerabilities or misbehavior before they become a threat for financial stability.

- **Supervision and regulation of CCIs**. The lack of a common supervisory approach to banks and CCIs has contributed to the accumulation of balance sheet and governance issues among the latter. The aim is to: (i) transfer supervisory and regulatory powers of the sector from the Ministry of Commerce, Industry and Tourism to the CBC and harmonize standards with those of the commercial banks; (ii) prohibit CCIs from lending to independent board members and remove all board members in arrears on existing loans; and (iii) require an annual audit performed by a recognized and independent auditing firm for the largest CCIs.

Strengthening the anti-money laundering (AML) framework

28. **The authorities agreed to further strengthen the AML framework.** Despite a relatively positive overall evaluation of the framework by Moneyval in 2011, a more recent evaluation shows that significant weaknesses remain, especially in its implementation. These may have contributed to the attractiveness and unsustainable growth of Cyprus' financial sector. To rectify these, the

authorities have amended the AML legal framework in December 2012 to incorporate tax and other fiscal-related elements. They have also agreed in April 2013 to an independent audit of the implementation of the AML framework by credit institutions. Going forward, they will undertake additional measures to improve transparency and enhance the effectiveness of the AML framework, by:

- **Further revising the legal framework in line with international standards and best practice** (structural benchmark for end-September 2013). These changes will help to facilitate the international exchange of financial intelligence prior to judicial proceedings. They will also enable the authorities to obtain adequate, accurate, and timely information on legal persons and trusts registered in Cyprus or subject to Cyprus law.

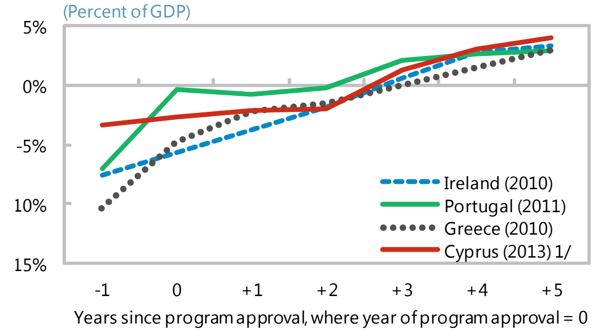
- **Ensuring that the transparency of legal persons and trusts is properly implemented**: The business register is currently dysfunctional and the supervision of lawyers, accountants and trusts and company service providers will need to be stepped-up.

- **Strengthening the AML supervision of financial institutions**: The CBC will revise its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision, and has requested Fund TA in this respect. By the time of the first review, it will be important to develop corrective measures to strengthen the implementation of customer due diligence measures by banks to address issues raised in the recently finalized independent audit.

B. Fiscal Policy

29. **An understanding was reached on the path of fiscal consolidation**. The 2013 budget and supporting legislation passed last December include consolidation measures estimated at about 5 percent of GDP for 2013-2016. These include scaled public sector wage cuts of 10-15 percent, rationalization of social benefits and pensions, and increases in the VAT, excise taxes, and social security contributions. Given this and the expected deep downturn, the mission advised to: (1) limit additional fiscal measures beyond those already in train; (2) provide more time to reach the authorities' long-term primary balance target of 4 percent of GDP; but (3) be ready to identify and implement at a later time additional measures taking effect during 2015-2018 required to reach the long-term target. The authorities concurred with the need to balance cyclical considerations and sustainability concerns. The pace of fiscal consolidation is comparable to that in other European programs.

Selected Program Countries: Primary Balance Path
(Percent of GDP)



Source: Eurostat.
1/ Figures for Cyprus exclude one-offs.

30. **The authorities agreed to supplement the significant consolidation underway with an additional modest adjustment in 2013-15**. The new measures (prior action), expected to permanently yield 2.2 percent of GDP, include: (i) increasing the corporate income tax rate from 10 to 12.5 percent; (ii) raising the existing bank levy on deposits from 0.11 to 0.15 percent; (iii) raising the withholding tax rate on interest income from 15 to 30 percent, which is closer to the European average; (iv) rationalizing housing programs with a view to consolidate and streamline these; and (v) reforming property taxation by amending rates and/or thresholds to bring effective taxation more in line with property values. Expenditure measures account for about 40 percent of the total implemented and agreed consolidation package for 2013-16. It was also agreed that program targets for 2013 could be adjusted as needed to allow for compensation of pension funds in CPB to ensure equal treatment with those in BoC (expected to take place before September), given social welfare considerations.

Fiscal Consolidation, 2013-18
(percent of GDP)

	2013	2014	2015	2016	2017	2018	Total
Approved Measures	**2.4**	**2.0**	**0.3**	**0.2**	**0.0**	**0.0**	**5.0**
Revenues	0.6	1.3	0.2	0.1	0.0	0.0	2.1
Increase in the VAT standard and reduced rates	0.2	0.3	0.1	0.0	0.0	0.0	0.6
Increases in excise rates	0.5	0.3	0.0	0.0	0.0	0.0	0.7
Increase in pension contributions	0.0	0.4	0.0	0.0	0.0	0.0	0.4
Other	-0.1	0.3	0.1	0.1	0.0	0.0	0.4
Expenditure	1.8	0.7	0.2	0.2	0.0	0.0	2.8
Nominal wage cuts	0.7	0.5	0.0	0.0	0.0	0.0	1.2
Rationalization of social transfers (eligibility tightening, abolition of benefits)	0.9	0.2	0.0	0.0	0.0	0.0	1.1
Rationalization of pension benefits	0.2	0.0	0.2	0.2	0.0	0.0	0.5
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Agreed Measures	**2.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**2.2**
Revenues	2.0	0.0	0.0	0.0	0.0	0.0	2.0
Increase in the corporate income tax rate from 10 to 12.5 percent	0.5	0.0	0.0	0.0	0.0	0.0	0.5
Increase in the withholding tax rate on interest from 15 to 30 percent	0.8	0.0	0.0	0.0	0.0	0.0	0.8
Increase in the bank levy rate from 0.11 to 0.15	0.1	0.0	0.0	0.0	0.0	0.0	0.1
Increased property taxation	0.5	0.0	0.0	0.0	0.0	0.0	0.5
Other	0.1	0.0	0.0	0.0	0.0	0.0	0.1
Expenditure	0.2	0.0	0.0	0.0	0.0	0.0	0.2
Rationalization of housing schemes	0.2	0.0	0.0	0.0	0.0	0.0	0.2
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified measures	**0.0**	**0.0**	**1.4**	**1.4**	**1.0**	**1.0**	**4.7**
Total	**4.6**	**2.0**	**1.7**	**1.6**	**1.0**	**1.0**	**11.8**

Source: IMF staff estimates.

31. **An additional 4.7 percent of GDP in measures over 2015-18 will be needed to attain the primary surplus target of 4 percent of GDP.** With public debt projected to reach 126 percent by the end of the program period, a primary balance of 4 percent is needed to place debt on a firmly downward path toward a long-term debt ratio of close to 100 percent of GDP. While a 4 percent of GDP primary surplus is ambitious by historical and international standards, evidence suggests that countries have been able to sustain such surpluses through time (Annex I).[1] The projected consolidation path includes measures of about 1.4 percent of GDP each in 2015 and 2016

[1] The April 2012 Fiscal Monitor describes a number of episodes of countries sustaining large primary surpluses, including through growth slowdowns.

and 1 percent of GDP in 2017 and in 2018. To buttress credibility of the adjustment in the outer years, fiscal targets will be defined and included in binding medium-term ceilings for future budgets, in line with the new medium-term budget framework.

32. **There is significant scope to streamline public spending while protecting vulnerable groups.** Given significant revenue measures taken upfront, the needed future consolidation is expected to rely largely on the spending side, in particular public sector wages and social transfers. In 2012, the public wage bill (including public pensions) and social transfers (including social security payments) represented about 67 percent of total expenditure. The public sector wage bill, even after recent cuts, is still expected to be significantly higher than the EU average. Public sector employees are also better paid than private sector counterparts and receive additional benefits, including generous pensions, favorable working hours, and overtime payments. Furthermore, in the area of social transfers, the generous pension scheme for public servants can be further reformed by streamlining gratuities and instituting career averages for pension calculations. Finally, a variety of programs with overlapping objectives or poor targeting can be reformed by streamlining them and adjusting eligibility criteria such that they can better reach those in need.

C. Structural Fiscal Reforms

33. **Discussions focused on the need to build on recent reforms to further strengthen public finances** (Figure 5). Last December, the authorities adopted a long overdue reform of the cost of living adjustment (COLA) public wage indexation system—allowing for partial (rather than full) indexation of public wages and its automatic suspension during recessions—expected to reduce the high public wage bill and moderate private wages, contributing to an improvement in Cyprus' competitiveness. Moreover, a parametric pension reform was introduced in January 2013, which has significantly improved the long-term viability of the pension system. The authorities agreed that further efforts are needed to: (i) strengthen the management of public resources; (ii) enhance revenue collections;(iii) improve targeting of social welfare programs; (iv) further improve the viability of the pension system; and (v) rationalize and privatize state-owned enterprises.

34. **The credibility of the fiscal consolidation efforts will be enhanced by stronger public financial management (PFM) practices:**

- **Medium-term budget framework (MTBF, MEFP ¶29)**. The proper implementation of the MTBF, consisting of a rolling three-year budget framework, will be key to anchor Cyprus' fiscal policy. This is particularly relevant as the program requires significant consolidation measures beyond the program period. An MTBF law compliant with EU requirements was approved in December 2012. The authorities agreed to finalizing secondary legislation and regulations to have the MTBF fully in place for the 2014 budget, as well as to submit to Parliament a fiscal responsibility and budget systems law (structural benchmark for end-December 2013) to support the MTBF and address other existing legal shortcomings.

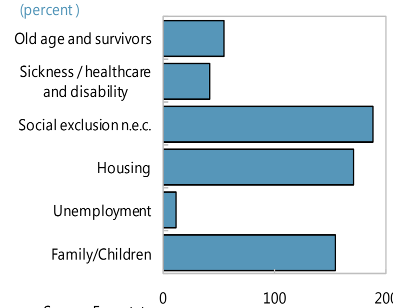
- **Framework to manage natural resources (MEFP ¶30).** While the authorities agreed with the need to put in place a comprehensive framework in line with best practice, they stressed the importance of maintaining autonomy to manage their natural resources, in particular with regard to related infrastructure investments. The framework will be discussed in future reviews, with the aim to ensure that these revenues are managed in the best interest of current and future generations and without causing distortions to the macro economy.

- **Public-private partnerships (PPPs, MEFP ¶31)**. The authorities have implemented some large scale investment projects as PPPs, which could also be used to address investment needs in the natural gas sector. But international experience suggests that PPPs come with substantial fiscal risks, which need to be managed carefully. The authorities agreed to put in place an adequate institutional and legal framework to manage PPPs and to improve reporting on fiscal risks from PPPs, semi-government entities, SOEs, and local governments.

35. **Strengthening revenue administration will be key to secure fiscal targets (MEFP ¶32).** The current organizational structure of revenue administration around types of taxes rather than administrative functions leads to a fragmentation of collections, weakening taxpayer compliance. Indeed, Cyprus' informal economy is larger than the OECD average (26 versus 14 percent of GDP), and declared income for more than 3/4th of self-employed taxpayers (about 15 percent of the tax base) was under the taxable threshold at end-2011. Improving revenue collection by modernizing revenue administration will thus help to maximize fiscal revenues. Based on a recent diagnostic assessment of the Inland Revenue Department and the VAT Services, the authorities agreed to finalize a reform strategy by end-June.

36. **In the current recessionary environment, adequate targeting of welfare programs to vulnerable groups is essential (MEFP ¶28)**. Social protection spending increased significantly over the past decade, although there has been significant leakage to richer groups. For child benefits and student grants, for example, less than 15 and 10 percent of the benefits reach the 20 poorest percent of the population. These inefficiencies are also due to a scattered allocation of responsibilities across ministries and agencies and inadequate means testing. The agreed reform of social benefits aims to create a safety net mitigating the adverse effects of the downturn on the most vulnerable groups, while consolidating benefits and providing for a more consistent application of means testing with binding income thresholds (structural benchmark, end-2013).

Real Growth of Benefit Spending per Capita, 2000-10
(percent)



Source: Eurostat.

37. **The authorities also agreed to undertake further steps to ensure the sustainability of the pension system as needed**. It was agreed that an actuarial study is needed to assess the effect of the recent pension reforms on the financial viability of the general pension system and the expected net budgetary cost of the public pension system. Based on this assessment, additional reform measures may need to be developed in future reviews with the aim to ensure the financial

viability of the systems through 2060, which will help to preserve long-run fiscal sustainability in the face of population aging.

38. **Privatization of state-owned enterprises will help to reduce debt and fiscal risks and raise economic efficiency**. An inventory of government assets, including SOEs and real-estate will be the basis for the formulation of a privatization plan aiming to raise €1.4 billion by 2018 (this will also help to identify public assets that could be swapped for debt currently held by the central bank of about €1 billion to further reduce indebtedness). Further streamlining the public sector by divesting public entities with neither privatization prospects nor necessary public functions can also help to reduce fiscal risks and minimize budget transfer costs (1.5 percent to GDP at end-2012).

PROGRAM MODALITIES

A. Access, Phasing and Conditionality

39. **The authorities' program will be supported by a three-year EFF arrangement for SDR 891 million (about €1 billion), or 563 percent of quota**. Cyprus faces sizable balance of payments financing needs that are medium-term in nature, in particular pressures on the capital account, the need for rollover of external debt, and a current account deficit. These can be most appropriately dealt with through an EFF-supported program. The overall size of the external financing package required to cover Cyprus' financing needs (after the authorities' measures below) over 2013Q2-2016Q1 is estimated at €10 billion (Table 5). Of this amount, European partners have pledged about €9 billion. The Fund's contribution would be SDR 891 million (about €1 billion) or 563 percent of quota, equally phased (Table 7).

40. **Assurances that financing needs under the program will be met also rely on the authorities' commitment to a number of measures.** These include: (i) rolling-over and extending maturity of at least €1 billion of domestic debt held by residents and rolling-over the €1.9 billion recapitalization bond injected in CPB in 2012 (end-June structural benchmark); (ii) privatizing public assets worth at least €500 million by end-program; (iii) rescheduling and lowering the interest rate (from 4.5 percent to 2.5 percent) on a Russian bond falling due in 2016; and (iv) using the allocation of future central bank profits (including from sales of gold reserves, if needed) of €0.4 billion, in line with CBC rules. In addition, in accordance with CBC rules and European Treaties, the government will swap approximately €1 billion of debt held by the central bank with state-owned assets not slated for privatization. Firm commitments from creditors on points (i) and (iii) are expected to be made at the time of the first review, but program financing buffers are sufficient to cover needs in the meantime. Accordingly, financing assurances are in place for the program (MEFP ¶34).

41. **Program monitoring will be guided by quarterly reviews, quarterly and continuous performance criteria, and structural benchmarks.** Conditionality has been developed in consultation with the EC/ECB to support the adjustment in macro-critical areas:

- **Prior actions:** The authorities agreed to pass legislation to implement fiscal measures of 2.2 percent of GDP as a prior action. In addition, they had completed a number of important policy actions identified as potential prior actions even before signing of the MEFP (Table 3 MEFP).

- **Quantitative targets** (Table 1 MEFP): Quantitative performance criteria for end-June and end-September 2013 are included for: (i) the general government primary balance; (ii) the general government primary expenditure; (iii) the stock of general government debt; (iv) the accumulation of new general government guarantees; (v) the accumulation of domestic arrears; (vi) the accumulation of VAT refund arrears by the general government; and (vii) the accumulation of external payments arrears. Given significant uncertainty about economic prospects, indicative targets are also included for end-December 2013 and end-March 2014. In addition, the program includes a standard continuous performance criterion on the non-imposition and non-intensification of exchange restrictions.

- **Structural benchmarks** (Table 2 MEFP): These are focused on strengthening financial stability and fiscal institutions and limiting fiscal risks. On financial stability, the government will: (i) complete an independent valuation of BoC and CPB assets and liabilities ; (ii) adopt legislation transferring supervision responsibility of CCIs to the CBC; (iii) complete an assessment of viability and capital needs for the CCIs not covered by the PIMCO exercise; (iv) develop a strategy to restructure and recapitalize the CCI sector; (v) require the BoC board to prepare a restructuring plan defining the bank's business objectives; (vi) adopt a legal framework for a central credit register; and (vii) revise the anti-money laundering legal framework. Structural fiscal benchmarks include: (i) the submission of a law on fiscal responsibility and budget systems; and (ii) the adoption of measures to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs. In addition, a benchmark on the rollover of domestic debt and the recap bond in CPB has been included.

B. Capacity to Repay the Fund and Risks to the Program

42. **Cyprus' capacity to repay the Fund is expected to remain adequate.** Outstanding credit to the Fund is expected to peak in 2016 at about 563 percent of quota, while debt service to the Fund as a ratio of exports of goods and services will peak at 1 percent in 2020. Under the baseline scenario, government debt would peak at 126 percent of GDP in 2015. Thereafter, the debt-to-GDP ratio is expected to decline as economic activity recovers, the government starts registering primary surpluses, and privatization receipts materialize.

43. **However, the program is subject to significant risks, especially related to a potentially worse outlook for nominal growth and hence the debt trajectory:**

- **The impact of the banking crisis is highly uncertain.** The program assumes a sharp contraction in output, but given the importance of the financial and business service sector for Cyprus' economy and the dislocations caused by the administrative controls, the decline could be deeper than projected. Significantly lower growth would raise fiscal financing needs and threaten debt sustainability.

- **The banking system could come under renewed pressure**. Despite the controls, outflows and leakage from the banks cannot be ruled out. On the other hand, their premature lifting could exacerbate liquidity pressures, jeopardizing financial stability. Even though the banking system is expected to be adequately recapitalized, given the expected downturn, asset quality could deteriorate sharply. Moreover, the newly restructured bank remains heavily reliant on emergency liquidity assistance. Liquidity and solvency problems could then reemerge and require additional actions. Finally, litigation risks related to the resolution and restructuring of the two large banks are high and could compromise the completion of the restructuring process.

- **Implementation capacity and political resolve could falter, eroding credibility**. Amid a deteriorating economic environment, social and political tensions could emerge, weakening the program's ownership. Lack of coordination among decision makers and unclear communication of the policy strategy for the financial sector could further complicate an already complex process. Moreover, the need for additional fiscal measures during and after the program and structural fiscal reforms could result in reform fatigue and dent confidence. In the case of privatizations, success will also depend on market conditions. The ability to reform the AML framework will also be a test on the capacity to reform the business model.

44. **There are factors mitigating these risks.** The financing envelope provides some buffers to accommodate increased needs in case of a larger-than-expected recession. As these are already accounted for in the debt sustainability analysis, their use would not lead to a further worsening of debt. More stringent capitalization requirements for the resolved banks (CT1 of 9 rather than 6 percent under a stress scenario) provide some margin for deterioration of bank asset quality. As to policies, significant upfront actions have already been undertaken both in the fiscal and financial areas. Moreover, the approval of fiscal measures taking effect in future years, together with the planned reform implementing the new multi-year budget framework, help to strengthen credibility of post-program fiscal targets.

45. **The CBC has provided required information to undertake a safeguards assessment, which is expected to be completed by the time of the first review**. Since IMF funds will be used for budgetary financing, safeguards requirements for a framework agreement between the central bank and government for servicing obligations to the Fund will also be necessary, including that Fund disbursements be deposited in a government account at the CBC. Staff has also confirmed that the CBC publishes its annual financial statements, which are independently audited in accordance with international standards.

STAFF APPRAISAL

46. **Cyprus faced mounting imbalances that culminated in a full blown confidence crisis.** Cyprus lost market access almost two years ago, as markets realized that internal and external imbalances were unsustainable, especially related to the oversized contingent liabilities posed by banks onto the sovereign. Lack of policy action exacerbated the problems. Ultimately, the inability to address these in a manner consistent with debt sustainability led to a banking sector crisis.

47. **The authorities have now shown exceptional resolve in addressing the crisis.** They took unprecedented action to intervene two insolvent banks with assets of around four times GDP. The large capital needs were covered by conversion into equity of bank claims, including uninsured deposits. This avoided using public funds that would have brought public debt to unsustainable levels, putting an unduly large burden on taxpayers. At the same time, insured depositors were protected, and the burden shared more broadly. Their actions averted a potential accident with unknown consequences for the euro-zone.

48. **Nevertheless, much remains to be done to restore confidence and growth**. In the aftermath of the crisis, activity will be severely affected, and time will be needed to rebuild a sustainable business model. The authorities have embarked on an ambitious program of reforms aimed at restoring the health of the banking sector and putting public finances on a sustainable footing. European partners and the Fund will provide official support to facilitate and provide time for the adjustment.

49. **The first challenge is to stabilize the banking sector.** Building on upfront actions to address the insolvent institutions, the authorities will need to complete the bank recapitalization process. The newly restructured bank needs to be put on a sound footing by completing an asset valuation and ensuring sufficient capitalization. Other banks and the cooperative sector, which were found viable but undercapitalized, will be recapitalized with public funds, and restructured as needed. Communication is key to clarify the strategy, reassure depositors, and rebuild confidence.

50. **Eurosystem liquidity support is critical to allow for the removal of payment restrictions**. The imposition of temporary restrictions was inevitable to avert a meltdown of the financial sector. However, this can choke real activity if prolonged. It is thus paramount to monitor the effects of restrictions carefully and relax them in line with the capacity of banks to build liquidity buffers. An adequate liquidity backstop by the Eurosystem is key to restore depositor confidence, and it is understood that the ECB will reinstate the counterparty status of the Bank of Cyprus once its solvency is established. Staff supports the authorities' request for approval of the exchange restrictions identified in Annex III in line with Fund policy, on the basis that they been imposed for balance of payments reasons, are temporary, and are non-discriminatory among Fund members.

51. **Looking forward, the authorities need to strengthen supervision and regulation**. Lax supervisory practices have contributed to the buildup of vulnerabilities in the banking sector. To prevent this from reoccurring, the authorities will need to correct deficiencies by strengthening the

monitoring of credit quality, enhancing early intervention frameworks, and harmonizing bank and coop supervision. Beefing up AML supervision and implementation of preventive measures by financial institutions and increasing transparency of legal entities and trusts will help to ensure a more sustainable financial and other business services sector.

52. **The second challenge is to put public finances on a sustainable path**. The authorities have already taken impressive steps to correct the fiscal deficit by passing a budget with measures for the next three years. Adopting remaining measures will go a long way in bringing the deficit down over the medium term. However, securing their ambitious long-run primary surplus target needed to place debt on a firmly downward path will require further measures beyond the program period. These should focus on the expenditure side and be embedded in the new multi-year budget framework to enhance credibility.

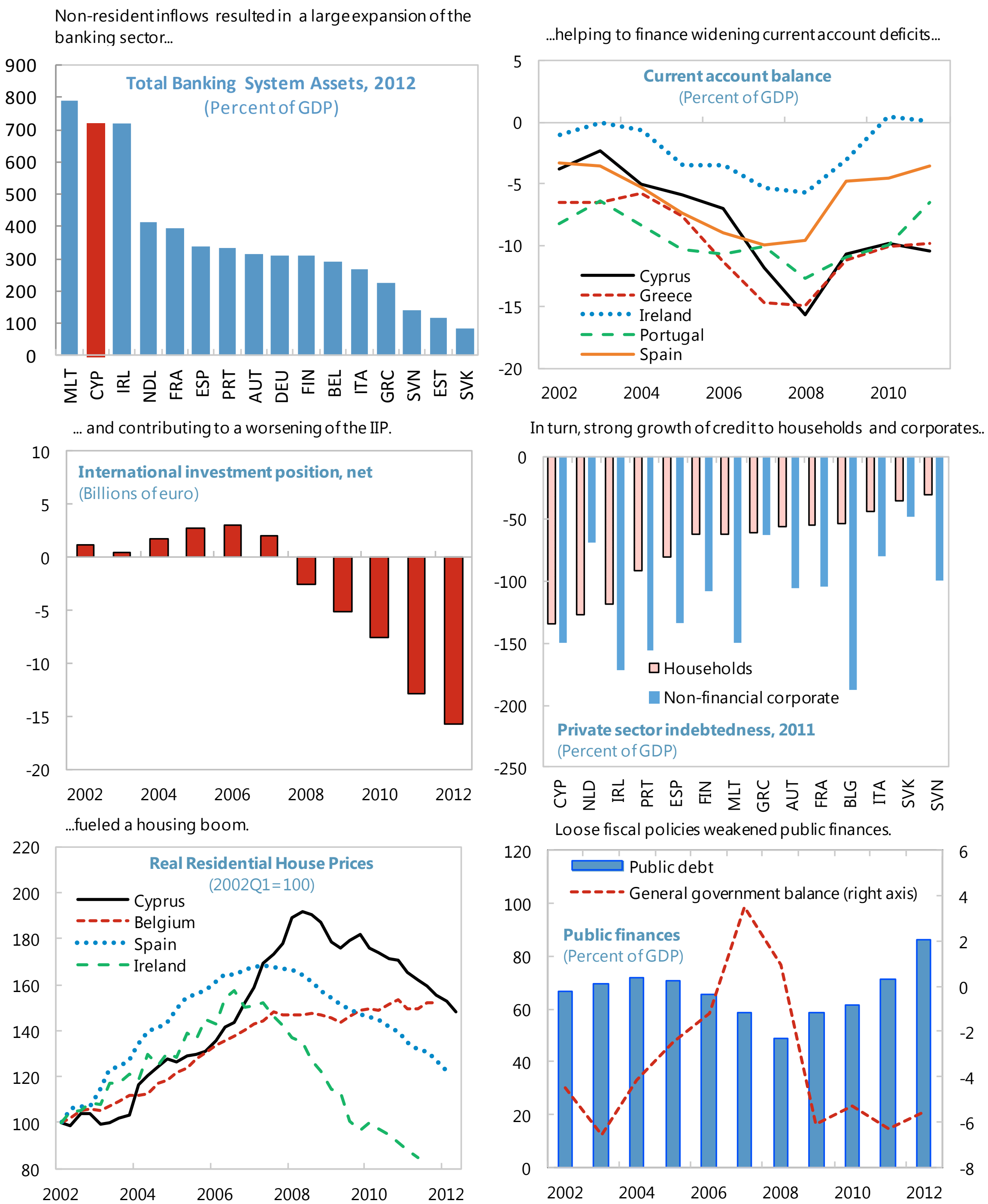
53. **Fiscal structural reforms should underpin the consolidation effort**. Two important reforms to the COLA wage indexation mechanism and pensions have already been done. These will help moderate wages and improve the sustainability of the pension system. Looking forward, improving budget processes and revenue administration will be key to securing the fiscal targets. At the same time, better targeting of social welfare programs is important to ensure vulnerable groups are protected.

54. **The authorities' commitments to share the burden of financing are welcome**. The extension of maturities of domestic debt and the rescheduling of the existing Russian loan at lower interest rates will help to smooth the debt redemption profile and lower interest payments. Privatization will not only help to reduce financing needs, but will also enhance economic efficiency. Finally, the allocation of central bank profits and a swap of debt held by the central bank with high quality assets will further bring down financing needs and public sector debt.

55. **Given substantial risks to the outlook and debt sustainability, there is no room for implementation slippages**. The recession could be deeper than projected, which could put debt sustainability at risk. The banking sector could come under renewed pressure, if asset quality deteriorates more than expected and liquidity pressures mount. This situation could be exacerbated by a weakening of ownership and inadequate coordination and communication of the program strategy. In this context, timely and comprehensive implementation of the adjustment program is critical to maintain the credibility of the adjustment program, including for actions beyond the program horizon. Should risks to debt sustainability materialize, additional financing measures may be necessary.

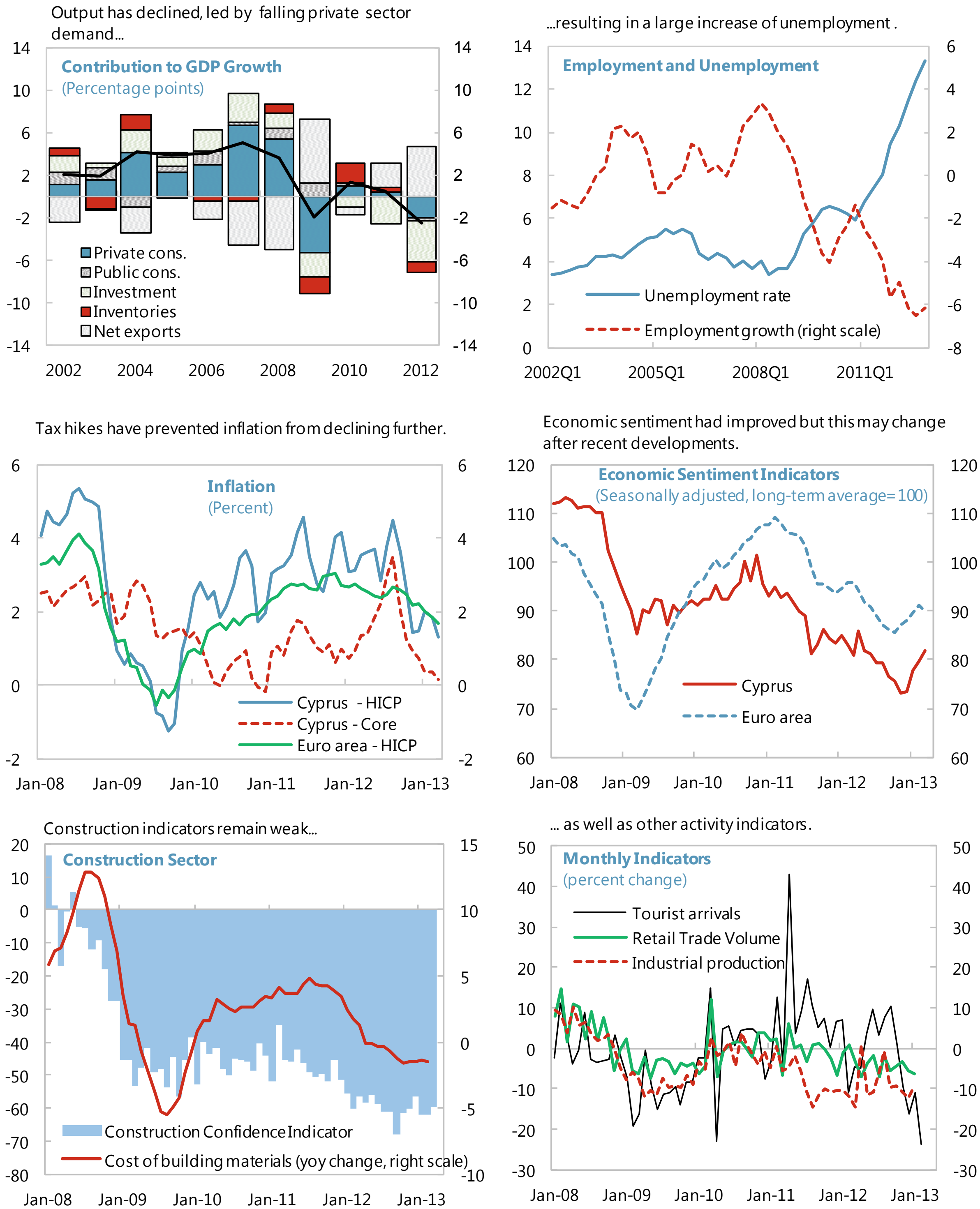
56. **Nevertheless, Fund support is warranted**. The government has demonstrated its strong determination by addressing insolvent banks upfront, implementing an ambitious fiscal consolidation at end-2012, and taking bold fiscal structural reforms. Significant co-financing by the ESM, including covering for additional financing buffers, provides reassurances on the adequacy of financing. Given these, Cyprus' balance of payments need, and the comprehensive reform package proposed by the authorities, staff supports the authorities' request for an EFF-supported program amounting to SDR 891 million.

Figure 1. Cyprus: Macroeconomic Imbalances



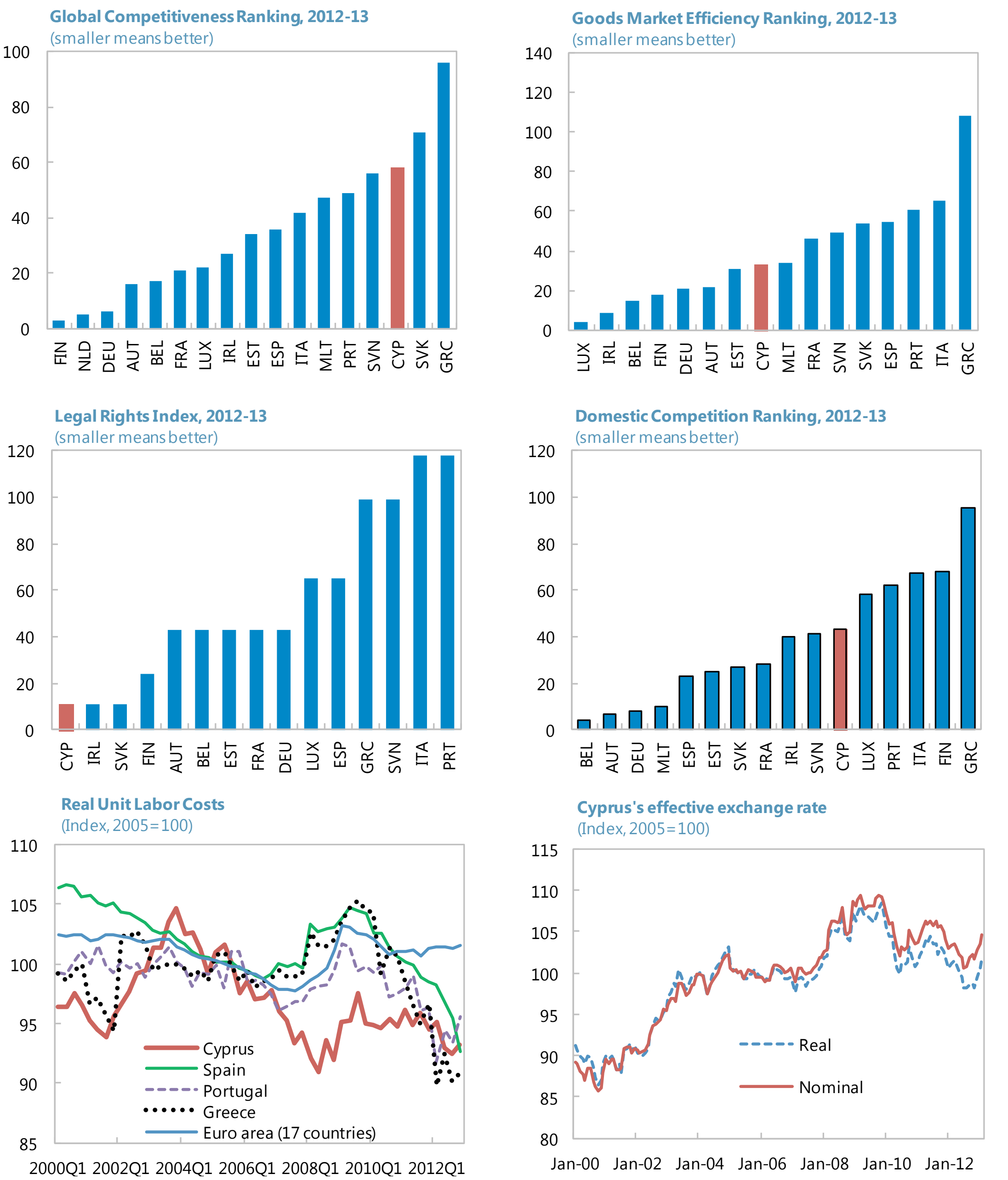
Sources: CBC; ECB; Eurostat; WEO; and IMF staff estimates.

Figure 2. Selected Economic Indicators



Sources: Cystat; IMF WEO; and IMF staff estimates.

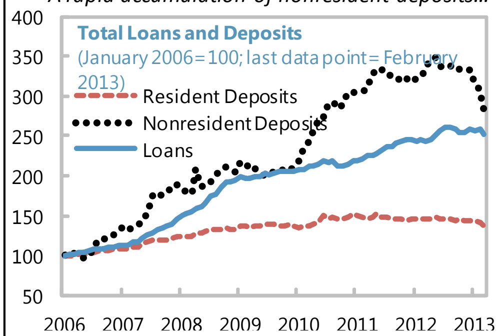
Figure 3. Cyprus: Selected Structural and Competitiveness Indicators



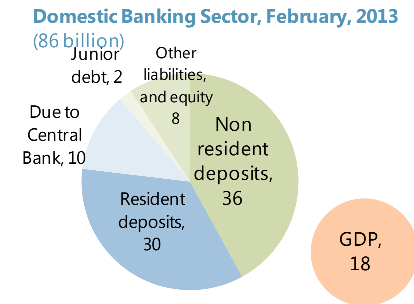
Sources: Eurostat; World Economic Forum; and IMF staff estimates.

Figure 4. Cyprus: Selected Financial Sector Indicators

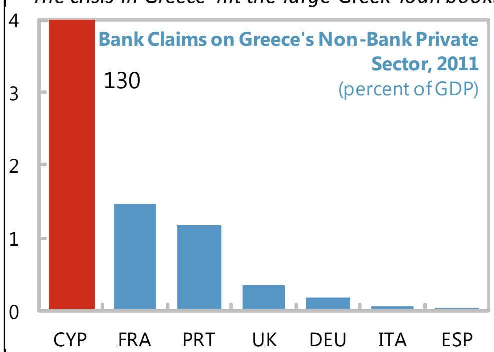
A rapid accumulation of nonresident deposits...



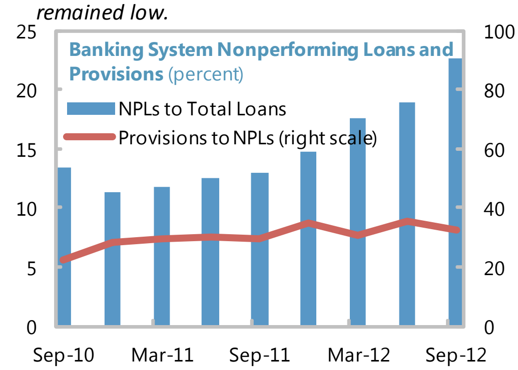
... led to an outsized banking system



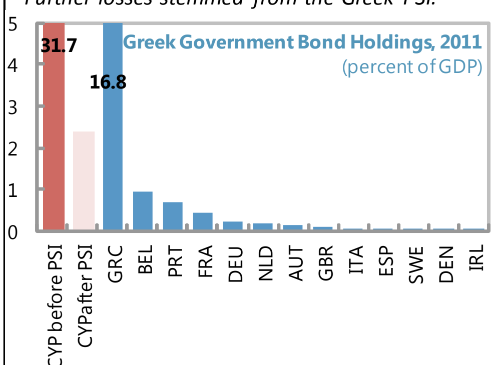
The crisis in Greece hit the large Greek loan books.



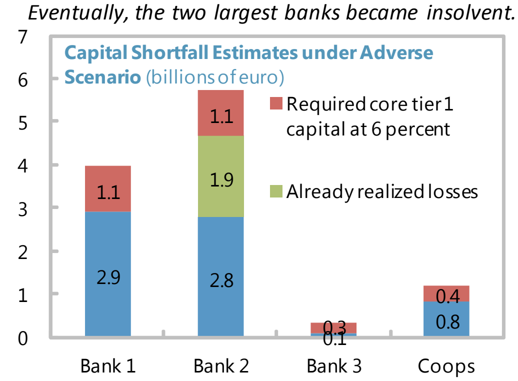
Despite a steady increase in NPLs provisions remained low.



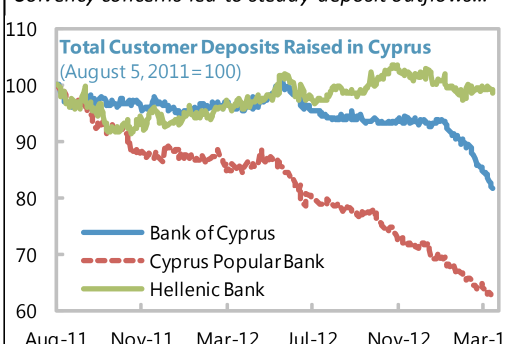
Further losses stemmed from the Greek PSI.



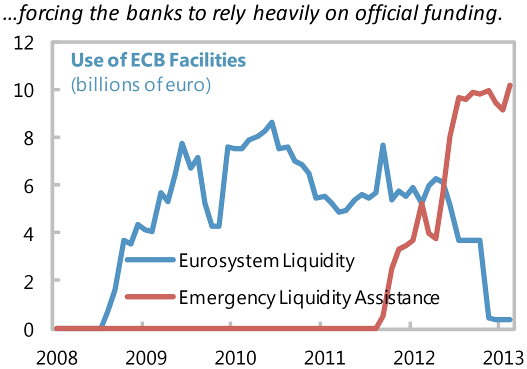
Eventually, the two largest banks became insolvent.



Solvency concerns led to steady deposit outflows...

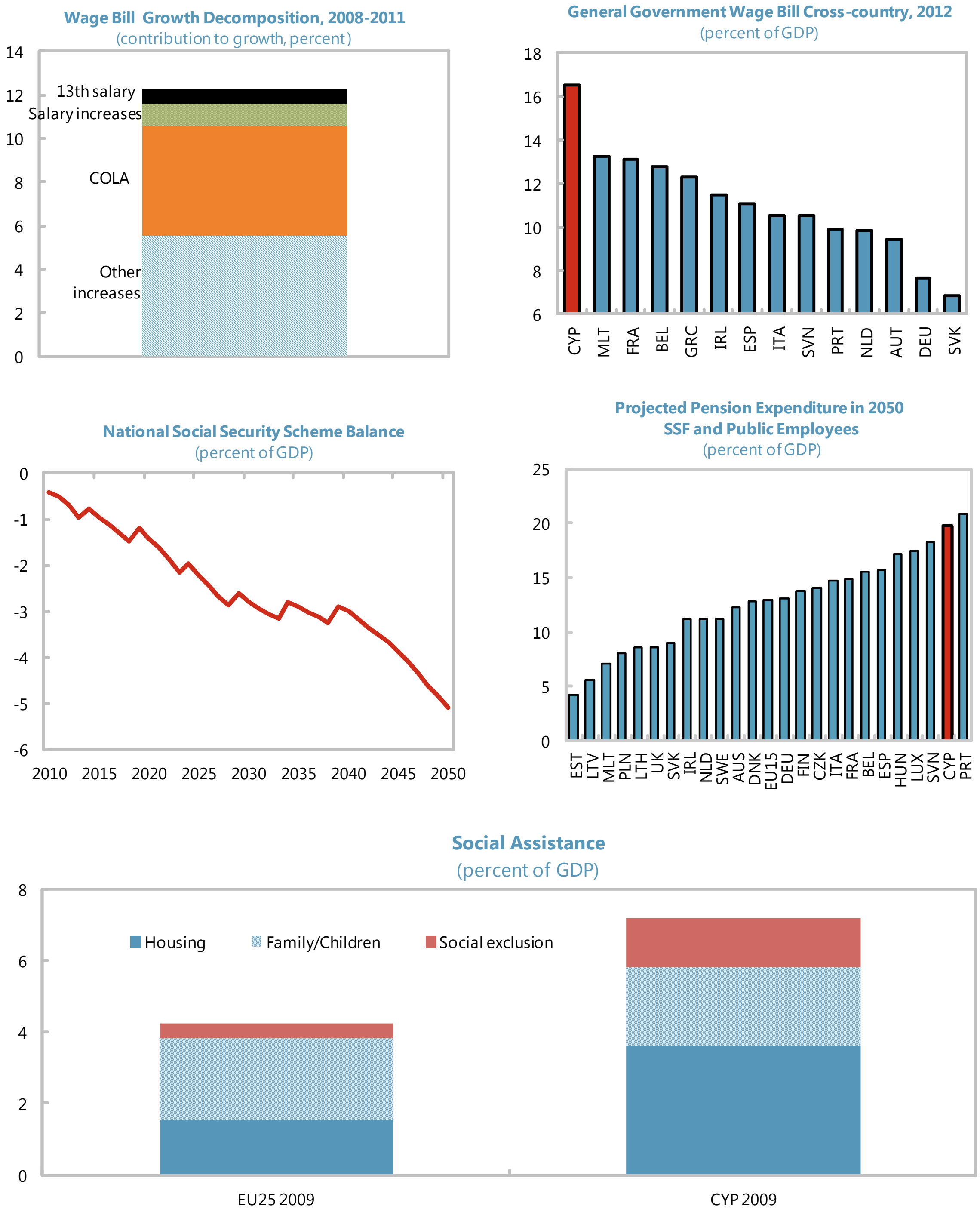


...forcing the banks to rely heavily on official funding.



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

Figure 5. Cyprus: Selected Structural Fiscal Indicators



Sources: Eurostat; European Commission; Ministry of Finance; and IMF staff estimates.

Table 1. Cyprus: Selected Economic Indicators and Macroeconomic Framework, 2008–2020

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Real Economy	(Percent change, unless otherwise indicated)												
Real GDP	3.6	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8
Domestic demand	8.0	-7.0	1.9	-1.6	-6.8	-13.9	-5.9	1.0	2.1	2.8	2.7	2.4	2.4
Consumption	7.4	-4.6	1.4	0.4	-2.7	-11.5	-5.1	0.8	1.9	2.5	2.5	2.2	2.2
Private consumption	7.8	-7.5	1.5	0.5	-3.0	-12.3	-5.6	1.6	2.9	3.4	3.3	2.6	2.4
Public consumption	6.1	6.8	1.0	-0.3	-1.7	-8.9	-3.7	-1.7	-1.3	-0.6	-0.1	0.9	1.5
Fixed investment	6.0	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.5	5.5	4.3	4.2	4.0
Inventory accumulation 1/	0.9	-1.5	1.8	0.5	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.3	4.7	5.2	1.6	0.2	-0.1	-0.3	-0.3	-0.4	-0.4
Exports of goods and services	-0.5	-10.7	3.8	4.4	2.3	-5.0	-2.5	1.7	2.7	3.3	3.3	3.3	3.3
Imports of goods and services	8.5	-18.6	4.8	-0.7	-7.2	-16.0	-6.5	1.7	3.3	4.5	4.6	4.7	4.7
Potential GDP growth	2.4	1.7	1.6	1.8	-1.5	-8.5	-3.7	0.1	0.8	1.3	1.6	1.7	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.5	-3.7	-2.8	-1.8	-0.8	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	3.7	5.4	6.2	7.8	11.9	15.5	16.9	14.6	13.7	12.9	12.0	11.1	10.2
Employment growth (percent)	1.3	-0.4	1.0	-5.6	-4.1	-6.7	-3.1	1.1	1.3	1.2	1.2	1.2	1.2
Public Finance	(Percent of GDP)												
General government balance	0.9	-6.1	-5.3	-6.3	-5.6	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Revenue	43.1	40.1	40.9	39.8	40.1	40.6	39.0	39.8	41.2	41.7	42.1	42.2	42.4
Expenditure	42.1	46.2	46.2	46.1	45.7	46.6	46.7	45.4	43.6	42.4	41.9	42.0	42.5
General government primary balance	3.8	-3.6	-3.0	-3.9	-2.1	-2.4	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.1	86.2	109.1	123.3	125.7	121.7	115.9	111.7	108.1	105.0
Balance of Payments	(Percent of GDP)												
Current account balance	-15.6	-10.7	-9.8	-4.7	-11.7	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-2.5	2.4	3.9	3.8	3.4	3.1	2.8	2.4	2.1
Exports of goods and services	45.0	40.2	41.3	42.7	42.5	44.6	45.4	45.7	45.9	46.4	46.8	47.5	48.2
Imports of goods and services	56.4	45.7	47.5	46.9	45.0	42.3	41.5	41.9	42.5	43.3	44.0	45.1	46.1
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.5	-19.8	-19.4	-19.7	-20.1	-20.5	-20.9	-21.5	-22.0
Services balance	21.0	20.0	20.6	19.9	19.0	22.2	23.3	23.5	23.5	23.6	23.7	23.9	24.1
Income, net	-3.9	-4.1	-3.0	0.6	-8.2	-3.8	-4.1	-4.3	-4.0	-4.0	-4.0	-3.9	-3.9
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.0	-0.6	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Capital account, net	0.0	0.3	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	16.1	10.9	9.5	5.7	9.5	-30.2	-14.9	-11.1	-1.2	1.1	1.6	2.2	2.6
Direct investment	-5.2	13.2	0.4	2.1	12.1	0.0	0.5	4.3	4.6	3.1	3.0	4.0	4.0
Portfolio investment	-74.1	-101.1	-11.1	32.0	25.1	14.5	4.9	-3.4	-3.3	-3.2	-3.0	-2.8	-2.7
Other investment	93.8	98.2	19.0	-28.6	-27.9	-44.7	-20.4	-12.0	-2.6	1.2	1.6	1.0	1.3
Reserves (- inflow; + outflow)	1.7	0.5	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	…	…	32.0	15.3	11.8	2.1	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.9	9.9	12.6	1.8	8.4	9.1	9.1	9.3	9.5	9.5	9.6	9.5
Government	4.9	-0.6	-0.1	-1.8	-2.4	-3.1	-5.1	-2.9	0.2	2.0	2.9	2.8	2.5
Non-government	2.8	9.5	9.9	14.4	4.2	11.5	14.2	12.1	9.1	7.6	6.7	6.8	7.0
Gross capital formation	23.3	19.6	19.7	17.3	13.5	10.4	9.7	10.0	10.4	10.8	11.0	11.3	11.4
Government	4.0	5.5	5.2	4.5	3.2	2.9	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Non-government	19.4	14.1	14.5	12.8	10.3	7.6	7.1	7.4	7.7	8.2	8.4	8.6	8.8
Foreign saving	-15.6	-10.7	-9.8	-4.7	-11.7	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	18.0	17.9	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8

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

Table 2. Cyprus: Fiscal Developments and Projections, 2008–2020 1/

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Revenue	43.1	40.1	40.9	39.8	40.1	40.6	39.0	39.8	41.2	41.7	42.1	42.2	42.4
Current revenue	43.0	40.0	40.8	39.8	40.0	40.6	38.9	39.7	41.1	41.6	42.0	42.1	42.3
Tax revenue	30.6	26.4	26.5	26.3	26.5	25.5	25.1	25.5	26.3	26.5	26.6	26.7	26.8
Indirect taxes	17.7	15.2	15.4	14.5	14.6	14.0	14.2	14.8	15.3	15.4	15.5	15.5	15.6
Direct taxes	12.9	11.2	11.1	11.7	11.9	11.5	10.9	10.8	11.0	11.1	11.1	11.2	11.2
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.7	8.5	8.2	8.4	8.5	8.6	8.7	8.8	8.8	8.9
Other current revenue	4.6	4.9	5.4	4.8	5.1	6.9	5.5	5.7	6.2	6.4	6.6	6.6	6.6
Sales	2.9	2.4	2.6	2.4	2.6	3.5	2.8	2.9	3.1	3.2	3.3	3.4	3.3
Other	1.8	2.5	2.8	2.4	2.5	3.4	2.7	2.8	3.1	3.2	3.3	3.3	3.3
Capital revenue	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure	42.1	46.2	46.2	46.1	45.7	46.6	46.7	45.4	43.6	42.4	41.9	42.0	42.5
Current expenditure	38.2	40.7	40.9	41.6	42.5	43.7	44.0	42.7	41.0	39.7	39.2	39.4	39.9
Wages and salaries	14.6	16.2	15.8	16.1	16.5	16.6	16.7	16.2	15.7	15.2	15.2	15.1	15.1
Goods and services	5.0	5.4	5.6	5.3	5.0	5.2	5.2	4.9	4.5	4.2	4.1	4.0	4.0
Social Transfers	12.2	13.5	14.4	14.6	15.2	15.7	16.1	15.8	15.2	14.8	14.5	14.6	14.7
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Interest payments	2.8	2.6	2.2	2.4	3.4	3.5	3.5	3.5	3.6	3.7	3.8	3.8	4.2
Other current expenditure	3.1	2.9	2.5	2.8	1.9	2.1	1.9	1.8	1.4	1.2	1.2	1.3	1.4
Capital expenditure	4.0	5.5	5.2	4.5	3.2	2.9	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Overall balance 2/	0.9	-6.1	-5.3	-6.3	-5.6	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-5.6	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Net financial transactions	0.9	-6.1	-5.3	-6.3	-5.6	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	9.2	8.7	2.7	-0.8	-2.7	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-1.4	6.0	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.6	8.8	3.3	-0.8	-2.7	-2.3	0.0	0.0	0.0
Other financial assets	0.2	0.3	0.0	-0.4	0.0	-6.1	-2.5	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.6	14.8	14.6	10.4	4.8	-0.3	-1.6	-0.2	-0.2	0.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	4.1	-10.5	-4.2	-6.2	1.4	1.5	3.6	3.8	4.2
Loans	3.0	-0.3	0.0	4.0	10.7	25.2	14.5	11.0	-1.6	-3.1	-3.8	-4.0	-4.1
Other liabilities	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Cyclically adjusted overall balance	-0.1	-5.8	-4.8	-5.4	-3.2	-2.6	-4.4	-2.9	-1.5	-0.6	0.2	0.2	-0.2
Cyclical balance	1.1	-0.3	-0.5	-0.9	-2.4	-3.3	-3.3	-2.7	-0.9	0.0	0.0	0.0	0.0
Cyclically adjusted primary balance	2.7	-3.2	-2.6	-3.0	0.2	0.9	-1.0	0.6	2.1	3.0	4.0	4.0	4.0
Structural Primary Balance 3/	0.7	-3.5	-3.1	-2.4	0.5	1.0	1.2	2.9	4.5	5.5	6.4	6.4	6.4
Primary balance	3.8	-3.6	-3.0	-3.9	-2.1	-2.4	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.1	86.2	109.1	123.3	125.7	121.7	115.9	111.7	108.1	105.0

Sources: Eurostat, and IMF staff estimates.

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

2/The final outcome for the 2012 fiscal deficit will depend on the statistical treatment by Eurostat of a contingent liability that materialized by end 2012 of 0.7 percent of GDP which relates to insurance payments associated with the destruction of the Vassilikos power plant in 2011 to be paid in 2013-2016.

3/ Cyclically adjusted primary balance net of one offs. Given the high uncertainty related to the size of the output gap and temporary versus permanent effects on potential output in the short run, it likely underestimates the amount of consolidation underway.

Table 3. Cyprus: Calculation of Gross Financing Requirements and Sources of Financing
(In millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**6,646.2**	**4,134.3**	**3,721.6**	**2,131.1**	**1,679.3**
Government	4,274.2	3,345.0	3,347.4	2,083.7	1,679.3
Fiscal deficit ("+" = financing need)	1,040.6	1,264.6	916.9	405.3	119.4
Debt maturities	3,233.6	2,080.4	2,430.4	1,678.4	1,560.0
Medium- and long-term	2,247.8	1,094.7	1,444.7	692.7	574.3
Domestic	788.3	463.9	535.2	468.5	364.3
Foreign	1,459.6	630.7	909.5	224.2	210.0
Short-term	985.7	985.7	985.7	985.7	985.7
Domestic	985.7	985.7	985.7	985.7	985.7
Foreign	0.0	0.0	0.0	0.0	0.0
Banks recapitalization/support	1,200.0	0.0	0.0	0.0	0.0
Market financing	**1,385.7**	**1,285.7**	**1,285.7**	**1,281.7**	**1,279.3**
Government	1,385.7	1,285.7	1,285.7	1,281.7	1,279.3
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	1,385.7	1,285.7	1,285.7	1,281.7	1,279.3
Medium- and long-term	400.0	300.0	300.0	296.0	293.6
Short-term	985.7	985.7	985.7	985.7	985.7
Net financing requirement	**5,260.4**	**2,848.6**	**2,435.9**	**849.4**	**400.0**
Government	2,888.4	2,059.3	2,061.6	802.0	400.0
Fiscal deficit	1,040.6	1,264.6	916.9	405.3	119.4
Debt maturities	1,847.8	794.7	1,144.7	396.7	280.6
Medium- and long-term	1,847.8	794.7	1,144.7	396.7	280.6
Short-term	0.0	0.0	0.0	0.0	0.0
Official Financing Sources and Financial Buffers	**5,260.4**	**2,848.6**	**2,435.9**	**849.4**	**400.0**
Domestic Official Financing Sources	**0.0**	**400.0**	**500.0**	**500.0**	**400.0**
Allocation of Central Bank Profits	0.0	400.0	0.0	0.0	0.0
Privatizations Proceeds	0.0	0.0	500.0	500.0	400.0
Official financing sources	**5,260.4**	**2,448.6**	**1,935.9**	**349.4**	**0.0**
IMF	258.4	344.5	344.5	86.1	0.0
ESM	5,002.1	2,104.1	1,591.4	263.2	0.0

Source: IMF staff estimates.

Table 4. Cyprus: Balance of Payments, 2008–2020[1/]

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
						(Millions of Euros)							
Current account balance	-2,679	-1,808	-1,712	-849	-2,092	-335	-99	-150	-175	-222	-271	-328	-390
Trade balance (Goods and Services)	-1,953	-930	-1,082	-763	-449	392	623	616	582	551	517	468	425
Goods balance	-5,555	-4,292	-4,664	-4,349	-3,853	-3,254	-3,089	-3,223	-3,405	-3,621	-3,848	-4,099	-4,363
Exports	1,190	1,001	1,137	1,411	1,439	1,323	1,294	1,326	1,374	1,442	1,515	1,591	1,672
Imports	-6,745	-5,293	-5,801	-5,760	-5,291	-4,578	-4,383	-4,549	-4,779	-5,063	-5,362	-5,690	-6,035
Services Balance	3,601	3,363	3,583	3,585	3,404	3,646	3,712	3,839	3,987	4,171	4,365	4,567	4,788
Exports	6,538	5,779	6,049	6,262	6,168	6,008	5,951	6,151	6,414	6,751	7,108	7,491	7,902
Imports	-2,937	-2,416	-2,467	-2,676	-2,765	-2,362	-2,239	-2,312	-2,427	-2,579	-2,744	-2,924	-3,115
Current income, net	-662	-686	-514	110	-1,460	-628	-655	-699	-686	-703	-728	-743	-768
Current transfers, net	-64	-193	-116	-196	-184	-99	-67	-67	-70	-70	-60	-53	-47
Private	22	-106	-56	-101	-126	-57	-30	-25	-22	-22	-19	-15	-10
Public	-86	-86	-60	-94	-57	-42	-37	-41	-48	-48	-41	-38	-37
Capital account, net	6	51	35	46	23	36	31	30	33	31	31	32	31
Financial account, net	2,765	1,834	1,647	1,025	1,707	-4,962	-2,381	-1,816	-210	198	297	411	524
Direct investment	-890	2,224	65	379	2,162	0	80	705	786	542	552	765	794
Portfolio investment	-12,722	-17,039	-1,934	5,753	4,482	2,381	788	-555	-556	-557	-551	-544	-538
Other investment	16,085	16,557	3,315	-5,149	-4,994	-7,343	-3,248	-1,966	-440	213	296	191	268
Reserves (- inflow; + outflow)	291	92	200	43	58	0	0	0	0	0	0	0	0
Program financing	…	…	…	…	0	5,260	2,449	1,936	352	-7	-57	-115	-165
Errors and omissions	-92	-77	30	-222	361	0	0	0	0	0	0	0	0
						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-4.7	-11.7	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-2.5	2.4	3.9	3.8	3.4	3.1	2.8	2.4	2.1
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.5	-19.8	-19.4	-19.7	-20.1	-20.5	-20.9	-21.5	-22.0
Exports	6.9	5.9	6.5	7.8	8.0	8.1	8.1	8.1	8.1	8.2	8.2	8.3	8.4
Imports	-39.3	-31.4	-33.3	-32.0	-29.6	-27.9	-27.5	-27.8	-28.2	-28.7	-29.1	-29.8	-30.4
Services balance	21.0	20.0	20.6	19.9	19.0	22.2	23.3	23.5	23.5	23.6	23.7	23.9	24.1
Exports	38.1	34.3	34.8	34.8	34.5	36.6	37.3	37.6	37.8	38.2	38.6	39.2	39.8
Imports	-17.1	-14.3	-14.2	-14.9	-15.5	-14.4	-14.0	-14.1	-14.3	-14.6	-14.9	-15.3	-15.7
Current income, net	-3.9	-4.1	-3.0	0.6	-8.2	-3.8	-4.1	-4.3	-4.0	-4.0	-4.0	-3.9	-3.9
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.0	-0.6	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Private	0.1	-0.6	-0.3	-0.6	-0.7	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2
Capital account, net	0.0	0.3	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	16.1	10.9	9.5	5.7	9.5	-30.2	-14.9	-11.1	-1.2	1.1	1.6	2.2	2.6
Direct investment	-5.2	13.2	0.4	2.1	12.1	0.0	0.5	4.3	4.6	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.1	-101.1	-11.1	32.0	25.1	14.5	4.9	-3.4	-3.3	-3.2	-3.0	-2.8	-2.7
Other investment 2/	93.8	98.2	19.0	-28.6	-27.9	-44.7	-20.4	-12.0	-2.6	1.2	1.6	1.0	1.3
Reserves (- inflow; + outflow)	1.7	0.5	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	… …		32.0	15.3	11.8	2.1	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

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

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

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

	2012	2013	2014	2015	2016	2017	2018	2019	2020
GROSS FINANCING REQUIREMENTS	**61,181**	**27,635**	**23,615**	**22,766**	**21,385**	**20,702**	**20,961**	**20,880**	**21,704**
Current account deficit ("-" = CA surplus)	2,092	335	99	150	175	222	271	328	390
Medium- and long-term debt amortizatio	6,015	4,141	2,601	3,408	2,796	2,740	3,365	3,415	4,250
Public sector	593	1,460	631	910	224	56	562	568	1,356
Banks	4,602	1,387	810	1,386	1,436	1,502	1,572	1,565	1,559
Other private	819	1,295	1,160	1,113	1,136	1,182	1,231	1,282	1,335
Short-term debt amortization	53,074	23,158	20,915	19,208	18,414	17,733	17,268	17,022	16,898
Public sector	8,297	7,468	6,792	6,007	5,163	4,412	3,748	3,165	2,657
Central Bank	7,992	7,468	6,792	6,007	5,163	4,412	3,748	3,165	2,657
Of which: ECB access									
General government and SOEs	306	0	0	0	0	0	0	0	0
Banks	43,724	14,414	13,475	12,678	12,678	12,637	12,703	12,881	13,075
Other private	1,053	1,277	648	523	573	684	816	976	1,167
EU and IMF	0	0	0	0	0	7	57	115	165
SOURCES OF FINANCING	**61,181**	**22,374**	**21,167**	**20,830**	**21,032**	**20,702**	**20,961**	**20,880**	**21,704**
Capital account (net)	23	36	31	30	33	31	31	32	31
Foreign direct investment (net)	2,162	0	80	705	786	542	552	765	794
New borrowing and debt rollover	55,793	21,931	20,024	20,885	20,764	20,334	20,807	20,752	21,878
Medium and long-term borrowing	6,635	1,016	816	2,471	3,032	3,066	3,785	3,853	4,707
General Government	2,120	0	0	0	224	56	562	568	1,356
Banks	1,307	369	-113	1,247	1,445	1,591	1,745	1,747	1,749
Other private	3,208	647	928	1,224	1,363	1,419	1,477	1,538	1,602
Short-term borrowing	49,158	20,915	19,208	18,414	17,733	17,268	17,022	16,898	17,171
Public sector	7,468	6,792	6,007	5,163	4,412	3,748	3,165	2,657	2,217
Central Bank	7,468	6,792	6,007	5,163	4,412	3,748	3,165	2,657	2,217
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	13,475	12,678	12,678	12,637	12,703	12,881	13,075	13,728
Other private	1,277	648	523	573	684	816	976	1,167	1,225
Other	3,202	407	1,032	-790	-550	-205	-429	-668	-999
Of which: Net errors and omissions	361	0	0	0	0	0	0	0	0
FINANCING GAP	**0**	**5,260**	**2,449**	**1,936**	**352**	**0**	**0**	**0**	**0**
ESM	0	5,002	2,104	1,591	266	0	0	0	0
IMF	0	258	344	344	86	0	0	0	0
ROLLOVER RATES									
General government	236%	0%	0%	0%	100%	100%	100%	100%	100%
Central bank	93%	91%	88%	86%	85%	85%	84%	84%	83%
Private	92%	82%	87%	100%	102%	103%	105%	105%	107%
Banks	86%	88%	88%	99%	100%	101%	102%	103%	106%
Non-financial corporates	240%	50%	80%	110%	120%	120%	120%	120%	113%

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

Table 6. Cyprus. Indicators of Fund Credit, 2012-20 [1/]

(Millions of SDR)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Prospective Fund credit									
Disbursement	0.0	222.8	297.0	297.0	74.3	0.0	0.0	0.0	0.0
Stock	0.0	222.8	519.8	816.8	891.0	884.8	835.3	736.3	594.0
Obligations	0.0	1.6	4.8	10.5	17.3	24.2	70.5	118.0	156.7
Repurchase	0.0	0.0	0.0	0.0	0.0	6.2	49.5	99.0	142.3
Charges	0.0	1.6	4.8	10.5	17.3	18.1	21.0	19.0	14.4
Stock of prospective Fund credit									
In percent of quota	0.0	140.8	328.5	516.3	563.2	559.3	528.0	465.4	375.5
In percent of GDP	0.0	1.4	3.7	5.9	6.3	6.1	5.5	4.6	3.6
In percent of exports of goods and services	0.0	1.8	4.3	6.5	6.8	6.4	5.8	4.8	3.7
Obligations to the Fund from prospective EFF									
In percent of quota	0.0	1.0	3.0	6.6	10.9	15.3	44.6	74.6	99.1
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.2	0.5	0.7	1.0
In percent of exports of goods and services	0.0	0.0	0.0	0.1	0.1	0.2	0.5	0.8	1.0

Source: IMF staff projections.

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

Table 7. Cyprus: Schedule of Review and Purchases

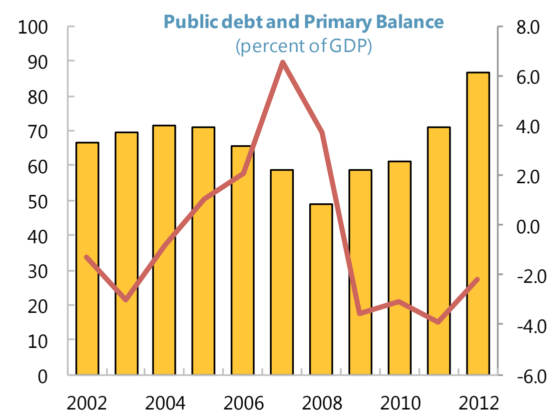
Availability Date	Amount of Purchase		Conditions
	Millions of SDR	Percent of Quota	
May 15, 2013	74.25	46.93%	Approval of arrangement
September 15, 2013	74.25	46.93%	First review based on end-June 2013 performance criteria
December 15, 2013	74.25	46.93%	Second review based on end-September 2013 performance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

Source: IMF staff estimates.

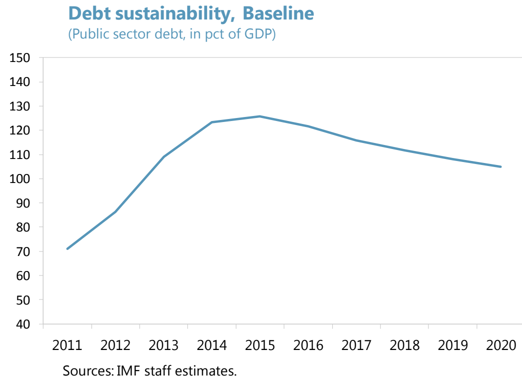
Annex 1. Public Sector Debt Sustainability Analysis

This appendix considers the sustainability of Cyprus's public debt. Results show that full implementation of the program can place Cyprus' debt on a sustainable trajectory. However, given high baseline debt levels and significant downside risks, the debt trajectory is vulnerable to shocks, in particular to growth. A potential upside risk not included in the projections is the exploitation of natural gas, which is difficult to quantify at this point.

1. **The general government public debt grew rapidly since 2008.** Cyprus's debt reached 86 percent of GDP in 2012 from close to 50 percent of GDP in 2008. The rapid increase is explained by a combination of expansionary fiscal policy in 2009 and the injection of 10 percent of GDP in the second largest bank which was found deeply undercapitalized in mid-2012. Developments in 2009, which led to a primary fiscal deficit 4 percent of GDP relative to a surplus of the same magnitude in 2008 were due to a 4 percent of GDP stimulus package, combined with revenue erosion given the global financial crisis and the beginnings of a correction of a real estate boom. As concerns mounted regarding potential fiscal needs due to banking sector problems and fiscal inaction, sovereign spreads rose sharply in June 2011, and market access was lost.



2. **In the baseline scenario public debt is expected to increase significantly during 2013-2015 and start to decline gradually in 2016.** Debt-to-GDP is expected to peak at 126 percent in 2015 and fall to 116 percent of GDP by end-2017, and to 105 percent of GDP by 2020. The debt path results from the combination of large program financing needs relative to the size of the economy (56 percent of GDP) and a 12.5 percent recession in 2013-14, followed by a gradual recovery and moderate long-run growth of under 2 percent of GDP. Given uncertainty surrounding the macroeconomic outlook, a buffer of about 10 percent of GDP has been included in the baseline, which affects the debt dynamics. The GDP deflator is expected to decline to close to 1 percent in the next two years, reflecting low core inflation, returning to 2 percent over the long term. Under the program, the primary balance is expected to improve gradually from a primary deficit of 2.1 percent of GDP in 2012 to a primary surplus of 1.2 percent in 2016, reflecting considerable adjustment but also the impact of the deep recession on revenues (some of which is expected to be permanent). The primary balance would continue to improve to 4 percent of GDP by 2018, given the economic recovery and additional fiscal consolidation. While this is ambitious relative to past performance in Cyprus, it is not without precedent.



Persistence of Large (Cyclically Adjusted) Primary Balances

	CAPB between 5 and 10 percent of GDP	Number of countries Total	Advanced countries
For 4 years	Panama (1989-92); Canada (1997-2000); Italy (1997-00); Tunisia (1986-89); Austria (1976-79)	5	3
For 5-7 years	Turkey (2000-06); Chile (2003-08); Jamaica (1983-88); New Zealand (1993-98); Barbados (1991-95); Denmark (1985-89)	6	2
For 8-10 years	Romania (1982-89); Egypt (1993-00)	2	0
For 11-13 years	Mexico (1983-95); Israel (1983-94)	2	0
For 14-15 years	Belgium (1990-04); Jamaica (1992-06); Bulgaria (1994-07)	3	1

Source: IMF staff estimates.

3. **The baseline debt path also assumes several measures to reduce financing and/or debt.** These include:

- **Privatization.** A total of EUR 1.4 billion in privatization proceeds are expected from the sale of government enterprises and other assets, of which €500 million are expected to materialize by end-2015, €500 million by end-2016, and €400 million by end-2017.

- **Asset swap of part of an outstanding pre EU-accession loan by the Central Bank of Cyprus**. The outstanding amount at end December 2012 was €1.4 bn. Real estate and other fixed assets valued at €1 billion will be swapped for an equal reduction in the loan amount in the third quarter of 2013.

- **Allocation of central bank profits:** Central bank profits for an amount of €400 million will be paid to the government in 2014. Pending the final details of this transaction, which will determine the final statistical treatment, and to avoid distorting the picture of the purely fiscal operations, this is currently included as a financing transaction not affecting the deficit but reducing the debt.

- **Rescheduling and reduction of interest rate of an existing loan from Russia.** It is assumed that the loan falling due in 2016 will be rescheduled to be repaid in 5 equal installments starting in 2018 at an annual interest rate of 2.5 percent (relative to the current rate of 4.5 percent). The reduction in the interest rate leads to savings of about 2 percent of GDP over the long run, highlighting the importance of successful negotiations in this respect.

- **Rollover of €1 billion of maturing domestic debt.** This will be implemented by end-June through a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The exchange is assumed to achieve a roll-over of €400 million in 2013, €300 million in 2014, and €300 million in 2015.

- **Rollover of the recapitalization bond injected in Cyprus Popular Bank in 2012**. It is assumed that the €1.9 billion bond will be rolled over annually at an interest rate of €5.15 percent, with the interest capitalized rather than paid. Given the program's cash fiscal accounting, the interest is included in the debt stock but not in the interest bill.

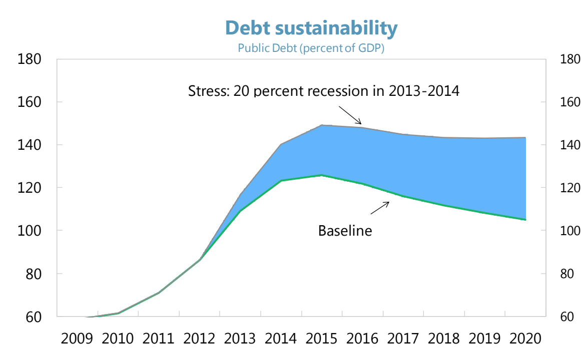
4. **Stress tests highlight the vulnerability of the debt trajectory to downside risks** (Table 1, Figure 1). These include:[1]

- **Growth risk.** This is the largest risk to sustainability. A permanent decline of growth by half of the historical standard deviation (i.e. about 1 percentage point) from the baseline projection during 2013-20 is simulated. This leads to an increase in debt to 132 percent of GDP by 2016, staying broadly unchanged thereafter, highlighting the dependence of debt dynamics on the growth recovery starting in 2015 and on adapting the business model to achieve moderate long-run growth.

- **Primary balance risk.** Weaker program implementation is also a risk. A shock reducing the primary balance by one-half standard deviation (i.e. by about 1.8 percentage points of GDP) each year during 2013-20 would bring the debt ratio to 129 percent of GDP 2016, falling to 119 percent of GDP by 2020.

- **Interest rate risk.** While program financing will considerably reduce the interest rate risk for Cyprus, official financing and new market financing after the program are still a function of market conditions. A shock increasing the interest rate by one-half standard deviation (i.e. by 0.75 percentage points) each year during 2013-20 would lead the debt to reach 125 percent of GDP in 2016 and 112 percent of GDP in 2020.

- **Contingent liabilities risk.** A worsening of macroeconomic conditions could give rise to additional non-performing loans and capital needs. A standard 10 percent of GDP contingent liability shock in 2013 would lead debt to reach 132 percent in 2016 and 115 percent of GDP by 2020. A more tailored shock capturing the effects of a 20 percent recession in 2013-2014, with growth recovering to the projected long term average could bring debt to 149 percent of GDP by 2016 and 143 percent in 2020, after full use of the macroeconomic buffer included in the baseline.



[1] The standard shocks presented here (with the exception of the tailored contingent liabilities shock) are additive to the baseline, which already includes a general buffer.

- **Delays in executing the privatization plan.** Delaying the proceeds of privatization would also impact debt. Delaying privatization by one year would lead to a debt ratio higher by 3 percent of GDP in 2016. Delaying the process beyond the projection period, however, would lead to a debt level of 128 percent of GDP in 2016 and 113 percent by 2020.

- **A combination of risks could also materialize simultaneously.** A combination of growth, interest rate, and primary balance shocks could occur simultaneously, leading to a debt increase to 138 percent of GDP in 2016, and broadly unchanged thereafter.

Sensitivity Analysis of Selected Shocks on Public Debt Levels

	Impact on the debt in years	
	2016	2020
Permanent one percentage point increase in the interest rate	4.6	9.1
Permanent one percentage point decline in growth	9.5	24.9
Permanent one percentage point decline in the primary balance	4.0	8.0
One year contingent liability shock of 10 percent of GDP in 2013	10.6	10.4
Delaying one year privatization receipt flows	3.0	0.2
Absence of Privatization	6.0	8.1

Source: IMF staff estimates

Box A1. Debt Tolerance /1

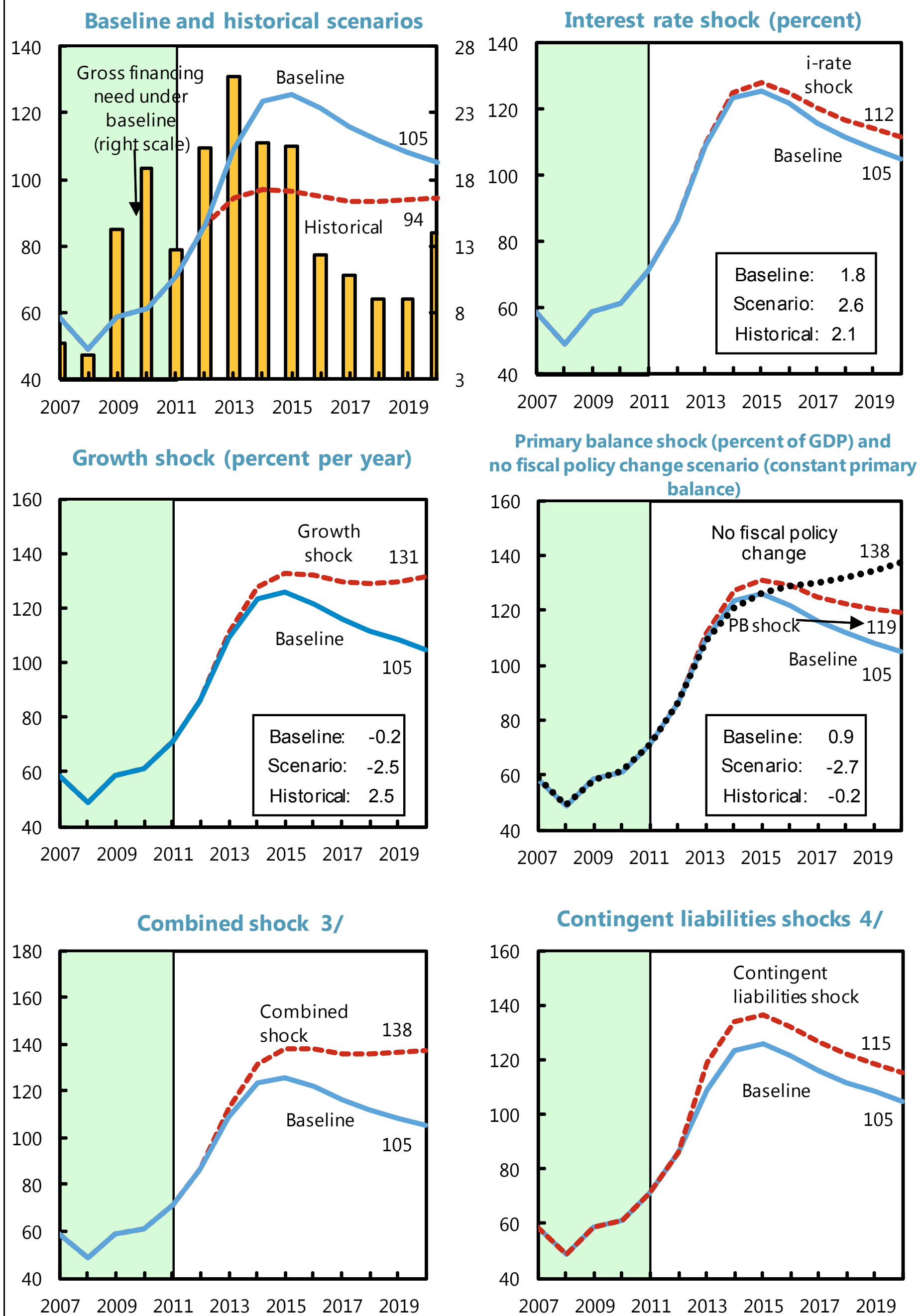
The level of debt, in addition to its trend, is important for sustainability. Having high debt has the following implications: (i) empirical analysis suggests that it depresses growth; (ii) it requires sustaining large primary surpluses for prolonged periods of time, which can be politically difficult; (iii) it increases vulnerability to growth shocks and inhibits countercyclical fiscal policy; and (iv) it imposes large financing requirements, magnifying sensitivity to changes in interest rates and raising exposure to shifts in market sentiment.

The sustainable level of debt varies by country. Conceptually, the tolerable level for a country depends on several factors: (i) ability to generate primary surpluses; (ii) growth prospects; (iii) cost of borrowing, reflecting existing debt and markets' perception of future debt servicing capacity; (iv) history of meeting debt obligations; (v) vulnerability to shocks; and (vi) nature of the investor base. Experience shows that some countries have run into problems at relatively low levels of debt, while others have been able to sustain high levels for prolonged period.

Cyprus' characteristics suggest prudence regarding the sustainable debt threshold. Cyprus lost market access with debt at close to 70 percent of GDP, reflecting markets concerns about contingent liabilities and debt sustainability. Since then, debt has climbed to 86 percent of GDP, and the banking crisis has taken a big hit on Cyprus' main growth engine in recent years and has greatly increased uncertainty. In addition, even after recent actions, the banking sector remains large and its outlook is subject to risks. The deposit-to equity conversion has likely lowered the tolerance threshold. Finally, Cyprus does not have a history of sustaining high debt levels and maintaining high primary surpluses (though this does not mean it could not do so in the future). These considerations suggest that a medium-term debt level of around 100 percent of GDP could be consistent with debt sustainability, albeit at the upper range.

1/ This box draws on the paper "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis", IMF, 2011.

Figure A1. Cyprus: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt as percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are one half of the historical standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variables are also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics 9 years ahead.
3/ Combines individudal shocks of one half of the historical standard deviation for each variable.
4/ One-time 10 percent of GDP shock to contingent liabilities in 2013.

Table A1. Public Sector Debt Sustainability Framework, 2007-2020

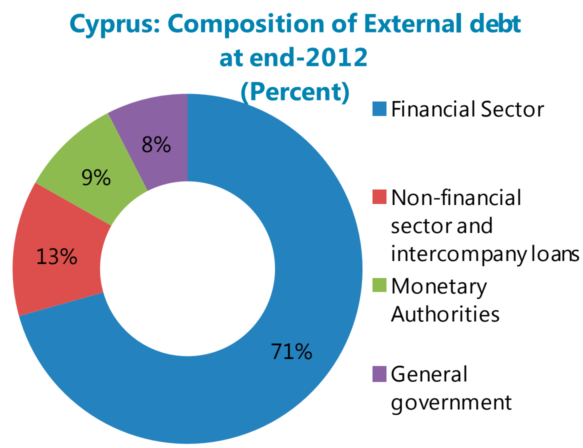
(In percent of GDP, unless otherwise indicated)

	Actual							Projections									
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	2018	2019	2020	
								I. Baseline Projections									Debt-stabilizing primary balance 8/
Public sector debt 1/	58.8	48.9	58.5	61.3	71.1			**86.2**	**109.1**	**123.3**	**125.7**	**121.7**	**115.9**	**111.7**	**108.1**	**105.0**	**0.1**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	-6.6	-9.9	9.6	2.8	9.7			15.1	22.9	14.2	2.4	-4.1	-5.8	-4.2	-3.6	-3.2	
Identified debt-creating flows (4+7+12)	-9.3	-5.5	7.0	3.4	4.3			5.9	13.6	10.9	2.5	-2.0	-4.2	-4.9	-4.3	-3.9	
Primary deficit	-6.6	-3.8	3.6	3.0	3.9			2.1	2.4	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	
Revenue and grants	45.0	43.1	40.1	40.9	39.8			40.1	40.6	39.0	39.8	41.2	41.6	42.0	42.1	42.3	
Primary (noninterest) expenditure	38.4	39.3	43.7	43.9	43.7			42.2	43.0	43.2	41.9	40.0	38.5	38.0	38.1	38.3	
Automatic debt dynamics 2/	-2.7	-1.7	3.4	0.4	0.4			3.8	11.2	6.7	0.4	-0.8	-1.2	-0.9	-0.3	0.1	
Contribution from interest rate/growth differential 3/	-2.7	-1.7	3.4	0.4	0.4			3.8	11.2	6.7	0.4	-0.8	-1.2	-0.9	-0.3	0.1	
Of which contribution from real interest rate	0.3	0.2	2.5	1.1	0.7			2.1	3.1	2.3	1.7	1.4	1.5	1.6	1.8	2.0	
Of which contribution from real GDP growth	-3.0	-1.9	0.9	-0.7	-0.3			1.7	8.2	4.4	-1.3	-2.3	-2.7	-2.4	-2.0	-1.9	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	2.6	-4.4	2.6	-0.6	5.4			9.2	9.3	3.3	-0.1	-2.0	-1.6	0.7	0.7	0.7	
Public sector debt-to-revenue ratio 1/	130.6	113.5	145.8	150.0	178.5			214.9	268.5	316.5	316.1	295.2	278.8	265.9	256.9	248.3	
Gross financing need 5/	5.7	4.9	14.2	18.9	12.7			20.4	25.7	20.8	20.4	12.3	10.7	9.0	9.0	14.0	
in billions of U.S. dollars	0.7	0.6	1.7	2.5	1.6			2.8	3.2	2.5	2.6	1.6	1.5	1.3	1.4	2.2	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation										Projected Average
Nominal GDP (local currency)	15.8	17.2	16.9	17.4	18.0	14.8	2.6	17.9	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8	17.6
Real GDP growth (in percent)	5.1	3.6	-1.9	1.3	0.5	2.5	2.1	-2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8	-0.4
Average nominal interest rate on public debt (in percent) 6/	5.1	5.2	5.1	4.0	4.0	5.0	0.6	4.8	3.8	3.1	2.9	3.0	3.2	3.4	3.6	4.0	3.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.8	0.6	5.1	2.0	1.2	2.1	1.5	2.8	3.2	2.0	1.4	1.2	1.4	1.4	1.7	2.0	1.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.1	6.8	5.7	5.0	-4.6	-3.0	9.5	8.2	-3.0	0.6	0.7	0.8	0.7	0.7	0.0	0.0	1.0
Inflation rate (GDP deflator, in percent)	4.4	4.6	0.1	1.9	2.7	2.9	1.5	2.0	0.6	1.1	1.5	1.8	1.8	1.9	1.9	2.0	1.6
Growth of real primary spending (deflated by GDP deflator, in percent)	1.1	5.9	9.1	1.9	0.1	4.8	4.1	-5.8	-7.0	-3.5	-2.1	-2.7	-1.4	0.7	2.1	2.3	-1.9
Primary deficit	-6.6	-3.8	3.6	3.0	3.9	0.2	3.5	2.1	2.4	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	-0.6
								II. Stress Tests for Public Debt Ratio									Debt-stabilizing primary balance 9/
A. Alternative Scenarios																	
A1. Key variables are at their historical averages in 2012-2020 7/								**86.2**	**94.3**	**96.9**	**96.6**	**94.7**	**93.2**	**93.5**	**93.9**	**94.2**	**-0.4**
A2. No policy change (constant primary balance) in 2012-2020								**86.2**	**108.8**	**120.9**	**126.4**	**128.7**	**130.2**	**132.1**	**134.6**	**137.6**	**0.2**
B. Bound Tests																	
B1. Real interest rate is at baseline plus one-half standard deviations								**86.2**	**109.8**	**124.9**	**128.2**	**125.1**	**120.2**	**116.8**	**114.0**	**111.7**	**1.0**
B2. Real GDP growth is at baseline minus one-half standard deviations								**86.2**	**110.8**	**127.6**	**132.8**	**131.7**	**129.2**	**128.9**	**129.6**	**131.3**	**1.6**
B3. Primary balance is at baseline minus one-half standard deviations								**86.2**	**110.8**	**127.0**	**131.1**	**128.8**	**124.7**	**122.2**	**120.3**	**118.9**	**0.2**
B4. Combination of B1-B3 using 1/2 standard deviation shocks								**86.2**	**112.8**	**131.3**	**137.9**	**137.8**	**136.0**	**135.8**	**136.4**	**137.5**	**2.6**
B5. 10 percent of GDP increase in other debt-creating flows in 2013								**86.2**	**119.1**	**133.9**	**136.4**	**132.3**	**126.4**	**122.1**	**118.5**	**115.3**	**0.2**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ 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.
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 for a given scenario.

Annex 2. External Sector Debt Sustainability Analysis

1. **At around 450 percent of GDP, Cyprus's external debt at end-2012 was extremely high.**[1] To a large extent, this reflected Cyprus's oversized banking sector, which accounted for around ¾ of its external debt. Claims on the financial sector, in turn, mostly comprised short-term debt in the form of deposits.



2. **While external debt under the baseline scenario is expected to decline markedly it will remain fairly elevated over the entire projection period**. In particular, external debt is expected to contract significantly in 2013 (from 450 percent of GDP to less than 350 percent) following the divestiture of Cypriot banks' Greek branches and expected losses incurred by non-residents on their uninsured deposits in CPB and BoC. Over the projection period, Cyprus's external debt is also expected to decline due to the substantial external adjustment underway. As a consequence, the external debt-to-GDP ratio is expected to fall to about 280 percent by 2020.

3. **The external debt dynamics remain vulnerable to macroeconomic shocks.**[2]

   a. A lack of external adjustment, exemplified by the historical scenario, due to weaker external competitiveness or significant fiscal slippages would lead to an unsustainable external debt.

   b. Higher interest rates on external debt (200 basis points above baseline assumptions) would significantly slowdown the reduction in external debt.

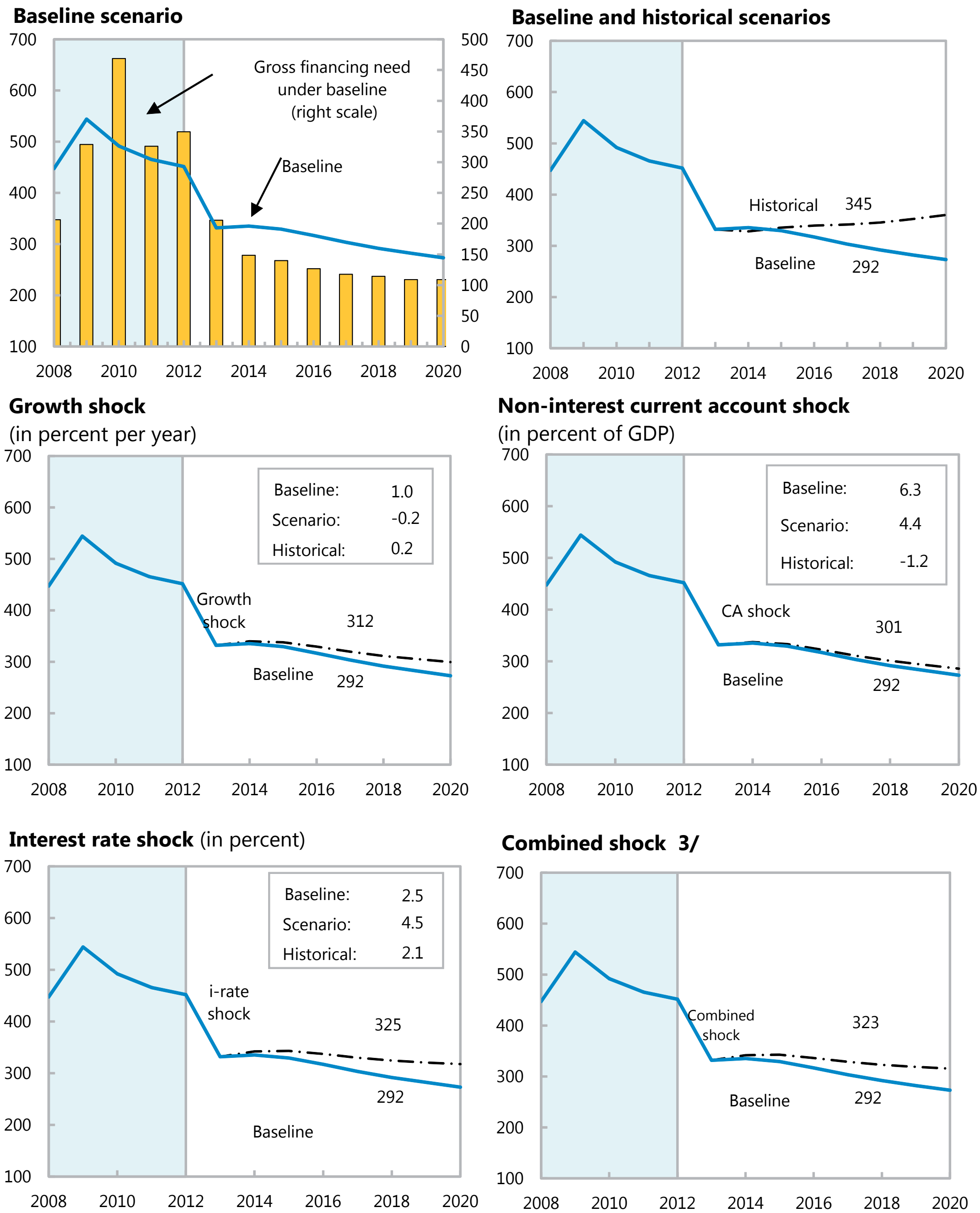
4. **Continued external adjustment is critical to ensure external sustainability going forward.** In addition, a continued decline in the size of the financial system and its use of non-resident deposits would help improve external sustainability and reduce gross financing needs.

[1] External debt is defined on a residency basis.

[2] For the purpose of this DSA, 5-year historical averages and standard deviations are used instead of the typical 10-year period.

Figure A2. Cyprus: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and 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 A2. Cyprus: External Debt Sustainability Framework, 2008-2020
(percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	447.4	544.1	491.9	465.6	451.8			**332.0**	**335.3**	**329.5**	**317.0**	**303.5**	**291.9**	**282.2**	**273.2**	**-6.5**
Change in external debt	100.3	96.7	-52.3	-26.3	-13.8			-119.8	3.3	-5.8	-12.5	-13.6	-11.6	-9.7	-9.0	
Identified external debt-creating flows (4+8+9)	-12.2	51.6	20.6	-41.5	35.3			40.5	12.6	-6.2	-8.9	-8.4	-7.4	-7.0	-6.4	
Current account deficit, excluding interest payments	6.6	2.1	0.8	-4.0	0.6			-5.0	-7.1	-6.8	-6.7	-6.4	-6.2	-5.8	-5.4	
Deficit in balance of goods and services	11.4	5.5	6.2	4.2	2.5			-2.4	-3.9	-3.8	-3.4	-3.1	-2.8	-2.4	-2.1	
Exports	45.0	40.2	41.3	42.7	42.5			44.6	45.4	45.7	45.9	46.4	46.8	47.5	48.2	
Imports	56.4	45.7	47.5	46.9	45.0			42.2	41.5	41.9	42.5	43.2	44.0	45.1	46.1	
Net non-debt creating capital inflows (negative)	20.0	7.0	1.8	-8.5	-17.1			-2.9	-1.5	-3.6	-4.0	-2.4	-2.4	-3.4	-3.5	
Automatic debt dynamics 1/	-38.8	42.5	17.9	-29.0	51.8			48.4	21.2	4.2	1.8	0.5	1.2	2.2	2.4	
Contribution from nominal interest rate	9.0	8.6	9.0	8.7	11.1			7.0	7.7	7.8	7.7	7.7	7.6	7.5	7.3	
Contribution from real GDP growth	-10.7	8.9	-7.2	-2.4	12.3			41.4	13.5	-3.5	-6.0	-7.2	-6.4	-5.3	-4.9	
Contribution from price and exchange rate changes 2/	-37.1	24.9	16.1	-35.3	28.4			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	112.5	45.1	-72.8	15.3	-49.1			-160.3	-9.3	0.4	-3.6	-5.2	-4.2	-2.7	-2.6	
External debt-to-exports ratio (in percent)	993.1	1352.6	1191.3	1091.0	1062.4			743.9	738.4	721.1	690.6	654.6	623.3	594.0	566.5	
Gross external financing need (in billions of US dollars) 4/	52.1	77.2	108.3	81.5	80.4			44.8	31.3	29.9	27.9	26.8	27.0	26.7	27.8	
in percent of GDP	206.5	329.1	468.8	325.8	349.4	5-Year	5-Year	205.4	148.7	139.8	126.7	117.7	114.4	109.1	109.2	
Scenario with key variables at their historical averages 5/								**332.0**	**328.3**	**335.3**	**339.3**	**341.7**	**360.1**	**0.0**	**0.0**	**3.2**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation									
Real GDP growth (in percent)	3.6	-1.9	1.3	0.5	-2.4	0.2	2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8	
GDP deflator in US dollars (change in percent)	12.0	-5.3	-2.9	7.7	-5.8	1.2	8.2	3.9	0.3	0.8	1.0	1.1	1.2	1.9	2.0	
Nominal external interest rate (in percent)	3.0	1.8	1.6	1.9	2.2	2.1	0.5	1.5	2.2	2.4	2.4	2.5	2.6	2.7	2.7	
Growth of exports (US dollar terms, in percent)	10.5	-17.0	1.0	11.9	-8.4	-0.4	12.4	-0.4	-1.9	2.5	3.4	4.4	4.5	5.3	5.4	
Growth of imports (US dollar terms, in percent)	21.5	-24.6	2.2	7.0	-11.7	-1.1	17.7	-11.0	-5.3	2.9	4.2	5.3	5.3	6.3	6.2	
Current account balance, excluding interest payments	-6.6	-2.1	-0.8	4.0	-0.6	-1.2	3.8	5.0	7.1	6.8	6.7	6.4	6.2	5.8	5.4	
Net non-debt creating capital inflows	-20.0	-7.0	-1.8	8.5	17.1	-0.7	14.3	2.9	1.5	3.6	4.0	2.4	2.4	3.4	3.5	

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.

Annex 3. Exchange Measures Giving Rise To Fund Jurisdiction Under Article Viii Of The Fund's Articles Of Agreement

(i) ***Limits on payments for transactions involving normal business activity.*** Limits applying to payments for current international transactions such as import of good and services.

(ii) ***Limitations on invisible payments by individuals, including firm limits on remittances for living expenses for certain family members***.

(iii) ***Limits on access to funds deposited with financial institutions in Cyprus***: Provisions that prevent non-residents from accessing, converting (where applicable) and transferring out of Cyprus recently acquired net income from current international transactions or investment income.

Appendix 1. Letter Of Intent

Nicosia, April 29, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington D.C.

Ms. Lagarde:

Cyprus is facing an unprecedented crisis originating from our oversized banks, some of which faced solvency problems, compounded by lax fiscal policies. The crisis will have severe implications for economic growth and fiscal sustainability. To face the challenges ahead, we are proposing a strong and ambitious reform program, backed by substantial financing from international organizations, aimed at stabilizing our financial system, achieving fiscal sustainability, and supporting the recovery of economic activity to preserve the welfare of the population and social cohesion.

We have already taken major steps to address these challenges. In the financial sector, these include: divestment of the Greek operations of the domestic banks; the prompt intervention and resolution of Cyprus Popular Bank and transfer of part of it to the Bank of Cyprus; recapitalization of the transferred part with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; recapitalization of Bank of Cyprus with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; and imposition of temporary restrictions on financial flows to preserve financial stability. On the fiscal side, key recent measures include: the inclusion in the 2013 budget of substantial consolidation measures for the period 2013-15; reform of the public sector COLA wage indexation mechanism; and implementation of reforms of the pension system to improve its long-term sustainability.

But more needs to be done. Under the proposed program, we intend to implement a comprehensive strategy to restore the viability of the financial system and strengthen the banking supervision and regulatory framework. We are also committed to an ambitious fiscal consolidation path that protects the most vulnerable. We will target a primary balance of 4 percent of GDP by 2018, required to ensure that that the public debt-to-GDP ratio is placed on a sustained downward trajectory toward a level of 105 percent of GDP by 2020. Finally, we are proposing substantial structural reforms to improve the efficiency of the public sector, including through the timely privatization of viable state-owned enterprises.

We are turning to our international partners for support as we implement these far-reaching objectives. Our estimate is that the external financing need would be up to €10 billion until the first quarter of 2016. We therefore request that the Fund support our policy program through an arrangement under the Extended Fund Facility which can be drawn over a period of 36 months in the amount of SDR 891 million (about €1 billion and 563 percent of quota). This arrangement, along with support of about €9 billion from the European Stability Mechanism, will help ensure financial stability as we restore market confidence and return to durable growth.

The attached Memorandum of Economic and Financial Policies (MEFP), which has been approved by the Council of Ministers on April 3, outlines the economic and financial policies that the Cypriot government and the Central Bank of Cyprus will implement during the next three years to restructure Cyprus' financial system and ensure fiscal sustainability. The government is fully committed to the policies stipulated in this document and its attachments. We are confident that by the end of the program we will achieve robust growth - eventually supported by the development of prospective gas resources - and lasting stability that will enable us to maintain social cohesion and create entrepreneurial opportunities for our people.

The implementation of our program will be monitored by the Fund through quarterly reviews, quantitative performance criteria and indicative targets, as well as structural benchmarks as described in the attached MEFP and the Technical Memorandum of Understanding (TMU). There will be 11 quarterly reviews under the arrangement. The quarterly reviews will assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

While we are confident that the policies set forth in the MEFP are adequate to achieve the objectives under the program, we stand ready to take any corrective actions that may be needed for this purpose. In accordance with the Fund's policies, we will consult with the Fund on the adoption of such actions in advance of revisions to the policies contained in this letter and the MEFP.

Sincerely,

/s/	/s/
Minister of Finance	Governor of the Central Bank of Cyprus

Attachment 1. Cyprus—Memorandum Of Economic And Financial Policies

A. Objectives, Strategy, and Outlook

1. **Cyprus is going through an unprecedented banking crisis.** The crisis came to a head following a buildup of large vulnerabilities in recent years. In part, these were related to significant bank exposure to Greece, which resulted in sizeable losses following the Greek debt restructuring (an amount in excess of €4 billion of losses was suffered by the Cypriot banks as a result of the Greek Government Bond restructuring). But the unwinding of a domestic housing boom and the economic downturn in Cyprus also contributed to the deterioration of the banks' loan portfolio. As a result, the two largest banks, comprising about 80 percent of our domestic banking sector and 400 percent of GDP in assets, were confronted with solvency problems. Loss of confidence in the system required prompt resolution of one bank, restructuring of the other bank, and imposition of temporary restrictions to financial flows, which constitute a severe strain on economic activity.

2. **Our weak public finances cannot fully support the large needs of the banking sector without significantly affecting public debt sustainability**. Over the last few years, expenditures have grown faster than revenues, leading to rising fiscal deficits and public debt. Last year, we took significant fiscal consolidation measures to correct these imbalances. However, given massive needs of the financial sector, burden sharing with bank creditors, including uninsured depositors, was also required to ensure that public debt does not become unsustainable. In this way, we have ensured that the Cypriot taxpayer does not need to bear the full burden of bank recapitalization costs. Still, given the difficult economic outlook and significant financing needs, in the absence of policy action, our public finances and sustainability would remain vulnerable.

3. **The country faces two key challenges**. The first challenge is to repair the banking sector, whose business model will need to adapt, so as to restore financial intermediation and support the economic recovery. The second challenge is to attain a sizeable primary fiscal surplus required to place public debt on a firmly downward path. These efforts need to be complemented with structural reforms aimed at raising the efficiency of Cyprus' public sector.

4. **To address these challenges, the government is undertaking a policy adjustment program based on two main pillars**:

- **The first pillar focuses on restructuring the financial sector**. We have already taken steps to deal with insolvency problems in the two largest banks: the Greek branches of the domestic banks have been sold; Bank of Cyprus (BOC) has been recapitalized through partial conversion of uninsured deposits into equity; and Cyprus Popular Bank (CPB) has been resolved and its insured deposits, central bank liabilities (ELA) and certain assets were folded into to BOC. Our efforts will continue to be focused on completing the bank recapitalization process, gradually restoring normal financial flows, and facilitating private sector debt restructuring. Moreover, the credit cooperative institution (CCI) sector will be recapitalized and restructured. To prevent the build-up of risks in the future, we will reform supervision and regulation and enhance transparency.

- **The second pillar entails a comprehensive fiscal consolidation plan underpinned by structural reforms.** This will build on the fiscal consolidation measures introduced last year, while taking into account short-run cyclical conditions and the need to protect vulnerable groups. In the short run, we will implement additional measures focused on increasing our corporate income tax and tax on interest. Other measures needed to attain our primary fiscal targets will be defined in future budgets. Structural fiscal reforms will focus on revenue administration, public financial management, and privatization. We are also planning to supplement the recent reform of the pension system with additional measures as needed to ensure its long-run sustainability.

5. **Our program will help to build the foundation for sustainable growth over the long run.** Nevertheless, in the short run, the outlook remains challenging and subject to high uncertainty:

- **Real GDP** is projected to contract by 12½ percent cumulatively in 2013-14. Short-run economic activity will be negatively affected by the restructuring of the banking sector and temporary restrictions on transactions, which have been required to safeguard financial stability. This, compounded by the impact of fiscal consolidation already underway, will result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector. Having had addressed our banking sector problems upfront, we expect growth to rebound in 2015 and attain close to 2 percent over the long run. Upside potential from exploitation of our recently discovered gas resources could further boost growth prospects.

- **Inflation** is projected to fall in the short-run as a result of the downturn. The recent reform of the COLA wage-indexation mechanism will help to ensure that public wages are aligned with developments in economic activity. Over the medium run, this will lead to an adjustment in overall wages and prices that can improve competitiveness and support the economic recovery.

- **The current account** deficit is expected to contract to less than 1 percent of GDP in 2013 from 5 percent of GDP in 2012, in tandem with the improvement of the trade balance. A modest adjustment is expected to continue in the medium term, with the current account stabilizing roughly in balance. External debt, in particular related to external liabilities of financial institutions, is expected to decline as part of the broader deleveraging of the financial sector.

5. **The policies contained in our program will put public debt on a sustainable path**. Given that Cyprus has lost access to the international capital markets, financing needs for the coming years will be largely covered by official loans. The banking sector restructuring strategy has been designed to minimize costs to the government. Nevertheless, support to our credit cooperative sector, together with fiscal deficit needs, are expected to lead to an increase in public debt,

which is expected to reach around 120 percent of GDP by end-2016. Debt will continue to decline steadily thereafter, reaching about 105 percent of GDP by 2020, as a result of the rebound in the economy and sustained fiscal efforts to maintain a primary fiscal surplus. Achieving debt sustainability will require full and timely implementation of the program, which is essential to providing a sound foundation for long-run growth.

B. Financial Sector Policies

7. **We are committed to restoring the health of our financial sector and reducing contingent risks from the banks to the sovereign**. Our oversized banking sector has experienced large losses and liquidity pressures. We are addressing these through a strategy based on five pillars: (i) resolving one insolvent bank and restructuring another at least cost to the Cypriot taxpayer, and restructuring and recapitalizing remaining financial institutions; (ii) normalizing financial flows; (iii) deleveraging core and non-core operations of deposit-taking institutions to reduce the size of the domestic banking sector to the EU average by end-2018; (iv) upgrading the supervisory and regulatory framework; and (v) enhancing preparedness to deal with troubled borrowers. We will also strengthen our AML framework.

Resolving, recapitalizing, and restructuring weak institutions

8. **We have identified capital needs in the banking sector.** In late 2012, in close consultation with program partners, PIMCO was commissioned to undertake an independent due diligence of Cypriot financial institutions accounting for about ¾ of the banking system assets. In February 2013, the final report identified an overall capital shortfall of close to €9 billion for the system, required to reach a core tier I ratio of 6 percent under a stress scenario. It also showed that the two largest banks were confronted with solvency problems, with negative capital of close to €6 billion and overall capital needs of about €8 billion. A sample of 17 cooperatives and the third largest bank were found to be undercapitalized by about €1 billion.

9. **In a first step, we have decisively addressed institutions facing solvency problems without recourse to public resources.** We have taken the following actions:

- **Effective intervention and restructuring of the two largest Cypriot banks**. To address insolvency problems in these banks, on March 25, 2013 the CBC intervened CPB and BoC. The Greek branches of the two banks were sold to Piraeus Bank. CPB was split according to a "good bank—bad bank" strategy. Insured deposits were fully protected by separating them, together with central bank liabilities (ELA) and with sufficient assets to attain a Core Tier I capital ratio of 9 percent under PIMCO's stress scenario by end-program, and were immediately folded into BoC. Shareholders and other bank creditors, including uninsured depositors and remaining assets were kept in CPB, which is to be liquidated over time. The resolution of CPB was done under the auspices of our new bank resolution law, passed on March 22, which provides for burden sharing, thus minimizing fiscal costs.

- **Completion of BoC's recapitalization**. On March 29, 2013 the resolution authority initiated the recapitalization of the bank with the participation of equity and bond holdings and subsequent conversion of 37.5 percent of uninsured deposits into shares with preferred voting and dividend rights. This was required to attain a CT1 capital ratio of 9 percent under PIMCO's stress scenario by end-program. This resulted in an immediate increase in the CT1 ratio to well above 9 percent. Part of the remaining uninsured deposits was temporarily frozen until the completion of an independent valuation (see below). As with CPB, this process minimized fiscal costs.

10. **In a second step, we will continue working toward finalizing the resolution process and ensuring the viability of the intervened banks.** Our work in this area aims to:

- **Complete an independent valuation of BoC and CPB assets by end-June 2013 (structural benchmark) as mandated in the resolution law**. This is needed to ensure that capitalization targets can be met based on a more detailed and updated valuation of assets. To this end, no later than end-April 2013, we will agree with the EC/ECB/IMF staff on the terms of reference of this valuation exercise.

- **Finalize the recapitalization of BoC.** Following the independent valuation described above, if required, an additional conversion of uninsured deposits into shares with preferred voting and dividend rights will be undertaken to ensure that the CTI target of 9 percent under stress by end-program can be met. Should the bank be found to be overcapitalized relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalization.

- **Ensure that BoC can operate with maximum safeguards to preserve stability and continued viability during a transition period**. In this regard, we plan to appoint a Board of Directors to manage the bank, in accordance with the resolution law. This team will take over the responsibilities of the special administrator once the resolution process is completed and until a new general assembly is convened. The CBC will require the board to prepare a restructuring plan defining the bank's business objectives by end-September-2013 (**structural benchmark**). To ensure that these issues do not affect its normal business activities, by end-June 2013 we will have ready institutional arrangements to insulate BoC from reputational and governance risks.

11. **In a third step, we will ensure adequate recapitalization of other commercial banks.** The CBC will increase minimum CT1capital requirement to 9 percent by end-2013. We have communicated the identified capital needs to remaining banks covered in the PIMCO due diligence. We will instruct them to take the necessary steps to ensure they meet regulatory requirements under PIMCO's stress scenario by end-September. If needed, public funds from the program will be used to recapitalize these institutions.

12. **We are also taking steps to recapitalize and restructure the CCI sector.** The government is committed to preserving a viable credit cooperative sector, as it provides valuable services while maximizing stakeholders' value. To this end:

- Sufficient program resources will be provided at the time of the first review in a dedicated account at the central bank to support the recapitalization and restructuring of the CCI sector. This will help to boost confidence in the sector. The amounts will be injected in the sector following the identification of capital needs and in accordance with the strategy below.

- We will instruct the CCIs covered by the PIMCO due diligence to meet capital requirements by end-July. If they are unable to raise capital, they will be recapitalized and/or restructured in the context of the overall strategy.

- For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability by end-June 2013 (**structural benchmark**). This will be done in accordance with terms of reference prepared in consultation with EC/ECB/IMF by end-April.

- By end-July 2013, the CBC will develop a strategy to recapitalize and restructure the sector with public money as needed **(structural benchmark)**.

Normalizing financial flows and ensuring adequate liquidity

13. **To safeguard financial stability, it was necessary to impose temporary administrative measures.** Following the intervention of the two banks and recapitalization of BoC, which required a bank holiday of six days, on March 28, 2013 the banks were opened with temporary capital controls and deposit withdrawal restrictions. Cash withdrawals, electronic payments and transfers abroad have been temporarily restricted to prevent deposit outflows and protect the liquidity position of the banks. The implementation of these measures has been appropriately differentiated across transactions to minimize disruptions in the payments system and ensure the execution of essential transactions.

14. **We aim to gradually lift deposit restrictions and capital controls**. We are committed to removing restrictive measures, including those that are inconsistent with our obligations under Article VIII of the IMF's Articles of Agreement, as soon as conditions allow. To this end, we will monitor liquidity conditions and the impact of restrictions in the banks on a daily basis and will review and relax current restrictions as needed in consultation with the EC/ECB/IMF. In the meantime, we request approval from the Fund of any measures that require such approval under Article VIII.

15. **We will ensure adequate liquidity in the banking system**. The CBC, in close cooperation with the ECB, stands ready to take appropriate measures to maintain sufficient liquidity in the banking system in accordance with Eurosystem rules and procedures. To this effect, the CBC and the ECB will require banks to submit funding plans and closely monitor their progress on returning to a sustainable funding model. Restrictions will be lifted as soon as funding conditions normalize. We commit not to impose any new restrictions or intensify any existing restrictions on the making of

payments and transfers for current international transactions, nor to introduce any new multiple currency practices.

Deleveraging of the banking sector

16. **We are taking resolute steps to reduce the size of our banking sector.** Our aim is to downsize our domestic banking sector to the EU average by end-2018 from more than 500 percent of GDP at end-2012. This will better serve the needs of our economy and ensure that contingent liabilities from the banks to the sovereign are further reduced. To this end:

- On March 25, 2013 we sponsored the agreement through which Cyprus Popular Bank (CPB), Bank of Cyprus (BoC), and Hellenic Bank (HB) transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus. This helped to reduce the size of our banks by about 130 percent of GDP, limiting contingent liabilities on the state and transferring responsibility to cover €9 billion of insured Greek deposits from Cyprus to Greece.

- In the context of the resolution of CPB and restructuring of BoC, fair value their asset portfolios as part of the independent valuation exercise mandated by the resolution law. The recognition of fair value losses on the asset portfolio will help to further reduce the size of our domestic banking sector to about 350 percent of GDP.

- We will encourage banks to further deleverage non-core assets and will downsize the CCI sector. This will help to meet the target of reducing the system to the euro-area average by end-2018.

Enhancing the supervisory and regulatory framework

17. **We remain committed to strengthening the supervisory and regulatory framework of the banking system.** This is paramount to prevent buildup of new vulnerabilities in the system and limit potential future contingent liabilities onto the state. To this end, we will:

- **Ensure conservative implementation of accounting standards on loan provisioning.** By end-May, the CBC will amend its regulations to classify as nonperforming (NPL) all loans past due by more than 90 days. To enhance transparency, the reclassified historical NPL series will be promptly published. Provisioning for NPLs will be done following international accounting standards and conservative provisioning practices. In this regard, by end-September 2013, we will complete, with the support of an international accounting firm, a technical comparison of the accounting practices followed by the Cypriot banks against those followed by other international financial institutions in other relevant jurisdictions.

- **Assess and strengthen oversight of bank credit-risk management practices.** New prudential regulations covering underwriting standards, proper loan-collection practices, and appropriate collateral valuation practices, will enter into force by end-March 2014. Additionally, legislation will be passed by end-September 2013 to strengthen governance by prohibiting commercial banks from lending to their independent board members including their related parties and removing any board members in arrears on existing debts to their banks.

- **Set up a central credit register.** This register aims to monitor credit risk concentration and enhance the monitoring of large business groups (including those related to bank owners), and become an important tool of off-site and on-site banking supervision. The legal framework for the credit register will be set up by end-September 2013 (**structural benchmark**) and the register will be operational by end-September 2014.

- **Introduce early corrective measures.** To provide stronger safeguards against forbearance and enhance supervisory independence, by end-March 2014 we will pass a law establishing a framework for mandatory supervisory action based on capitalization levels. This framework will require prompt supervisory remedial action at a bank or CCI upon deterioration of its capitalization (such as suspension of dividend payments, etc.).

18. **Supervision and Regulation of CCIs will also be revamped.** To prevent excessive risk taking and protect consumers, we will undertake a reform of supervisory practices for the credit cooperative sector. The reform will include the following elements:

- **Transferring supervisory responsibility to the CBC**. By end-June 2013 we will submit legislation establishing the CBC as the supervisor of CCIs with the view to completing the operational, supervisory, and regulatory transfer of powers by end-July 2013. By end-March 2014, regulatory and supervisory frameworks for CCIs will be harmonized with those of commercial banks to ensure a level playing field and reduce potential mispricing of risks.

- **Enhancing transparency of financial information.** To enhance transparency, by end-September 2013 the largest CCIs (threshold to be determined by the CBC in consultation with the EC, ECB and IMF), will be required to have an annual audit performed by a recognized and independent auditing firm, starting with the 2013 annual accounts.

- **Revising lending practices.** We plan to submit legislation by end-September 2013 to strengthen the governance of CCIs to *inter alia* limiting the CCIs from lending to natural persons that are non-members, independent board members including their related parties, and removing any board members in arrears on existing debts to the cooperative credit institution.

Enhancing preparedness to deal with troubled borrowers

19. **We will take measures to provide for private sector debt restructuring.** We plan to establish a framework for targeted private sector debt restructuring following the implementation of the resolution and recapitalization of weak banks. This will help to revive financial activity, facilitate new lending, and diminish credit constraints. We are working on three fronts:

- **Temporary moratorium.** Before end-April, 2013 the CBC will issue a directive to recommend banks to provide borrowers a grace period of 60 days without penalties to pay interest only on loans coming due. This measure aims to prevent disruptive effects in related payments throughout the whole economy.

- **Tax incentives to facilitate debt restructuring.** By end-May, 2013 we will amend legislation if needed to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers.

- **A well-targeted approach to debt restructuring of viable debtors.** By end-June 2013 we will identify measures as needed to address legal, administrative, or other impediments affecting the restructuring of viable borrowers while preserving credit discipline. Our approach will be based on market-based voluntary workouts underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented by end-2014, macroeconomic conditions permitting. Moreover amendments to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring will be introduced. Finally, we will establish by end-June 2013 a mediation service to intermediate between banks and their clients to achieve fair debt restructuring.

Strengthening the AML framework

20. **We remain fully committed to strengthening our anti-money laundering (AML) framework in line with the FATF standards**. While Cyprus' AML regime has received an overall positive evaluation in the 2011 MONEYVAL report, we have agreed to an independent audit of the implementation of the AML framework in credit institutions. We remain committed to strengthening our AML legal and implementation framework. To this end:

- We will further build on recent revisions to our legal framework, as appropriate to:(i) ensure the exchange by the financial intelligence unit of financial intelligence on money laundering, associated predicate offenses and terrorist financing with foreign counterparts without the need to secure a court order; (ii) ensure that all trustees of trusts under Cyprus law are regulated or otherwise registered; (iii) ensure that adequate and accurate information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities; and (iv) ensure that the use of "nominee directors" (i.e., professionals who provide director services) or nominee shareholders does not create any obstacle to the timely access to adequate, accurate and current information on the beneficial ownership and control of companies. We will finalize these by end-September 2013 (**structural benchmark**).

- To implement the revised legal framework related to the transparency of Cypriot corporations and trusts, we will: (i) conduct a third party assessment of the functioning of the Registrar of

Companies and appropriately resource the department of the Registrar; and (ii) strengthen the AML/CFT supervision of lawyers, accountants and trust and company service providers by providing adequate staffing of supervisors, applying a risk-based approach to supervision, and revising the methodology used for supervision and inspection by end-December 2013.

- The supervision department of the CBC will revise its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision by end-December 2013.

- Finally, should the independent audit reveal that there is a need, we stand ready to take corrective actions in the implementation of the preventive measures by financial institutions. These will be agreed by end-June 2013.

C. Fiscal Policy

21. **To place debt on a sustained downward path, the government is committed to achieving a primary fiscal surplus of 4 percent of GDP by 2018.** We will pursue a balanced fiscal consolidation that boosts credibility in our public finances and lowers debt in the long run, while taking into account cyclical considerations. For 2013, we will target a primary balance of -2.4 percent of GDP, after taking into account a significant consolidation already underway, as well as some one-off revenues. Our target may be revised down to incorporate compensation for pension funds in CPB with program funds to ensure equal treatment with such funds in BoC following the conversion of deposits into equity. With the economy continuing to contract and no additional one-off revenues, we will aim for a primary balance of -4.3 percent of GDP in 2014. Thereafter, we will plan to reach a primary deficit of -2.1 percent of GDP in 2015, and surpluses of 1.2, 3, and 4 percent of GDP in 2016, 2017, and 2018 and beyond, respectively.

22. **In a first step toward fiscal consolidation, last December we legislated a comprehensive package of measures for 2013-15.** Under our revised macroeconomic framework, these are estimated to yield about 5 percent of GDP. On the expenditure side, we implemented permanent wage cuts applying to the broad public sector, abolished and/or reduced a number overlapping benefits, increased the mandatory retirement age in the public pension scheme, and implemented an early retirement penalty, while preserving acquired rights. On the revenue side, we increased excise taxes and VAT rates, extended the existing extraordinary contributions on wages scheduled to expire in 2014, and further increased the contribution rate to the general pension system by both employees and employers.

23. **Achieving our planned fiscal path will require additional consolidation measures amounting to about 7 percent of GDP during 2013-2018**. To this end, we will implement an additional 2.2 percent of GDP in measures in 2013. To secure our long-term primary fiscal target of 4 percent of GDP, we commit to identifying an additional 4.7 percent of GDP of measures to be implemented during 2015-2018. Given our still relatively high budget spending, we will ensure that our consolidation efforts deliver at least 60 percent of total specified yields for 2013-18 in expenditure rationalization.

24. **At the onset of the program, we will implement measures amounting to 2.2 percent of GDP through the adoption of legislation and Council of Minister decisions, as needed (prior action).** On the revenue side, these measures will include: (i) increasing the corporate income tax rate from 10 to 12.5 percent; (ii) raising the bank levy rate from 0.11 to 0.15 percent; (iii) raising the withholding tax rate on interest received to 30 percent; and (iv) reforming the property tax; and (v) other. These measures are expected to yield 2 percent of GDP. On the expenditure side, we will rationalize housing benefits, which will save 0.2 percent of GDP.

25. **During upcoming reviews, we commit to identifying an additional 4.7 percent of GDP in measures to attain a primary balance target of 4 percent of GDP by 2018**. These will be included in the annual budgets for 2015-18 and the corresponding medium term frameworks. Fiscal structural reforms in the areas of expenditure rationalization and revenue administration will help us to achieve these needed budget savings. In the event of revenue shortfalls or higher social spending needs, the government stands ready to take additional measures to preserve the program's medium-term fiscal balance and debt objectives, including by reducing discretionary spending. Conversely, if there is an over-performance, to the extent that it is deemed permanent, it will reduce the need for additional measures in the outer years. Finally, one-off windfall revenues will not be used to increase spending.

D. Structural Fiscal Reforms

26. **We are committed to implementing structural reforms to support our fiscal consolidation efforts and ensure the sustainability of our pension system**. Last year, we implemented a comprehensive reform of the COLA wage indexation mechanism to limit the growth of the public sector wage bill. We also implemented parametric pension reforms to improve the system's financial viability and make it more equitable. Building on these efforts, we will: (i) review the system of social insurance and social welfare schemes to contain spending while protecting the vulnerable and preserve long-run viability; (ii) improve public financial management by strengthening our budget framework, and enhancing the management of fiscal risks and future revenues from natural resources; (iii) reform our revenue administration to fight tax evasion and improve revenue collection; and (iv) rationalize the public sector by discontinuing non-core activities and privatizing public assets.

Social Insurance and Social Welfare System

27. **We will continue our reforms of the general insurance pension scheme (GSIS) and the public sector occupational pension scheme (GEPS) to enhance their intra- and inter-generational fairness and to ensure their financial viability**. Taking into account the recent reforms, by end-July 2013 we will conduct an actuarial analysis to determine options to ensure the long-run viability of GSIS until 2060 without the need for government transfers beyond credited contributions. In this context, we will separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) GSIS pension scheme. Reforms resulting from the

actuarial analysis will be adopted by end-December 2013 and enter into force by end-March 2014. The reform will encompass an adequate combination of benefit reduction, statutory retirement age increases, and/or contribution rate increases, taking into account the latter's impact on labor costs. The recent GEPS pension reforms will also be extended to the broader public sector.

28. **We will also reform the social welfare system to minimize overlaps in benefits and improve targeting**. Spending on social programs has increased rapidly in recent years to levels well above the EU average, in part due to overlapping benefits and suboptimal targeting. Building on earlier reforms, by end-June 2013, we will prepare an action plan based on a review that will cover all social programs (i.e., social assistance, housing benefits, family benefits, education allowances, and any other transfer schemes) provided by all public entities. The plan, which will include proposals to consolidate welfare programs, improve targeting, and streamline administration, will aim to attain the budget savings required to reach our program fiscal targets, while ensuring that the poor and vulnerable groups are adequately protected. We will implement this reform by end-2013 (**structural benchmark**).

Public Financial Management

29. **We are committed to improving our budget processes.** We have legislated a medium-term budget framework (MTBF) in line with EU directives, including a rolling three-year budget framework with a view of enhancing fiscal discipline. In consultation with the EC/ECB/IMF, through regulations in the form of an expanded budget circular, we will ensure that the MTBF will be fully effective starting with the 2014 budget. In the context of a broad review of our PFM system to be completed by end-June 2013 we will develop a new comprehensive *Law on Fiscal Responsibility and Budget Systems* including supplementary secondary legislation to address any remaining inconsistencies between the MTBF law and existing legislation, which will be submitted to parliament by end-December 2013 (**structural benchmark**). The new law will provide an enabling framework for a medium-term PFM reform program.

30. **We will establish a framework for the management of natural resources in line with best practices**. To ensure transparency and accountability, the framework's legal basis and governance structure will be based on internationally recognized best practices. In this context, we plan to establish a resource fund with clear rules governing inflows and outflows as part of our budgetary framework, taking into account the need to develop the hydrocarbons industry, the need to bring public debt on a steady downward path, and the need to invest for future generations. We will submit both a draft legal framework and a strategy to the EC/ECB/IMF by end-September 2013.

31. **Management of and reporting on fiscal risks from public-private partnerships (PPPs) will be strengthened.** We will put in place a legal and institutional framework for assessing and entering into PPPs or concession agreements, as well as for monitoring their execution by end-2013 through: (i) establishing an effective "gateway process" that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Ministry of Finance in reviewing and approving PPPs at critical points in the gateway process; and (iii) developing financial

reporting and accounting rules that ensure timely and transparent communication of PPP related obligations. We will not enter into any new PPPs or concessions (except for any project having reached commercial close by end October 2012) at any government level until the new framework is in place.

Revenue Administration

32. **We will modernize our revenue administration to increase its efficiency, improve taxpayer compliance, and boost revenue collection.** Enforcing the timely collection of tax revenues and controlling tax evasion remain a challenge, as the current arrangements do not provide for modern and harmonized systems and procedures, good sharing of information between tax agencies, alignment of filing and payment arrangements, and adequate enforcement tools and approaches. The tax administrations need to find ways to benefit from economies of scale and optimized operations. Correcting this means that not only will tax administration be more effective and efficient, but taxpayer compliance costs can be reduced. We will reform the revenue administration in line with the recommendations provided by recent technical assistance on inland revenue and VAT. To this end, we will present by end-June 2013, a comprehensive reform agenda to improve the efficiency and effectiveness of revenue collections, taxpayer services, and compliance, in line with best international practices.

Rationalization of Broader Public Sector and Privatization

33. **To ensure debt sustainability and improve the efficiency of the public sector, we will streamline extra-budgetary entities and consider divesting state-owned enterprises (SOEs).** While many extra-budgetary entities do not perform essential public services, they are costly to the budget, receiving almost 2 percent of GDP in transfers. To reduce costs, we will take the following steps:

- **Based on their functionality, extra-budgetary entities will be assessed with a view to determine the need to reclassify, restructure, or divest them.** All extra-budgetary entities will be assessed on their relevance for the public sector and their operational performance. On this basis, entities will be classified according to functionality. Entities that perform necessary public functions will be considered to be integrated into the budget, the rest will be either restructured or divested by the end of the program period.
- **We will develop a privatization plan for SOEs and other state assets**. As a first step, by end-June 2013 we will create an inventory including assets with the highest commercial value and at least one third of SOEs, while the full inventory will be completed by end-December 2013. A privatization plan will be developed by end-September 2013 with the aim of achieving proceeds of at least €1.4 billion by end-2018. To support the privatization process, we will implement a legal and institutional framework by end-December 2013.
- **Other SOEs will be closely monitored or closed if needed.** To improve the monitoring of SOEs and semi-government entities, starting with the 2014 budget, we will include a "Statement

of SOEs and semi-government entities" as an Appendix I to the annual budget law and annual financial reports. Non-viable SOEs will be either restructured or closed.

E. Program Financing

34. **Cyprus will face sizable financing needs during the program period.** To reduce these needs and their impact on public debt, we will undertake several measures during the program period:

- Rolling over and extending the maturity of at least €1 billion of domestic debt held by residents. In order to implement this, we will undertake a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The maturing bonds will be exchanged for new longer dated sovereign bonds with maturities between 5 and 10 years. This offer would be par for par and with no change in annual interest cost. The recapitalization bond of €1.9 billion injected in CPB in June 2012 will also be rolled over (both rollovers are an end-June 2013 **structural benchmark**).

- Realizing privatization receipts of at least €500 million for financing purposes.

- Intensifying efforts to obtain financing assurances from the Russian authorities to reschedule the Russian bond falling due in 2016 and extend its maturity to be paid in 5 equal installments starting in 2018 and lower the interest rate to 2 ½ percent.

- Using the allocation of future central bank profits of EUR €0.4, in line with the CBC duties under the Treaties and the Statute (subject to the same safeguards, balance sheet adjustments by the central bank decided by the Board of Directors of the CBC and in accordance with the Treaty will also contribute approximately €1.4 billion in terms of debt reduction).

35. **Remaining balance of payments financing needs of about €10 billion will need to be covered through official financing**. Cyprus faces sizable balance of payments financing needs that are medium term in nature, in particular (a) pressures on the capital account, (b) the need to refinance external debt and (c) a small current account deficit. Beyond our request to the Fund for a three-year EFF (in an amount of SDR891 million, equivalent to about €1 billion, or 563 percent of quota), we have secured additional financial resources from our European partners to fill remaining needs. Euro area partners have committed a total of €9 billion over the period covering May 2013–March 2016. To ensure that this financing helps to maintain debt on a sustainable debt trajectory delivering a debt-to-GDP ratio of about 100 percent by 2020 and declining thereafter, they have committed to new lending at an average maturity of 10-15 years and at favorable interest rate (2.5-3 percent), using the ESM as a financing vehicle. We are confident that resolute implementation of our economic program will help our economy recover and bolster market sentiment. If fiscal consolidation proceeds faster than expected, or if market conditions improve significantly during the program period, we would refrain from drawing on the IMF support on an as needed basis.

F. Program Monitoring

36. **Progress in the implementation of policies under our program will be monitored through quarterly (and continuous) quantitative performance criteria (PCs) and indicative targets, and structural benchmarks.** These are detailed in Tables 1 and 2. The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria, indicative targets, and structural benchmarks under the program. Quantitative targets up to September 2013 are PCs. The remaining targets for end-2013 and 2014 are indicative. Quarterly targets for the remainder of 2013 will be converted into PCs at the time of the first review. A Memorandum of Understanding (MoU) on specific policy conditionality agreed with the EC, on behalf of the European Stability Mechanism, specifies additional structural policies, and sets a precise timeframe for their implementation.

37. **As is standard in all Fund arrangements, a safeguards assessment of the CBC will be completed by the first review.** In this regard, the CBC will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review. As a related matter, and given that financing from the IMF, in the context of addressing Cyprus' balance of payment needs, will be used to provide direct budget support, a framework agreement will be established between the government and the CBC on their respective responsibilities for servicing financial obligations to the IMF. As part of these arrangements, Fund disbursements will be deposited into the government's account at the CBC.

Table 1. Cyprus: Quantitative Conditionality, 2013 1/
(millions of Euros)

	Performance criteria		Indicative targets	
	Jun-13	Sep-13	Dec-13	Mar-14
Floor on the general government primary balance 2/	-222	-248	-395	-54
Ceiling on the general government primary expenditure 2/	3230	4911	7069	1576
Ceiling on the stock of general government debt	17153	17464	17917	18076
Ceiling on the accumulation of new general government guarantees 2/ 3/	145.3	145.3	145.3	0
Ceiling on the accumulation of external arrears 4/	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0	0	0	0
Ceiling on the accumulation of new VAT refund arrears by the general government 5/	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ The figures for 2013 reflect guarantees already approved by the government on loans not yet drawn.
4/ Continuous performance criterion.
5/ Cumulative since March 2013.

Table 2. Cyprus: Structural Conditionality	
Measures	**Timing**
Prior action	
Adopt legislation and Council of Minister decisions, as needed, implementing measures consistent with the program targets. Measures include: increasing the CIT rate from 10 to 12.5 percent, raising the bank levy rate from 0.11 to 0.15 percent, raising the tax rate on interest from 15 to 30 percent, and reforming the property tax (for a total consolidation of 2 percent of GDP with immediate effect); and rationalizing the housing benefits (savings of 0.2 percent of GDP).	Before Board meeting
Structural benchmarks	
A. Strengthen financial stability	
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous performance criterion
Complete the due diligence valuation of CPB and BoC assets as described in the resolution law in accordance with the terms of reference agreed with the EC/ECB/IMF	End-June 2013
For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability in accordance with terms of reference prepared in consultation with EC/ECB/IMF	End-June 2013
Develop a strategy to recapitalize and restructure the CCI sector with public money as needed	End-July 2013
Revise the anti-money laundering legal framework (TMU ¶15)	End-September 2013
CBC to require the BoC board to prepare a restructuring plan defining the bank's business objectives	End-September 2013
Adopt the legal framework for a central credit register (TMU ¶16)	End-September 2013
B. Strengthen fiscal institutions, reduce fiscal risks and protect vulnerable groups	
Roll over and extend the maturity of at least €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and roll over the € 1.9 billion recapitalization bond of CPB.	End-June 2013
Submit to Parliament a law on fiscal responsibility and budget systems (TMU ¶17)	End-December 2013
Adopt measures to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs.	End-December 2013

Table 3. Cyprus: Actions Taken Prior to the Signature of the MEFP

<table>
<tr><th>A. Strengthen financial stability</th><th>B. Strengthen fiscal institutions and reduce fiscal risks</th></tr>
<tr><td>Anti-money laundering. Amended legislation with a view to providing the widest possible range of cooperation to foreign counterparts (December 2012)
Identification of capital needs. Hired a consultant to assess the capital needs of the financial institutions accounting for about 75 percent of total financial system assets (February 2013)
Bank Resolution. Adopted legislation putting in place a modern bank resolution framework (March 2013)
Deleveraging of non-core assets. Sponsored the agreement through which CPC, BoC, and HB transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus (March 2013)
Bank intervention and resolution. Intervened CPB, split it according to a "good bank-bad bank" strategy, sold the "good bank" to BoC while safeguarding insured deposits (March 2013)
Recapitalization. Recapitalized BoC through the full dilution of equity and bond holdings and conversion of 37.5 percent of uninsured deposits into preferred shares (March 2013).</td><td>COLA reform. 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.
Pension reform. Introduced reforms to the General Social Insurance Scheme, including freezing pensions under the Social Security Fund until end-2016 and raising employee and employer contributions in 2014. Also introduced reforms to the government pension scheme and froze public sector pensions.
Medium-term budget framework. Legislated a framework in line with EU directives, including a rolling three-year budget framework.
2013 budget. Implemented a budget with significant fiscal consolidation measures for 2013-15, including:
• Reduced outlays for social transfers through the abolition of a number of redundant and overlapping schemes.
• Introduced a graduated reduction of the remuneration of the public and broader public sector employees (6.5-12.5%) and legislated a 3% flat reduction for 2014.
• Extended the freeze of general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions until end-2016.
• Took steps with a view to reducing the number of public sector employees by at least 4,500 over the period of 2012-16.
• Reduced transfers to SOEs and semi-public institutions.
• Increased excise duties on tobacco products, alcoholic beverages, and oil products with effect in 2013; and legislated an additional increase for energy products in 2014.
• Increased the standard VAT rate from 17 to 18% in 2013 and to 19% in 2014, and the reduced rate from 8 to 9% starting in 2014.
• Increased fees for public services by at least 17%.
• Abolished all exceptions for paying the annual company levy of EUR 350.</td></tr>
</table>

Attachment 2. Cyprus—Technical Memorandum Of Understanding

April 29, 2013

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

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

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

A. Quantitative Performance Criteria and Indicative Targets

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

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

- *The central government*. Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.
- *The local governments*. Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.
- *The social security funds.* These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.
- *Any newly created institution defined as general government under ESA 95.* This includes any new budgetary institution, special fund, social security fund, semi-government organization,

municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

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

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

6. 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.
- The payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank.

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.

8. 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 payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank

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

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

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

- Upward (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upward, 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.
- Upward by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank

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

11. The ceiling on new general government sector guarantees shall include domestic and external guarantees granted during the test period, as well as guarantees for which the maturity is being extended beyond the initial contractual provisions. The ceiling shall exclude guarantees granted under a risk sharing instrument of the EU structural funds (see COM (2011) 655 final) that do not create contingent liabilities for the Cypriot State. Government entities outside of the general government (e.g. state owned enterprises) but within the non financial public sector are not permitted to grant guarantees. The stock of guarantees at end March 2013 was €3.1 billion. For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.

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-March 2013 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. In case no due date is specified on the supplier contract, an unpaid commitment is considered to be in arrears 90 days after the initiation of the invoice. The stock of domestic expenditure arrears as of end March 2013 was €0 million.

Ceiling on the Accumulation of new 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 March 2013 was €140 million.

B. Monitoring of Structural Benchmarks

15. **Revision of the anti-money laundering legal framework (end-September 2013).**

Specification. The adopted legal framework will provide for the following:

- Ensure that the financial intelligence unit can exchange adequate information with foreign counterparts on money laundering, associated predicate offenses and terrorist financing, in the context of its analytical function, without having to secure a court order;
- Ensure that all trustees of trusts created under and governed by Cyprus law are regulated or otherwise registered. Registers will be kept by the relevant supervisory authorities in order to enable them to carry out their duties and will contain adequate, accurate and current information on the name of a trust and the name and address of its trustee(s);
- Ensure that adequate, accurate and up-to-date information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities;
- Ensure that the use of "nominee" directors (i.e. professionals who provide director services) or "nominee" shareholders does not create any obstacle to the authorities' timely access to adequate, accurate and up-to-date information on the beneficial ownership, and control of companies by having a mechanism in place consistent with the FATF standards. To this end, the authorities will require that all nominee directors and nominee shareholders be authorized or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).

16. **Adopt the legal framework for a central credit register (end-September 2013)**

Specification. The adopted legal framework shall include provisions to:

- Establish a framework that allows credit institutions to keep in a centralized manner critical information on household and corporate borrowers (including their consolidated debt exposure, past due and performing loans, collateral, etc.), while sensitive and/or confidential information shall be safeguarded;

17. **Submit to Parliament a law on fiscal responsibility and budget systems (end-December 2013).**

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

- It will provide a comprehensive coverage of the general government sector and the government's financial relationships with state enterprises and other public entities that are outside the boundary of the general government sector.
- It will incorporate provisions (i) on fiscal transparency and accountability requiring the government to articulate a comprehensive, legally based and independently monitored fiscal strategy consistent with EU requirements and (ii) for the development over time of a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down approach to budget preparation that is closely linked to the process of fiscal policy-making, and providing more flexibility to ministries and semi-governmental organizations.

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.	25 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).	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Details on any financial balance sheet transactions	Monthly	MOF. Treasury Department	25 days after the end of the month except December data which will be provided 30 days after the end of the year
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.	25 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 of the Budgetary Central Government 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 and their corresponding quarterly flows	Quarterly	MOF. Customs and Excise Department, VAT service	15 days after the end of the quarter
Stock of government guarantees and their quarterly flows by	Quarterly	MOF. Treasury	25 days after the end of the

institution.		Department.	quarter.
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Weekly	Central Bank of Cyprus	1 working day after the end of the week
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 group balance sheets, including foreign operations) by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period
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, details 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/	Monthly	Central Bank of Cyprus	30 days after the end of the month
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, profitability, asset quality, balance sheet and capital adequacy ratios	Quarterly	Central Bank of Cyprus	90 days after the end of the month 2/

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

2/ The scope and frequency of reporting of financial soundness indicators will be revised at the time of the first review.

Appendix 2. Cyprus—Letter of Intent to the European Commission

MEMORANDUM OF UNDERSTANDING

BETWEEN

THE EUROPEAN COMMISSION

ACTING ON BEHALF OF THE

EUROPEAN STABILITY MECHANISM

AND

THE REPUBLIC OF CYPRUS

WHEREAS

(A) The European Stability Mechanism ('ESM') was established by the Treaty Establishing the European Stability Mechanism entered into between the euro area Member States (the "**ESM Treaty**") for the purpose of mobilising funding and providing stability support for the benefit of ESM members which are experiencing, or are threatened by, severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member states.

(B) ESM may grant financial assistance under financial assistance facility agreements by way of loan disbursements under precautionary conditioned credit lines or enhanced conditions credit lines, loans to ESM members under macro-economic adjustment programmes, facilities to finance the recapitalisation of financial institutions in an ESM member state, facilities for the purchases of bonds in the primary or secondary markets, all subject to strict conditionality appropriate to the financial instrument(s) chosen (each such loan or disbursement under such a financial assistance facility agreement being a "**Financial Assistance**").

(C) The European Commission, in liaison with the ECB, assessed (i) the existence of a risk of financial stability of the euro area as a whole or of its member states, (ii) whether the public debt of the Beneficiary Member State was sustainable and (iii) the actual or potential financing needs of the Beneficiary Member State, and on the basis of such assessment the ESM Board of Governors decided in principle to grant stability support to the Beneficiary Member State in the form of a financial assistance facility.

(D) This Memorandum of Understanding has been negotiated and finalised between the European Commission (on behalf of the ESM and with the approval of its Board of Governors), the ECB, the IMF and the Beneficiary Member State. The financial assistance to be provided to the Beneficiary Member State by the ESM shall be dependent upon compliance by the Beneficiary Member State with the measures set out in the Memorandum of Understanding.

(E) The ESM Board of Governors approved this Memorandum of Understanding and the European Commission signing the Memorandum of Understanding on behalf of the ESM.

(F) The release of Financial Assistance by ESM under financial assistance facility agreement, shall, unless otherwise specified, be conditional upon the ESM Board of Directors deciding, on the basis of reports from the European Commission (in liaison with the ECB) in accordance with Article 13(7) of the ESM Treaty, that the Beneficiary Member State has complied with the conditionality attached to the financial assistance facility agreement, including compliance with the measures set out in this Memorandum of Understanding.

This Memorandum of Understanding may be amended upon mutual agreement of the parties, in liaison with the ECB and the IMF, in the form of an addendum. The addendum will be an integral part of the memorandum and will become effective upon signature.

Done in Brussels on and in Nicosia on in five (5) originals, in the English language.

REPUBLIC OF CYPRUS

/s/

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Represented by Harris Georgiades,

Minister of Finance

CENTRAL BANK OF CYPRUS

/s/

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Represented by Panicos O. Demetriades,

Governor of Central Bank of Cyprus

THE EUROPEAN COMMISSION, ON BEHALF OF THE EUROPEAN STABILITY MECHANISM

/s/

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Represented by Olli Rehn,
Vice-President of the European Commission

Attachment 1. Cyprus—Memorandum Of Understanding On Specific Economic Policy Conditionality (European Commission)

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

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls, in line with the political agreement of the Eurogroup of 25 March 2013;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the sector's problems are home-grown and relate to overexpansion in the property market as a consequence of the poor risk management practices of banks. Furthermore, the financial sector is vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector would benefit from a considerable downsizing and restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress to date

The domestic banking sector, including the cooperative credit institutions, represented until recently 550% of GDP. The necessary downsizing and restructuring of the banking sector is already under way. The House of Representatives adopted legislation on 22 March 2013 establishing a comprehensive framework for the recovery and resolution of credit institutions, drawing, inter alia, on the relevant proposal of the European Commission[1] (EC). Under the terms of that legislation, the Central Bank of Cyprus (CBC) is the single resolution authority for banks and cooperative credit institutions alike. Using this new framework, the Cypriot authorities have proceeded with (i) the carve-out of the Greek operations of the largest Cypriot banks, (ii) the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus and (iii) the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without the use of public money. As a result of these actions, the Cypriot banking sector was downsized immediately and significantly to 350% of GDP and the Bank of Cyprus has been fully recapitalised in order to regain its eligible counterparty status for the purpose of its participation in regular Eurosystem monetary policy operations. Further downsizing will be achieved through the restructuring of the cooperative credit institutions. To preserve the liquidity of the Cypriot banking sector, administrative measures have also been imposed.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. As bank liquidity was under pressure, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of the credit institutions. Cash withdrawals, electronic payments and transfers abroad were temporarily restricted. The implementation of these measures was designed to minimise disruptions in the payment systems, and to ensure the execution of transactions essential for the functioning of the economy. The Government committed to managing the introduction and implementation of restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions will be monitored on a daily basis with full information sharing with the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). The restrictions on capital movements will be gradually relaxed, after consultation with the EC, the ECB and the IMF and will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system. A Monitoring Board comprising the EC, the EBA and the Cypriot authorities is being established to ensure the monitoring and assessment of the implementation of the temporary capital controls.

1.2. Furthermore, the Cypriot authorities will encourage banks to strengthen their collateral and liquidity buffers. The CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

1.3. The authorities will request domestic banks relying on central bank funding or receiving state aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter, **starting from June 2013**, to the CBC, which will be

[1] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#framework2012

transmitted to the ECB, the EC, the European Stability Mechanism (ESM) and the IMF. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central banks, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.

1.4. The lack of concentration limits in the liquidity framework for euro-denominated assets allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the CBC will update the liquidity regulations **by December 2014**, after consultation with the ECB, the EC and the IMF.

Regulation and supervision for banks and cooperative credit institutions

1.5. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on a report commissioned to an independent expert, the necessary legislative changes will be submitted to the House of **Representatives by mid-2014** and implemented **by end-2014**, macroeconomic conditions permitting.

1.6. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. The CBC's guidance on the classification of loans as non-performing will be amended to include all loans past due by more than 90 days. This amendment will be introduced **by 30 May 2013**. The time series for non-performing loans will be published including historical observations reaching as far back as possible.

1.7. The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. The legal framework for the credit register will be set up **by 30 September 2013** and the central credit register will be operational **by 30 September 2014**.

1.8. After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC will review, **by end-September 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.

1.9. Legislation will be passed by end-September 2013 to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members in arrears on existing debts to their banks, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.10. The CBC will introduce mandatory supervisory action based on capitalisation levels, drawing upon technical assistance and international best **practices by end-March 2014**.

1.11. The CBC will implement a unified data reporting system for the banks and the cooperative credit institutions **by end-June 2013**. The publication of the statistical data will be extended to the cooperative credit institutions, for which the CBC will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.

1.12. Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed **before end-June 2014**.

1.13. Cooperative credit institutions play a significant role in the domestic economy and an important objective of the programme is to strengthen the cooperative credit sector. Due to its economic relevance and legal specificities, as well as deficiencies in risk assessment, this segment of the financial sector requires stronger regulation and supervision. The Cypriot authorities will align the regulation and supervision of cooperative credit institutions to that of commercial banks. Since December 2012, the supervision of cooperative credit institutions is being conducted independently of considerations for the development of this sector. The supervision of cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and integrated into the CBC **by end-July 2013**, for which legislation will be passed **by end-June 2013**. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, a time-bound, actionable plan to achieve this **by end-June 2013**. By end-May 2013 legislation will be introduced to authorise the CBC to instruct the current cooperative credit sector supervisor to intervene also at the level of individual cooperative credit institutions.

1.14. The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF, will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution.

<u>Monitoring of corporate and household indebtedness</u>

1.15. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. These enhanced monitoring actions will be put in place **by end-June 2013**.

1.16. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of weak banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs. First, **by end-April 2013** a directive will be circulated by the CBC to recommend banks to provide a grace period of 60 days without penalties to pay interest only on loans coming due. This legislation aims to prevent disruptive effects in related payments throughout the whole economy. Second, legislation will be passed, if needed, to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers. Third, **by end-June 2013** the Cypriot authorities will develop a framework and issue legislation as needed to address legal, administrative or other impediments affecting the restructuring of viable borrowers, while preserving credit discipline. The approach will be based on market-based voluntary workouts, underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented. Moreover, amendments will be introduced to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring. Finally, a mediation service between banks and their clients to achieve fair debt restructuring will be established **by end-June 2013**.

Increasing financial transparency

1.17. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the Cypriot authorities are committed to further enhancing their standing by taking a number of measures, in line with recommendations made by IMF staff.

- The legal framework will be further revised[2] to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.

- Following the completion of the April 2013 audit, the findings and recommendations contained in the final reports of MONEYVAL and the auditor will be taken into account in the action plan envisaged in the programme, and the customer due-diligence and suspicious-transaction reporting procedures will be enhanced following the audit report recommendations **by Q2-2013**.

- Furthermore, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to an action plan on entity transparency to revise the legal framework and ensure its dutiful implementation, so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters. To this end, the action plan will envisage that the Cypriot authorities will promptly revise relevant pieces of legislation, including, inter alia, the Trust

[2] The legal framework was substantially revised in December 2012.

and Company Services Provider law and the Anti-Money Laundering law **by Q2-2013**. In addition, directives and circulars issued by supervisory authorities (CBC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) will be revised to lay down clear implementing procedures that are in line with relevant legislation and international standards **by Q2-2013**.

- As part of the action plan, the Cypriot authorities intend to establish trust registers with the supervisory authorities and launch a third-party assessment of the functioning of the Registrar of companies. The trust registers will be for all trusts established under Cyprus law, will be kept by the relevant supervisory authorities in order to enable them to carry out their duties, and will contain the name of the trust and the name and address of the trustee.
- Finally, the supervision department of the CBC will review its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision **by Q4-2013**. In particular, the off-site supervisory tool will include monthly reporting by credit institutions on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

B. Recapitalisation, due diligence, resolution and restructuring

1.18. A Coordination Committee with representatives from the CBC and the Ministry of Finance will be set up to oversee the implementation of the financial sector reform programme and to monitor developments in the banking sector.

<u>Due diligence and restoring adequate capital buffers</u>

1.19. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by 31 December 2013**.

1.20. An international consultant has conducted an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a sample representing about 63% of the cooperative credit institutions' assets, as well as Alpha Bank Cyprus and Eurobank Cyprus. The assessment, which was overseen by a Steering Committee including representatives of the Cypriot authorities, the EC, the ECB, the EBA and the ESM (as members) and the IMF (as observer), started formally on 4 October 2012, with the selection of the external consultant. This due diligence review included both an accounting review and an assessment of the economic value of banks' assets. Its results formed the basis for the bank-by-bank stress tests.

1.21. The bank-by-bank stress tests conducted by the CBC resulted in an overall capital shortfall of EUR 6 billion under a baseline scenario with a Core Tier 1 target ratio of 9% and a shortfall of EUR 8.9 billion under the adverse macroeconomic scenario with a Core Tier 1 target ratio of 6%. These numbers include one foreign bank, but do not include the EUR 1.8 billion of capital already injected by the Cypriot State in Cyprus Popular Bank in June 2012, which will be rolled over, nor do they include the capital needs of those credit cooperative institutions that were not covered by the due diligence exercise. The specific capital needs were communicated to each participating bank on 18 March 2013.

1.22. In response to the results of the due diligence exercise, Bank of Cyprus and Cyprus Popular Bank have been intervened and restructured using the recently-adopted resolution law. The other commercial banks will be instructed by the CBC to take the necessary steps to ensure that they meet regulatory requirements in a stress scenario by end-September 2013. Cooperative credit institutions will be instructed to meet capital regulatory requirements by July 2013. If necessary, public programme funds will be used to recapitalize these institutions in accordance with EU state-aid rules.

Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus

1.23. The accounting and economic value assessment already mentioned revealed that the two largest banks of Cyprus were insolvent. To address this situation the government has implemented a far-reaching resolution and restructuring plan. In order to prevent the build-up of future imbalances and to restore the viability of the sector, while preserving competition, a fourfold strategy was adopted, which does not involve the use of taxpayer money. The Cypriot authorities will closely monitor the implementation of this strategy.

1.24. First, all Greek-related assets (including shipping loans) and liabilities were carved-out, estimated in the adverse scenario at EUR 16.4 billion and EUR 15.0 billion, respectively. The Greek assets and liabilities were acquired by Piraeus Bank, the restructuring of which will be dealt with by the Greek authorities. The carve-out was based on an agreement signed on 26 March 2013. With the book value of the assets at EUR 19.2 billion, the carve-out has substantially reduced the cross exposures between Greece and Cyprus.

1.25. With respect to the UK branch of Cyprus Popular Bank, all the deposits were transferred to the UK subsidiary of the Bank of Cyprus. The associated assets were folded into the Bank of Cyprus.

1.26. Second, Bank of Cyprus is taking over -via a purchase and assumption procedure- almost the entire Cypriot assets of Cyprus Popular Bank at fair value, as well as the latter's insured deposits and Emergency Liquidity Assistance exposure at nominal value. The uninsured deposits of Cyprus Popular Bank will remain in the legacy entity. The aim is for the value of the transferred assets to be higher than the transferred liabilities with the difference corresponding to the recapitalisation of Bank of Cyprus by Cyprus Popular Bank amounting to 9% of the risk-weighted assets transferred. Bank of Cyprus is being recapitalised to reach a core tier one ratio of 9% under the adverse scenario of the stress test by the end of the programme, which should help to restore confidence and normalise funding conditions. The conversion of 37.5% of the uninsured deposits in Bank of Cyprus into class A shares with full voting and dividend rights provides the largest part of the capital needs with additional equity contributions from the legacy entity of Cyprus Popular Bank. Part of the remaining uninsured deposits of Bank of Cyprus will be frozen temporarily until the completion of the independent valuation referred to in the paragraph below.

1.27. Third, to ensure that the capitalisation targets are met, a more detailed and updated independent valuation of the assets of Bank of Cyprus and Cyprus Popular Bank will be completed, as required by the bank resolution framework, **by end June 2013**. To this end, **no later than mid-**

April 2013, the terms of reference of the independent valuation exercise will be agreed in consultation with the EC, the ECB, and the IMF. Following that valuation, and if required, an additional conversion of uninsured deposits into class A shares will be undertaken to ensure that the core tier one capital target of 9 % under stress by end-programme can be met. Should Bank of Cyprus be found to be overcapitalised relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalisation.

1.28. Finally given the systemic importance of Bank of Cyprus, it is important that the operations of Cyprus Popular Bank are quickly integrated, operational efficiency is improved, the recovery of non-performing loans is optimised with the work-out implemented by the going concern entity and the funding conditions are progressively normalised. In order to achieve these goals and to ensure that Bank of Cyprus can operate with maximum safeguards to preserve stability and continued viability during a transition period, the CBC, following consultation with the Ministry of Finance, will appoint a new Board of Directors and an acting Chief Executive Officer until Bank of Cyprus' new shareholders are organised in a general meeting. The CBC will require the Board of Directors to prepare a restructuring plan defining the bank's business objectives and credit policies **by end-September 2013**. To ensure that normal business activities are not affected, institutional arrangements will be designed **by end-June 2013** in accordance with Cypriot law to insulate Bank of Cyprus from reputational and governance risks.

Restructuring and recapitalisation of other commercial banks

1.29. Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. In order to ensure timely recapitalisation, the Cypriot authorities should submit **by 30 November 2013** restructuring plans for these banks to the EC, which are drawn up in compliance with EU state-aid rules, while also informing the ECB and the IMF.

1.30. Capital should, to the largest extent possible, be raised from private sources including internal measures, asset disposals and liability management exercises. Banks in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, including on pay levels of executive and supervisory board members, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. If the recapitalisation takes the form of state aid, funds for the recapitalisation of these banks will be made available in the context of the programme.

Restructuring and recapitalisation of cooperative credit institutions

1.31. With a view to minimising state aid, cooperative credit institutions requiring recapitalisation should seek private sector participation **no later than 31 July 2013**.

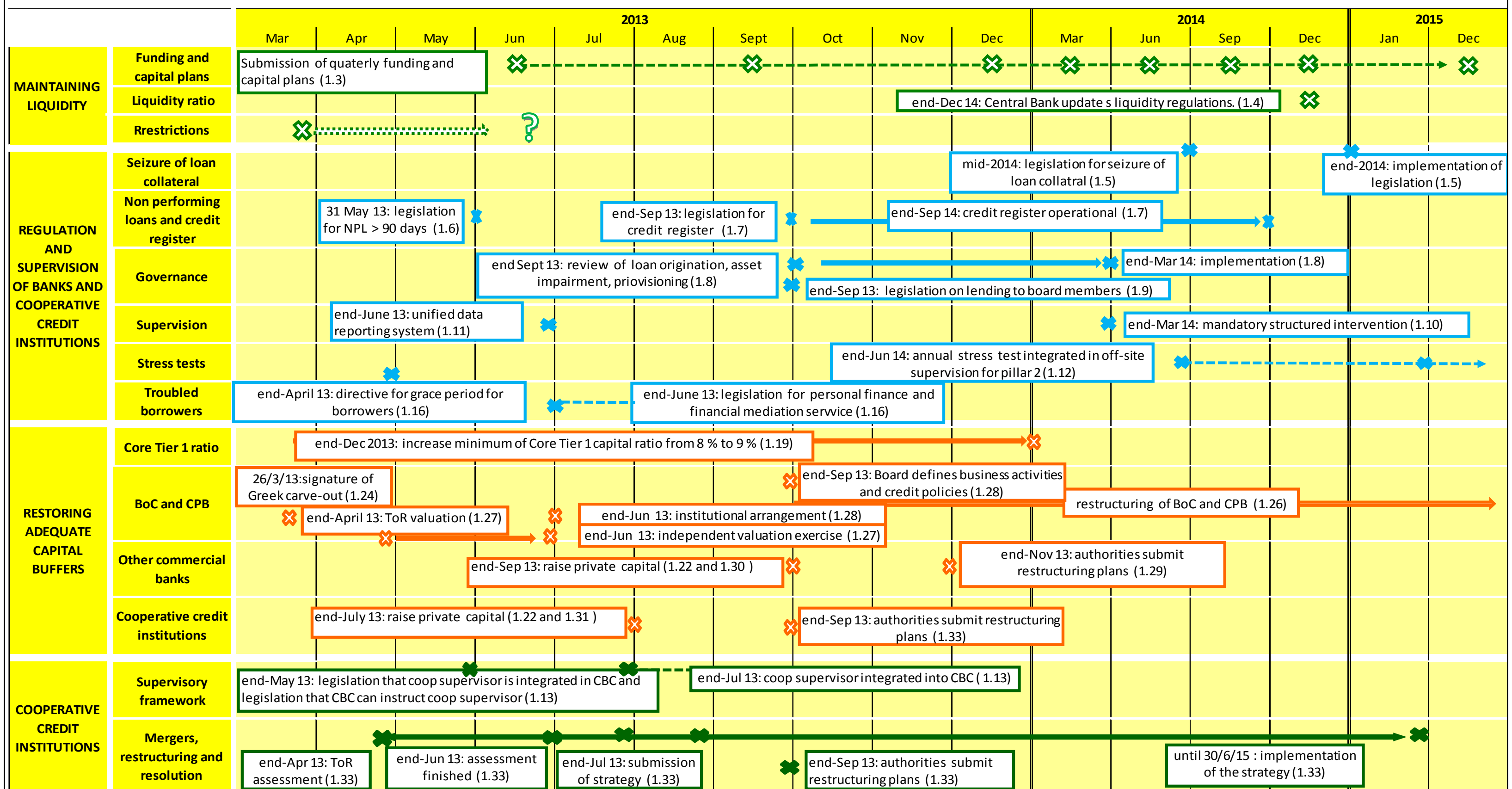
1.32. As regards the cooperative credit institutions, the CBC, assisted by the current supervisor and in consultation with the EC, the ECB and the IMF, will ascertain the viability of individual cooperative credit institutions and design a strategy for restructuring and recapitalising the sector.

1.33. This strategy, including the possibility of the application of mergers and restructuring, will be submitted to the EC, also informing the ECB and the IMF **by end-July 2013** based on an assessment of capital needs and viability to be finalised **by June 2013**. The terms of reference for this assessment will be finalised in consultation with the EC, the ECB and the IMF **by April 2013**. The restructuring plans for the cooperatives will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. Implementation of the strategy should be completed **by 30 June 2015**. Until the overall strategy has been agreed, there will be no change in the structure of the sector, without prior consultation with the EC, the ECB and the IMF.

1.34. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the first programme review and will be deposited in a dedicated account with the Central Bank to boost confidence in the system. The amounts will be injected following the identification of the capital needs and in accordance with the agreed strategy, after approval of the restructuring plans. A new governance structure will be established, which allocates clear levels of continued accountability and provides for proper incentives to avoid moral hazard, having regard to a two-tier supervisory system applied in other EU Member States.

1.35. Information pertaining to articles 1.4, 1.13, 1.14, 1.32 and 1.33, will also be shared with the ESM.

Time Span for Conditionality in the Financial Sector



2. *Fiscal policy*

Key objectives

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

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to correct the excessive general government deficit as soon as possible; (3) to this end, to fully implement the fiscal consolidation measures listed in Annex 1 and the fiscal consolidation measures for 2013 listed in paragraphs 2.2 – 2.11 below; (4) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms.[3] The authorities commit to the full implementation of these measures (see Annex I) and to monitoring the budgetary effect of the measures taken on a monthly basis. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. The fiscal measures taking effect in 2012 were included in the amended 2012 Budget Law, which was submitted to the House of Representatives after consultation with the programme partners (i.e. EC/ECB/IMF). Likewise, the budgetary measures with effect in 2013 were embedded in the 2013 Budget Law after consultation with the programme partners. The impact of the additional permanent measures for 2014 has been embedded in the multi-annual expenditure targets accompanying the 2013 Budget Law.

In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the

[3] The adopted bills amounted to consolidation measures of about 5.0% of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 2.3% of GDP in 2013, and 1.9% of GDP in 2014, and ½% of GDP in 2015-2016 based on the macro-economic projections of 23 November 2012.

programme period, cash revenues above programme projections, including any windfall gains,[4] will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a general government primary deficit of no more than EUR 395 million (2.4% of GDP) in 2013. The 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation.

Over 2013, the Cypriot authorities will rigorously implement the 2013 Budget Law with additional permanent measures of at least EUR 351 million (2.1% of GDP).

After consultation with the programme partners, the 2013 Budget Law was adopted in December 2012. The budgetary target for 2013 was also adopted, accompanied by elements for a medium-term budgetary framework, in particular expenditure ceilings for the budget years 2013-2015 for each government entity.

Additional permanent measures for 2013 will be adopted after review by and consultation with the programme partners and prior to the granting of the first disbursement of financial assistance (applicable to the measures outlined in 2.2, 2.3, 2.4, 2.5, 2.7, 2.8, 2.9, 2.10 and 2.11).

To this end, the Cypriot authorities will amend the 2013 Budget Law, which will contain the additional consolidation measures, and, accordingly, the revised general government primary deficit. In addition, the authorities will update the expenditure ceilings for the budget years of 2013-2015.

The additional consolidation measures will include the following and will, where legally possible, be applicable retroactively from 1 January 2013:

Revenue measures

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

2.3. Increase the statutory corporate income tax rate to 12.5%.

2.4. Increase the tax rate on interest income to 30%.

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

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

2.6. Undertake by June 2013 a reform of the tax system for motor vehicles, based on environmentally-friendly principles, with a view to raising additional revenues, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

2.7. Complete the increase in fees for public services by at least 17% of the current values.

Expenditure measures

2.8. Introduce measures to control healthcare expenditure (see 3.2, measures a), b), c), d) and e).

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

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

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

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

Fiscal policy in 2014

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014.

The budgetary target and the permanent measures for 2014 already adopted by the Cypriot authorities (see Annex I) were considered in the adopted Medium-Term Budgetary Framework, accompanying the 2013 Budget Law. After review by and consultation with the programme partners **by mid-September 2013**, the 2014 Budget Law will be adopted **by mid-December 2013**. The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document. The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided.

Fiscal policy in 2015-16

The Cypriot authorities will achieve a deficit in the 2015 general government primary balance of no more than EUR 344 million (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204 million (1.2% of GDP).

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

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

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While taking note that the Cypriot authorities have recently introduced significant reforms (as noted below), the implementation of further reforms of the pension system to address the high projected increase in pension spending may be necessary in order to put the pension system on a sustainable path. The overarching objectives of the reforms are: i) to reduce the increase in pension spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

In view of this, the Cypriot authorities have implemented/agreed to implement the following measures:

- separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme **by 30 June 2013**. The non-contributory part will be tax financed;
- for the General Social Insurance System (GSIS): (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012) ;
- for the Government Employee Pension Scheme (GEPS): (i) increase the statutory retirement age by 2 years for the various categories of employees; (ii) increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; (iii) while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iv) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; (v) introduce a change of indexation of all benefits from wages to prices; and (vi) pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013);
- ensure that total annual public pension benefits for public sector employees and state officials do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (in place since January 2013);
- ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013); and
- ensure that all of the above measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

An actuarial study for the GSIS will be carried out and submitted for peer review in the Ageing Working Group of the Economic Policy Committee **by end-July 2013**. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.

The actuarial study should project the scheme's finances on a cash basis. Given the financial sustainability focus, on the revenues side, the study should not take into account any government subsidy (i.e. contribution that is currently at 4.3% of the payroll and the return on the accumulated notional reserves as at the start of the projection period) with the exception of credited contributions and the contributions made by the government as an employer on behalf of its employees. On the expenditures side, the study should only take into account benefits related to contributions paid and credited contributions, i.e. excluding the costs related to the top-up for the minimum pension (which is considered to be tax financed). The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs.

After review by and consultation with the programme partners, if needed, a comprehensive reform with the aim of establishing the long-run viability of the system, will be carried out; and, this reform will be adopted **by end-December 2013** and enter into force **in Q1-2014**.

Health care expenditure

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted prior to the granting of the first disbursement of financial assistance:

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

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

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

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

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

In addition, the programme partners will review and be consulted on the following measures before their implementation:

f) assess and publish, before parliamentary discussion, the potential risks and benefits of the planned introduction of the National Health System (NHS) in an updated actuarial study, taking into account possible proposals for implementing NHS in stages **by Q2-2013**;

g) make the award of the tender for the IT-infrastructure conditional upon the results of the study and the decision for implementing the NHS;

h) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q4-2013**;

i) create protocols for laboratory tests and the prescription of pharmaceuticals based on thorough scientific evidence;

j) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;

k) conduct an assessment of the basket of the top 4 publicly reimbursable healthcare products in terms of annual spending and prepare a report to establish an integrated system for health-technology assessment to increase the cost-effectiveness of the basket of publicly reimbursed products; and prepare the implementation of 10 new clinical guidelines focusing on high annual volume and high cost diseases **by Q2-2013**;

l) start coding inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**;

m) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.11) **by Q1-2014**; and

n) define a basket of publicly-reimbursable medical services based on objective, verifiable, criteria, including cost-effectiveness criteria **by Q2-2013**.

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

Budgetary framework

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in law **by Q2-2013**;
- complete the adoption of the law transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts ensuring that adopted measures are fully effective **by Q2-2013**. In particular, integrate the presentation of the existing multi-annual budgetary objectives (MoU fiscal targets and the rolling three-year expenditure ceilings) into a comprehensive Fiscal Strategy Statement in compliance with MTBF requirements in the sense of Directive 2011/85/EU to guide the preparation of the 2014 budget **by Q2-2013**; and
- submit to the House of Representatives a draft high-level Fiscal Responsibility and Budget System Law applicable to the entire general government sector. The draft law will encompass, inter alia, macro-fiscal policy-making, and budget formulation and approval. It will address remaining gaps and inconsistencies and codify existing good budget practices **by Q4-2013**.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. As of 2014, the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to the annual financial report;
- put in place an adequate legal and institutional framework for PPPs designed according to best practices, including ex-ante assessment and monitoring of the fiscal risks of engaging in PPPs and concessions as compared to other public investments. A proposal for such a

strengthened legal and institutional framework for PPPs should be drafted **by Q3-2013** and implemented **by Q4-2013**; and

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

State-owned enterprises and privatisation

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

- establish an inventory of assets, owned by central government, municipalities and regional administrations, including real estate and land. As a first step, priority will be given to assets with the highest commercial value, including at least one third of SOEs **by Q2-2013** and the remaining SOEs **by Q3-2013**. This inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets will be ready **by Q3-2013**. The full inventory of all assets (SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;
- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.11) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfil this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and
- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**.

3.6. The Cypriot authorities will initiate a privatisation plan to help improving economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability:

- This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules;
- The privatisation plan will be based on the report reviewing the operations and finances of SOEs, as well as the inventory of assets. The privatisation plan will be created after

consultation with the programme partners, including asset-specific timelines and intermediate steps **by Q3-2013**;

- In parallel, the specific legal and institutional framework for the privatisation process will be drafted **by Q3-2013** and implemented **by Q4-2013**, after consultation with the programme partners; and
- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion by the end of the programme period and an additional EUR 400 million by 2018 at the latest.

Revenue administration, tax compliance, and international tax cooperation

3.7. The Cypriot authorities will propose a comprehensive reform plan to improve the effectiveness and efficiency of tax collection and administration **by Q4-2013**, for implementation as of the budget year 2014. The reform shall encompass the following elements:

- attribute personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company;
- attribute personal responsibility to the responsible manager for fraudulent filing of company taxes;
- strengthen powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer;
- harmonise the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and that there is an administrative appeals process for all of these taxes before going to the courts;
- increase staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- where not in place, establish clear performance objectives, including on revenue collection results, for each revenue administration entity, and improved transparency regarding the performance of revenue administration entities, e.g. via publication of the tax gap for main revenue categories (the difference between the tax owed and the amount actually collected);
- optimise use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities; (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers); (iii) improving the exchange of information, including data on natural and legal persons, between relevant authorities for tax collection purposes, taking into account legal provisions for data protection; (iv) enhancing reporting capabilities in relation to obligations under Council Directive 2003/48;
- enhance the efforts to reduce administrative burden on businesses, with a view to reducing informal activities and achieving voluntary compliance to the widest possible extent. In this

respect, systematically measure the time and cost for taxpayers to complete revenue administration procedures such as registration or filing;

- step up administrative tax fraud investigations and enhance cooperation between the tax and judicial systems, while addressing potential bottlenecks in the tax appeal system;
- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and
- remove from the income tax law the Director's prerogative to act as deemed necessary in relation to the application of the Law's provisions, including the decision on the withdrawal of lawsuit for unpaid taxes.

3.8. The Cypriot authorities will implement reforms, which build on the main recommendations derived from the diagnostic technical assistance mission conducted in February 2013. To this end, the authorities will elaborate a comprehensive reform agenda and consult with the programme partners on this agenda **by Q2-2013**.

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

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation [5] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure timely access to information on beneficial ownership of trusts and to an audit trail of financial transactions of trustees. To this end, the programme partners take note of the Cypriot authorities' intention to establish registers of trusts held by the respective competent supervisory authority and of the recently-introduced obligation to have, at any given time, for trusts under Cyprus law at least one trustee who is a resident in Cyprus. Professional trustees should be authorised or otherwise regulated (i.e. as lawyers, accountants or Trust and Company Service Providers) and all trustees, whether regulated or not, should be registered (see paragraph 1.17). Trustees should report information to their respective supervisors on their relation to a trust. In addition, the Cypriot authorities will require trustees of trusts under Cyprus law to declare their status to credit institutions[6] when using the financial system in Cyprus, and require credit institutions established in Cyprus to

[5] The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

[6] As defined bin Art. 2.1(1) of the Third Anti-Money Laundering Directive, 2005/60/EC

obtain a corresponding declaration of status from trustees of trusts created under and governed by foreign law as a mandatory condition for using the financial system in Cyprus **by Q3-2013**;

- ensure that they have timely access to information on who truly and effectively controls a company established in Cyprus. To this end, they will either a) require nominee directors[7] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs). In the case of the trustee service being provided by a TCSP, the information that the TCSP is a professional service provider will be accessible through the registers under the TCSP Law **by Q3-2013**;
- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and
- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

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

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

Immovable Property Tax Reform

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

3.10. In view of this, the Cypriot authorities have agreed to implement the following measures:

- implement a property price index that establishes the average property market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each non-agricultural cadastral plot **by Q2-2014**, in time for its application in the calculation of the immovable property tax in 2014. The index shall vary according to location and zoning as well as other building- and plot-related characteristics. Moreover, propose and implement a methodology for annual updates of such imputed market valuations;
- implement the recurrent immovable property tax based on imputed market valuations of land plots according to a unit tax base established by this property index **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent executive authority **by Q3-2014**; and
- in order to retain a stimulus to property demand and reduce distortions in property prices, provide for an extension of the reduction in property transaction fees until 2016 by Q2-2013.

In addition, the following studies should be initiated **by mid-2013**, and their recommendations implemented at the latest **from 1 January 2015 onwards**:

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- a further study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenue from transaction fees and taxes to recurrent taxation **by early 2015**.

Public administration reform

3.11. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will undertake the following reform measures:

- reduce impediments to staff mobility within the public and broader public sector, inter alia, by removing restrictions arising from the Public/Broader Public Service Laws as to the duration and placement of secondments, as well as the need for employee consent **by Q2-2013**; and
- in a first step, as of 1.9.2013, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following part 1 of the below review, in a second step, further reduce overtime and related costs to the public sector wage bill by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) **by Q1-2014**.

In addition, the Cypriot authorities will commission an independent external review of possible further reforms of the public administration based on the terms of reference already agreed with the programme partners.

The review will comprise two parts, covering the following areas:

Part 1:

- examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- examination of the possibility of abolishing or merging/consolidating Non-profit Organisations/Companies and publicly owned enterprises; and
- re-organisation/re-structuring of local government.

Part 2:

- appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and
- introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The first part of the review will be published **by Q1-2014**. The second part of the review will be published **by Q3-2014**. Based on the findings of the review, the Cypriot authorities will agree upon a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement a reform of the public administration (part 1 **by Q2-2014** and part 2 **by Q4-2014**).

Welfare system

3.12. The welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), the Cypriot authorities will carry out a reform of the welfare system to be implemented and applied as of 1 January 2014 after review by and consultation with the programme partners (draft reform plan to be submitted **by Q2-2013**). The reform will cover the following elements:

- streamlining the number of benefits available through merging and phasing out;
- better targeting of various social transfers, so as to reduce the total number of beneficiaries while protecting the most vulnerable by:
    - the introduction of a common definition of income sources, financial assets and movable and immovable property to be taken into account for means-testing, so as to ensure consistency across different benefit schemes;
    - the introduction or tightening of means-testing criteria, on the basis of the above definition, for benefit provision and continued access to benefits by lowering income thresholds, accounting for wealth such as financial assets, movable and immovable property, and broadening the sources of income to be taken into consideration. With respect to the latter, as a general principle benefits provided should be fully accounted for in the computation of personal income;
- a review of the appropriate levels of individual benefits and the index for adjustment of benefit levels; and
- transferring of all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Security, which should be appropriately equipped in terms of financial and human resources, reassigned from other departments of the public administration by Q1-2014 (see 3.11).

The reforms must be consistent with the fiscal targets defined in this MoU.

4. Labour market

Key objectives

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

Cost of living adjustment (COLA) of wages and salaries

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

- a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;
- a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and
- a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

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

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by end-2013**. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.

Minimum wage

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

Public assistance and activation of the unemployed

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.12. Therefore, the Cypriot authorities will:

- ensure that the planned reform of public assistance includes measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt. To this end, the draft reform plan on public assistance will be submitted to the programme partners by Q2-2013 for review and consultation;
- provide an assessment of current activation policies by Q2-2013; and
- review and enhance the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

5. Goods and services markets

Key objectives

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

Services Directive: Sector-specific legislation

5.1. The Cypriot authorities will adopt the remaining necessary amendments to the sector-specific legislation in order to fully implement the Services Directive, easing the requirements related to entry and establishment. In addition, requirements concerning minimum tariffs should be eliminated unless they are justified according to article 15(3) of the Services Directive. Amendments will be presented to the House of Representatives by Q2-2013 and minimum tariff requirements without justification will be abolished by Q2-2013.

Reform of regulated professions

5.2. The Cypriot authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in regulated professions, as required by the Services Directive by Q2-2013; and
- further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the exercise of activity by Q3-2013 and eliminating those that are not justified or proportional by Q1-2014; and
- requirements affecting the access to the activity shall be assessed in order to repeal those which are not justified or proportionate after the adoption of the Directive amending Directive 2005/36/EC on the recognition of professional qualifications and Regulation on administrative cooperation through the Internal Market Information System, and in accordance with the evaluation, methodology and timeframe to be defined in the said amending Directive.

Competition and sectoral regulatory authorities

5.3. The Cypriot authorities will:

- ensure the independence and enhance the effective functioning of the Commission for the Protection of Competition and its ability to enforce effectively the competition rules **by Q4-2013**; and
- ensure the necessary independence and power of the national regulatory authorities (NRA) and enhance their ability to exercise their responsibilities and to carry out effectively their tasks, including monitoring the competitive situation in their respective sector **by Q4-2013**.

Housing market and immovable property regulation

5.4. The Cypriot authorities will take the following measures to ensure market clearing of the property market, allow for efficient seizure of property collateral, and for market-based assessment of property prices, as well as alleviating the factors deterring both domestic and foreign demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- provide for mandatory registration of sales contracts for immovable property **by Q2-2013**. **By Q4-2014**, eliminate the title deed issuance backlog to less than 2,000 cases of immovable property sales contracts with title deed issuance pending for more than one year. The Cypriot authorities will enhance cooperation with the financial sector to ensure the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property, and implement guaranteed timeframes for the issuance of building certificates and title deeds;

- publish quarterly progress reviews of the issuance of building and planning permits, certificates, and title deeds, as well as title deed transfers and related mortgage operations throughout the duration of the programme;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the financial sector and government services **by Q4-2014**. Personal data privacy legislation shall be reviewed and amended to alleviate legal impediments to such electronic access, in particular concerning the procedures for proof of legal interest **by Q2-2013**;
- introduce legislation on amending the procedure on the forced sale of mortgaged property to allow for private auctions as under the rules for immovable property recovery under bankruptcy regulations. The Cypriot authorities shall enact regulations to provide for the conclusion of such private auctions within shortest feasible timespans (see 1.5) **by end-2013**; and
- better target the rules of court to improve the pace of court case handling. The Cypriot authorities shall assess the need for additional measures – including if necessary legislative reforms - to eliminate court backlogs by end of the programme. Moreover the authorities shall provide for specialized judges akin to the rules for criminal case handling in order to expedite the handling of cases under commercial and immovable property laws **by Q4-2013**.

Tourism

5.5. Tourism is an important export sector and is of great importance to domestic value added and employment. Since 2011, tourism has experienced a significant increase in tourism arrivals and incomes, while the prospects for the continuation of that upward trend in 2013 are excellent. In particular, in 2011, there was an increase of 10.1% in tourism arrivals and 12.9% in revenue growth compared to 2010, while in 2012 (latest data August) there was a further increase of 5% and 8.5% respectively compared to 2011. To strengthen the competitiveness of the tourism sector, the Cypriot authorities will:

- carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, increasing occupancy rates of hotels and promoting resident tourism during winter time, developing a multi-dimensional and high quality tourism, *inter alia,* by defining thematic niches such as sport, cultural and medical tourism, developing individual tourism, promoting professionalism of tourist service providers and ensuring the dissemination of best-practices on upgrading the quality of the services provided, improving the role of tourism-related infrastructure investment. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings **by Q2-2013**;
- facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments **by Q2-2013**; and

- in order to enhance attractiveness of the country as a destination, engage in a thorough analysis of the best means of achieving sufficient air connectivity for Cyprus, including by negotiating new or amending existing air services agreements.

Energy

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package has been completely transposed and fully implemented and notify the European Commission that the necessary legislation has been transposed; indicate the date of delivery of the first commercial supply of natural gas under a long-term supply contract, thereby ending Cyprus' derogation of an isolated energy network and initiating the application of the emergent market derogation; and indicate the intended duration of the latter derogation;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, to be developed under the full authority of the Cypriot Government, should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:
  1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;
  2. *an outline of the regulatory regime (CERA) and market organisation* for the energy sector and gas exports, which would be conducive to the introduction and proper functioning of open, transparent, competitive energy markets, taking into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues **by Q2 2013**; and
  3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage the public revenues from offshore gas exploitation. The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. In particular, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, giving due respect to the need to develop the hydrocarbon

industry, including the necessary infrastructure, the importance of bringing Cyprus' public debt on a steady downward path and the need to invest and generate value for all strata of society, including future generations **by Q3-2013**.

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

Appendix I—Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

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

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

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

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.11); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

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

Revenue measures

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

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

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

Fiscal measures with effect in 2013

Expenditure measures

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

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

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

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

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

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

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

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

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

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

i. freeze public sector pensions;

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

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

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

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

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

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

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

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

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

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

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

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

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

Revenue measures

I.17 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.18 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.19 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.20 Increase the standard VAT rate from 17% to 18%.

I.21 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.22 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

Fiscal measures with effect in 2014

Expenditure measures

I.23 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.24 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.25 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

Revenue measures

I.26 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

I.27 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.28 Increase the reduced VAT rate from 8% to 9%.

I.29 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.30 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

CYPRUS

REQUEST FOR ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—SUPPLEMENTARY INFORMATION

May 10, 2013

Prepared By | European Department

1. **This supplement provides information that has become available since the issuance of the staff report on April 30, 2013** (EBS/13/47). This information does not alter the thrust of the staff appraisal.

2. **The Cypriot authorities have adopted all remaining legislation and decisions required to comply with the prior action specified in the MEFP**. Specifically, the House of Representatives approved the necessary bills to implement a reform of property taxation and complete an average increase in fees of public services of 17 percent from current values. The Council of Ministers also approved the rationalization of housing programs.

3. **Eurostat released final fiscal numbers for 2012 on an ESA95 basis** (Tables 1, 2, 3). The 2012 fiscal deficit was revised upward to 6.3 percent of GDP relative to 5.6 percent of GDP estimated by staff based on provisional cash data. This reflects a 0.7 percent of GDP one off inclusion of insurance payments associated with the destruction of the Vassilikos power plant in 2011 that will be paid in 2013-2016 but is recorded upfront under accrual accounting. The composition of revenues and expenditures was also revised. On the revenue side, accrued VAT revenues were larger than estimated on a cash basis, while one-off direct tax revenues were smaller. On the expenditure side, capital outlays were larger than previously estimated, while wages and salaries (including pensions) declined, reflecting a smaller-than-estimated increase in pension outlays and a minor level revision for 2011. Staff projections of components were adjusted to reflect these changes, without impacting the fiscal targets.

4. **HICP year-on-year inflation in April declined to 0.1 percent from 1.3 in March.** This was mainly driven by lower prices of energy and clothing.

5. The temporary administrative measures have been eased further. The cash withdrawal limit for legal persons was increased from €300 to €500 per customer per day. The ceiling on wire transfers of businesses for domestic transactions not requiring authorization was raised from €300,000 to €500,000. The limit on the amount that individuals may transfer from one domestic bank to another was raised from €3,000 to €10,000 per month. The export of bank notes abroad per person per journey was raised from €2,000 to €5,000. The €5,000 monthly cap on credit and debit card spending abroad was abolished. Foreign banks have been exempted from restrictions, provided they complete an application process.

6. The ECB Governing Council decided to readmit market debt instruments issued or guaranteed by the Cypriot government for ECB refinancing operations. The decision, effective May 9, 2013, will likely contribute to ease bank liquidity pressures further.

Table 1. Cyprus: Selected Economic Indicators and Macroeconomic Framework, 2008–2020

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Real Economy					(Percent change, unless otherwise indicated)								
Real GDP	3.6	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8
Domestic demand	8.0	-7.0	1.9	-1.6	-6.8	-13.9	-5.9	1.0	2.1	2.8	2.7	2.4	2.4
Consumption	7.4	-4.6	1.4	0.4	-2.7	-11.5	-5.1	0.8	1.9	2.5	2.5	2.2	2.2
Private consumption	7.8	-7.5	1.5	0.5	-3.0	-12.3	-5.6	1.6	2.9	3.4	3.3	2.6	2.4
Public consumption	6.1	6.8	1.0	-0.3	-1.7	-8.9	-3.7	-1.7	-1.3	-0.6	-0.1	0.9	1.5
Fixed investment	6.0	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.5	5.5	4.3	4.2	4.0
Inventory accumulation 1/	0.9	-1.5	1.8	0.5	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.3	4.7	5.2	1.6	0.2	-0.1	-0.3	-0.3	-0.4	-0.4
Exports of goods and services	-0.5	-10.7	3.8	4.4	2.3	-5.0	-2.5	1.7	2.7	3.3	3.3	3.3	3.3
Imports of goods and services	8.5	-18.6	4.8	-0.7	-7.2	-16.0	-6.5	1.7	3.3	4.5	4.6	4.7	4.7
Potential GDP growth	2.4	1.7	1.6	1.8	-1.5	-8.5	-3.7	0.1	0.8	1.3	1.6	1.7	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.5	-3.7	-2.8	-1.8	-0.8	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	1.0	1.2	1.6	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	3.7	5.4	6.2	7.8	11.9	15.5	16.9	14.6	13.7	12.9	12.0	11.1	10.2
Employment growth (percent)	1.3	-0.4	1.0	-5.6	-4.1	-6.7	-3.1	1.1	1.3	1.2	1.2	1.2	1.2
Public Finance						(Percent of GDP)							
General government balance	0.9	-6.1	-5.3	-6.3	-6.3	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Revenue	43.1	40.1	40.9	39.8	40.0	40.6	39.0	39.8	41.2	41.7	42.1	42.2	42.4
Expenditure	42.1	46.2	46.2	46.1	46.3	46.6	46.7	45.4	43.6	42.4	41.9	42.0	42.5
General government primary balance	3.8	-3.6	-3.0	-3.9	-2.9	-2.4	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.1	86.2	109.1	123.3	125.7	121.7	115.9	111.7	108.1	105.0
Balance of Payments						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-4.7	-11.7	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.2	-2.5	2.4	3.9	3.8	3.4	3.1	2.8	2.4	2.1
Exports of goods and services	45.0	40.2	41.3	42.7	42.5	44.6	45.4	45.7	45.9	46.4	46.8	47.5	48.2
Imports of goods and services	56.4	45.7	47.5	46.9	45.0	42.3	41.5	41.9	42.5	43.3	44.0	45.1	46.1
Goods balance	-32.4	-25.5	-26.8	-24.2	-21.5	-19.8	-19.4	-19.7	-20.1	-20.5	-20.9	-21.5	-22.0
Services balance	21.0	20.0	20.6	19.9	19.0	22.2	23.3	23.5	23.5	23.6	23.7	23.9	24.1
Income, net	-3.9	-4.1	-3.0	0.6	-8.2	-3.8	-4.1	-4.3	-4.0	-4.0	-4.0	-3.9	-3.9
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.0	-0.6	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.2
Capital account, net	0.0	0.3	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	16.1	10.9	9.5	5.7	9.5	-30.2	-14.9	-11.1	-1.2	1.1	1.6	2.2	2.6
Direct investment	-5.2	13.2	0.4	2.1	12.1	0.0	0.5	4.3	4.6	3.1	3.0	4.0	4.0
Portfolio investment	-74.1	-101.1	-11.1	32.0	25.1	14.5	4.9	-3.4	-3.3	-3.2	-3.0	-2.8	-2.7
Other investment	93.8	98.2	19.0	-28.6	-27.9	-44.7	-20.4	-12.0	-2.6	1.2	1.6	1.0	1.3
Reserves (- inflow; + outflow)	1.7	0.5	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	...	...	...	...	32.0	15.3	11.8	2.1	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.9	9.9	12.6	1.8	8.4	9.1	9.1	9.3	9.5	9.5	9.6	9.5
Government	4.9	-0.6	-0.1	-1.8	-2.4	-3.1	-5.1	-2.9	0.2	2.0	2.9	2.8	2.5
Non-government	2.8	9.5	9.9	14.4	4.2	11.5	14.2	12.1	9.1	7.6	6.7	6.8	7.0
Gross capital formation	23.3	19.6	19.7	17.3	13.5	10.4	9.7	10.0	10.4	10.8	11.0	11.3	11.4
Government	4.0	5.5	5.2	4.5	3.2	2.9	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Non-government	19.4	14.1	14.5	12.8	10.3	7.6	7.1	7.4	7.7	8.2	8.4	8.6	8.8
Foreign saving	-15.6	-10.7	-9.8	-4.7	-11.7	-2.0	-0.6	-0.9	-1.0	-1.3	-1.5	-1.7	-2.0
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	18.0	17.9	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8

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

Table 2. Cyprus: Fiscal Developments and Projections, 2008–2020 1/

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
Revenue	43.1	40.1	40.9	39.7	40.0	40.6	39.0	39.8	41.2	41.7	42.1	42.2	42.4
Current revenue	43.0	40.0	40.8	39.6	39.9	40.6	38.9	39.7	41.2	41.6	42.1	42.2	42.3
Tax revenue	30.6	26.4	26.5	26.2	25.8	24.9	24.5	25.0	25.8	26.0	26.1	26.1	26.3
Indirect taxes	17.7	15.2	15.4	14.5	14.8	14.1	14.3	14.9	15.5	15.6	15.7	15.7	15.8
Direct taxes	12.9	11.2	11.1	11.7	11.1	10.8	10.2	10.1	10.3	10.4	10.4	10.4	10.5
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.7	9.1	8.8	9.0	9.1	9.2	9.4	9.5	9.5	9.6
Other current revenue	4.6	4.9	5.4	4.7	4.9	6.8	5.4	5.6	6.2	6.3	6.5	6.6	6.5
Sales	2.9	2.4	2.6	2.4	2.8	3.8	3.0	3.2	3.5	3.6	3.7	3.7	3.7
Other	1.8	2.5	2.8	2.3	2.2	3.0	2.4	2.5	2.7	2.8	2.8	2.9	2.8
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.1	46.2	46.2	46.0	46.3	46.6	46.7	45.4	43.6	42.4	41.9	42.0	42.5
Current expenditure	38.2	40.7	40.9	41.5	42.3	42.9	43.3	42.0	40.2	39.0	38.5	38.6	39.1
Wages and salaries	14.6	16.2	15.8	16.0	15.8	15.8	16.0	15.4	14.9	14.5	14.5	14.4	14.4
Goods and services	5.0	5.4	5.6	5.3	5.1	5.2	5.2	4.9	4.5	4.2	4.1	4.0	4.0
Social Transfers	12.2	13.5	14.4	14.6	15.1	15.6	16.1	15.7	15.1	14.7	14.4	14.5	14.6
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Interest payments	2.8	2.6	2.2	2.4	3.4	3.5	3.5	3.5	3.6	3.7	3.8	3.8	4.2
Other current expenditure	3.1	2.9	2.5	2.8	2.4	2.1	2.0	1.9	1.5	1.2	1.2	1.3	1.4
Capital expenditure	4.0	5.5	5.2	4.5	4.0	3.7	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Overall balance 2/	0.9	-6.1	-5.3	-6.3	-6.3	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.3	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.3	-5.9	-7.7	-5.6	-2.4	-0.7	0.2	0.2	-0.2
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.6	8.7	2.7	-0.8	-2.7	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.5	6.0	1.9	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.4	8.8	3.3	-0.8	-2.7	-2.3	0.0	0.0	0.0
Other financial assets	0.2	0.3	0.0	-0.4	0.1	-6.1	-2.5	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.6	14.9	14.6	10.4	4.8	-0.3	-1.6	-0.2	-0.2	0.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	1.7	-10.5	-4.2	-6.2	1.4	1.5	3.6	3.8	4.2
Loans	3.0	-0.3	0.0	4.0	12.6	25.2	14.5	11.0	-1.6	-3.1	-3.8	-4.0	-4.1
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Cyclically adjusted overall balance	-0.1	-5.8	-4.8	-5.4	-3.9	-2.6	-4.4	-2.9	-1.5	-0.6	0.2	0.2	-0.2
Cyclical balance	1.1	-0.3	-0.5	-0.9	-2.4	-3.3	-3.3	-2.7	-0.9	0.0	0.0	0.0	0.0
Cyclically adjusted primary balance	2.7	-3.2	-2.6	-3.0	-0.5	0.9	-1.0	0.6	2.1	3.0	4.0	4.0	4.0
Structural Primary Balance 2/	0.7	-3.5	-3.1	-2.4	0.5	1.0	1.2	2.9	4.5	5.5	6.4	6.4	6.4
Primary balance	3.8	-3.6	-3.0	-3.9	-2.9	-2.4	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.1	86.2	109.1	123.3	125.7	121.7	115.9	111.7	108.1	105.0

Sources: Eurostat, and IMF staff estimates.

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

2/ Cyclically adjusted primary balance net of one offs. Given the high uncertainty related to the size of the output gap and temporary versus permanent effects on potential output in the short run, it likely underestimates the amount of consolidation underway.

Table 3. Public Sector Debt Sustainability Framework, 2007-2020
(In percent of GDP, unless otherwise indicated)

	Actual							Projections										
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	2018	2019	2020		
								I. Baseline Projections										**Debt-stabilizing primary balance 8/**
Public sector debt 1/	58.8	48.9	58.5	61.3	71.1			**86.2**	**109.1**	**123.3**	**125.7**	**121.7**	**115.9**	**111.7**	**108.1**	**105.0**		**0.1**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Change in public sector debt	-6.6	-9.9	9.6	2.8	9.7			15.1	22.9	14.2	2.4	-4.1	-5.8	-4.2	-3.6	-3.2	0.0	
Identified debt-creating flows (4+7+12)	-9.3	-5.5	7.0	3.4	4.3			5.9	13.6	10.9	2.5	-2.0	-4.2	-4.9	-4.3	-3.9	0.0	
Primary deficit	-6.6	-3.8	3.6	3.0	3.9			2.1	2.4	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	**-0.1**	
Revenue and grants	45.0	43.1	40.1	40.9	39.8			40.1	40.6	39.0	39.8	41.2	41.6	42.0	42.1	42.3		
Primary (noninterest) expenditure	38.4	39.3	43.7	43.9	43.7			42.2	43.0	43.2	41.9	40.0	38.5	38.0	38.1	38.3		
Automatic debt dynamics 2/	-2.7	-1.7	3.4	0.4	0.4			3.8	11.2	6.7	0.4	-0.8	-1.2	-0.9	-0.3	0.1	0.1	
Contribution from interest rate/growth differential 3/	-2.7	-1.7	3.4	0.4	0.4			3.8	11.2	6.7	0.4	-0.8	-1.2	-0.9	-0.3	0.1	0.1	
Of which contribution from real interest rate	0.3	0.2	2.5	1.1	0.7			2.1	3.1	2.3	1.7	1.4	1.5	1.6	1.8	2.0	2.0	
Of which contribution from real GDP growth	-3.0	-1.9	0.9	-0.7	-0.3			1.7	8.2	4.4	-1.3	-2.3	-2.7	-2.4	-2.0	-1.9	-1.8	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	2.6	-4.4	2.6	-0.6	5.4			9.2	9.3	3.3	-0.1	-2.0	-1.6	0.7	0.7	0.7	0.0	
Public sector debt-to-revenue ratio 1/	130.6	113.5	145.8	150.0	178.5			214.9	268.5	316.5	316.1	295.2	278.8	265.9	256.9	248.3		
Gross financing need 5/	5.7	4.9	14.2	18.9	12.7			20.4	25.7	20.8	20.4	12.3	10.7	9.0	9.0	14.0		
in billions of U.S. dollars	0.7	0.6	1.7	2.5	1.6			2.8	3.2	2.5	2.6	1.6	1.5	1.3	1.4	2.2		
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation										For debt stabilization	Projected Average
Nominal GDP (local currency)	15.8	17.2	16.9	17.4	18.0	14.8	2.6	17.9	16.4	16.0	16.4	17.0	17.7	18.4	19.1	19.8	20.6	17.6
Real GDP growth (in percent)	5.1	3.6	-1.9	1.3	0.5	2.5	2.1	-2.4	-8.7	-3.9	1.1	1.9	2.3	2.2	1.9	1.8	1.8	-0.4
Average nominal interest rate on public debt (in percent) 6/	5.1	5.2	5.1	4.0	4.0	5.0	0.6	4.8	3.8	3.1	2.9	3.0	3.2	3.4	3.6	4.0	4.0	3.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.8	0.6	5.1	2.0	1.2	2.1	1.5	2.8	3.2	2.0	1.4	1.2	1.4	1.4	1.7	2.0	2.0	1.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.1	6.8	5.7	5.0	-4.6	-3.0	9.5	8.2	-3.0	0.6	0.7	0.8	0.7	0.7	0.0	0.0	0.0	1.0
Inflation rate (GDP deflator, in percent)	4.4	4.6	0.1	1.9	2.7	2.9	1.5	2.0	0.6	1.1	1.5	1.8	1.8	1.9	1.9	2.0	2.0	1.6
Growth of real primary spending (deflated by GDP deflator, in percent)	1.1	5.9	9.1	1.9	0.1	4.8	4.1	-5.8	-7.0	-3.5	-2.1	-2.7	-1.4	0.7	2.1	2.3		-1.9
Primary deficit	-6.6	-3.8	3.6	3.0	3.9	0.2	3.5	2.1	2.4	4.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0		-0.6
								II. Stress Tests for Public Debt Ratio										**Debt-stabilizing primary balance 9/**
A. Alternative Scenarios																		
A1. Key variables are at their historical averages in 2012-2020 7/								**86.2**	**94.3**	**96.9**	**96.6**	**94.7**	**93.2**	**93.5**	**93.9**	**94.2**		**-0.4**
A2. No policy change (constant primary balance) in 2012-2020								**86.2**	**108.8**	**120.9**	**126.4**	**128.7**	**130.2**	**132.1**	**134.6**	**137.6**		**0.2**
B. Bound Tests																		
B1. Real interest rate is at baseline plus one-half standard deviations								**86.2**	**109.8**	**124.9**	**128.2**	**125.1**	**120.2**	**116.8**	**114.0**	**111.7**		**1.0**
B2. Real GDP growth is at baseline minus one-half standard deviations								**86.2**	**110.8**	**127.6**	**132.8**	**131.7**	**129.2**	**128.9**	**129.6**	**131.3**		**1.6**
B3. Primary balance is at baseline minus one-half standard deviations								**86.2**	**110.8**	**127.0**	**131.1**	**128.8**	**124.7**	**122.2**	**120.3**	**118.9**		**0.2**
B4. Combination of B1-B3 using 1/2 standard deviation shocks								**86.2**	**112.8**	**131.3**	**137.9**	**137.8**	**136.0**	**135.8**	**136.4**	**137.5**		**2.6**
B5. 10 percent of GDP increase in other debt-creating flows in 2013								**86.2**	**119.1**	**133.9**	**136.4**	**132.3**	**126.4**	**122.1**	**118.5**	**115.3**		**0.2**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ 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.
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 for a given scenario.

Figure 1. Selected Structural Fiscal Issues

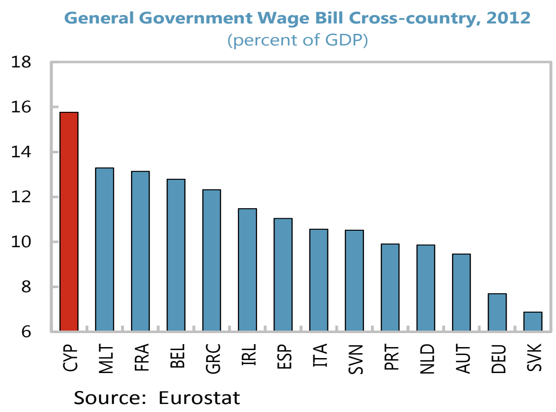


Figure 2. Public debt and Primary Balance

(percent of GDP)

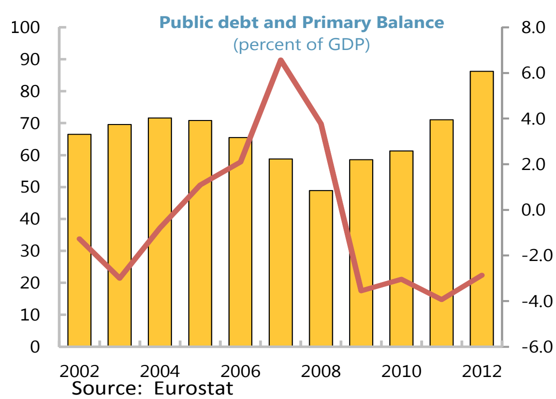
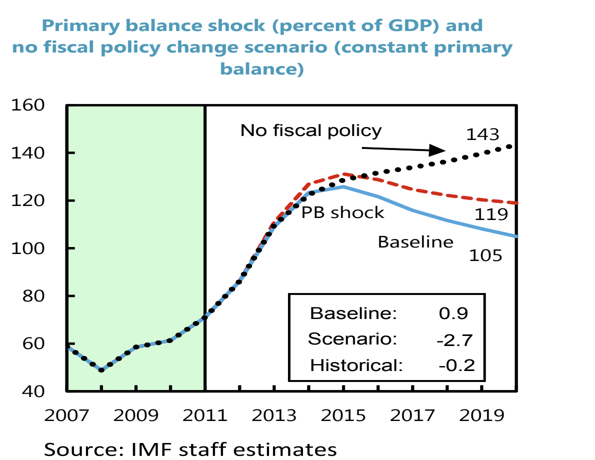


Figure 3. Public Debt Sustainability: Bound Tests



Press Release No. 13/175
FOR IMMEDIATE RELEASE
May 15, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves €1 Billion Arrangement Under Extended Fund Facility for Cyprus

The Executive Board of the International Monetary Fund (IMF) today approved a three-year SDR 891 million (about €1 billion, or US$1.33 billion; 563 percent of the country's quota) arrangement under the Extended Fund Facility (EFF) for Cyprus in support of the authorities' economic adjustment program. The approval allows for the immediate disbursement of SDR 74.25 million (about €86 million, or US$110.7 million).

The EFF arrangement is part of a combined financing package with the European Stability Mechanism (ESM) amounting to €10 billion. It is intended to stabilize the country's financial system, achieve fiscal sustainability, and support the recovery of economic activity to preserve the welfare of the population.

Following the Executive Board's action, Ms. Christine Lagarde, Managing Director and Chair of the Board, said:

"The Cypriot economy has suffered a confidence crisis, linked to weaknesses in the oversized banking sector and large external and internal imbalances. The authorities took bold steps to address the crisis, including the upfront resolution and restructuring of the two largest and insolvent banks at no fiscal cost, while protecting insured depositors. They also implemented ambitious fiscal consolidation measures. Nevertheless, challenges ahead are significant, including restoring credibility in the banking sector and reducing fiscal deficits and debt to sustainable levels.

"The three-year ESM/IMF-supported program will help Cyprus address these challenges. The program aims to achieve financial sector stability and debt sustainability to restore growth. The authorities' commitment to use internal financing resources, together with support from European partners, helps to ensure that the program is fully financed.

"The immediate priority is to stabilize the banking sector. The authorities need to complete the bank recapitalization process, including by using public funds for solvent institutions where necessary. In parallel, decisive steps will be taken to restructure weak banks. Temporary payment restrictions should be relaxed at a pace consistent with maintaining financial stability, while minimizing distortions to economic activity. It is important to strengthen supervision and regulation of banks and credit cooperatives, and to enhance the framework for anti-money laundering.

“Another priority is to achieve sustainable public finances. The fiscal consolidation package balances cyclical and sustainability considerations. It needs to be complemented by structural reforms to strengthen budget processes and revenue administration, while better targeting welfare programs to protect vulnerable groups. Additional fiscal measures of close to 5 percent of GDP will be needed in outer years to put debt on a sustained downward path.

“The macroeconomic outlook is subject to high uncertainty and risks to the program are substantial. There is no room for implementation slippages. Full and timely implementation of the program is critical to maintain credibility and achieve the program’s objectives,” Ms. Lagarde stated.

ANNEX

Recent Economic Developments

Cyprus accumulated large imbalances in the run-up to the global financial crisis. Sizeable non-resident inflows attracted by the low corporate tax regime led to a rapid increase in the size of the banking sector to over eight times GDP. These inflows helped to finance large current account deficits. It also facilitated fast domestic credit growth, fueling a housing boom and an increase in gross household and corporate sector indebtedness to one of the largest levels in the euro area. Loose fiscal policies, following Cyprus’ entry in the euro zone in 2008, contributed to a rapid rise in fiscal deficits and public debt.

Tight sovereign-bank links exacerbated these imbalances as the crisis intensified. Given deep financial links to Greece, as the Greek crisis unfolded, Cyprus’ sovereign debt spreads soared, and it lost market access by mid-2011. The economy fell into recession in late 2011, exacerbating the correction of the housing market that had started in 2009. This, together with the Greek private sector involvement, impacted banks’ balance sheets. Negative feedback loops further weakened public finances, and public debt climbed to 86 percent of GDP in 2012.

Program Summary

The authorities’ economic program aims to restore the health of the banking sector and place public finances on a sustainable footing. The program builds on resolute policy steps taken recently and aims to lay the foundations for a recovery of Cyprus’ economy.
Restoring financial sector stability: The authorities’ policy actions aim to place the banking system on a sustainable footing to restore financial intermediation and support economic activity. The program builds on the recent actions to deal with the two largest and troubled

banks to complete their recapitalization process. It also develops a strategy to recapitalize and restructure remaining viable banks and the cooperative sector, using public funds, as needed. The program supports the gradual removal of temporary restrictions while preserving financial stability. Finally, measures will be put in place to deal with private sector debt restructuring, reform financial sector supervision, and strengthen the Anti-Money Laundering (AML) framework.

Achieving sustainable public finances: The program entails an ambitious and well-paced fiscal adjustment that balances short-run cyclical concerns and long-run sustainability objectives, while protecting vulnerable groups. The consolidation will be anchored in a primary fiscal surplus target of 4 percent of GDP by 2018 needed to achieve a debt level of close to 100 percent of GDP by 2020. This includes an adjustment of 2¼ percent of GDP during 2013-2015, which has been recently implemented by the Cypriot authorities, in addition to 5 percent of GDP already underway for the same period of time. To attain the long-term debt and deficit targets while keeping a gradual approach to fiscal consolidation, a further effort of 4¾ percent of GDP will be implemented during 2015-18. Given the significant revenue measures already taken, the future consolidation is expected to rely largely on reducing spending. In addition, structural fiscal reforms will support these efforts, with privatization and reforms to the public wage indexation mechanism also helping to strengthen the economy's efficiency and competitiveness.

Growth Expectations

Output contracted by 2½ percent in 2012, with the decline accelerating toward the end of the year, as economic uncertainty intensified. Private demand led the decline: investment plunged by 25 percent, and consumption fell by around 3 percent. Activity is expected to contract by 9 and 4 percent, respectively, in 2013 and 14, consistent with other banking-crisis episodes.

As problems have been addressed upfront, removing a drag on economic growth, a gradual recovery is expected to start in 2015, driven by a normalization of private consumption and a rebound of investment from a low base. Growth is, however, expected to remain modest as the economy adapts its business model, stabilizing at just under 2 percent by 2020.

Additional Background

Cyprus, which became of member of the IMF on December 21, 1961, has an IMF quota of SDR 158.20 million.

For additional background on the IMF and Cyprus, see:
http://www.imf.org/external/country/cyp/

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

May 15, 2013

Background

On March 25 2013, after exactly nine months of protracted discussions since its request for assistance, Cyprus reached a political agreement with its international partners on the key elements of a macroeconomic adjustment programme. Cyprus's request for assistance on June 25, 2012 was triggered by increasing pressure in financial markets, against the background of rising concerns about the sustainability of its public finances and the increasingly fragile position of the two largest banks.

In the months and years leading to this point, several events and circumstances contributed to the deterioration of the Cypriot economy. Although Cyprus had weathered the beginnings of the European crisis relatively well, reluctance to correct long standing imbalances, the lax fiscal policies and the banking sector's large exposure to Greece had started taking the toll on the country's ability to refinance its debt at rates compatible with long term fiscal sustainability. These imbalances became increasingly more evident in 2011 as rating agencies launched a series of downgrades and investors increasingly focused on the large exposure of the country's banks to Greece. By mid-2011, Cyprus lost access to long-term sovereign debt markets.

While these imbalances were reasonably manageable at the time, the events that followed accelerated and magnified the island's problems. On July 11, 2011 a catastrophic explosion of a huge cache of confiscated munitions stored at a military base caused significant loss of life and destroyed the next-door Vassilikos power plant, which supplied half the island's power. The fallout included rolling blackouts in the summer months, with adverse effects on output and government revenues, deepening the sense of economic uncertainty. After the explosion, the economy was thrown into recession.

Three months later, on October 26, 2011 at the EU council in Brussels, the decisions taken on the Greek PSI resulted in an effective loss of about 80% of the value of the debt that the private sector held. Cyprus's two largest banks had significant exposures, costing them overnight more than €4.5 billion (around 25% of GDP) and a substantial amount of capital.

Failing to request assistance at that point, when the island's lending partners may have been more sympathetic, Cyprus's fate had taken a path of inevitability. Following these events, a new wave of consecutive downgradings rendered the sovereign debt non-investment grade and made government securities ineligible as collateral for borrowing from the euro system. In parallel, the banking sector was increasingly cut off from international market funding and major financial institutions recorded substantial capital shortfalls. The situation in the banking sector worsened dramatically in early-2013. The delays in concluding an assistance package, unfavorable statements and rumors in the press regarding deposit haircuts and the consequent fall in confidence led to accelerated and substantial deposit outflows.

Against the background of these severe economic and financial disturbances, on March 16 and 25, 2013, an agreement was forged on the key elements of a programme, which included the restructuring and substantial downsizing of the banking sector, the reinforcement of efforts on fiscal consolidation, and initiation of structural reforms. Arguably, the most important and extraordinary element of the programme was that the recapitalisation of banks would be almost exclusively generated from the banks' retail deposits. Deposits up to €100,000 were to remain unaffected. Amidst financial turmoil and public outcry, a bank holiday of 10 days was imposed, followed by an introduction of capital controls and restrictions on deposit withdrawals – a course of action considered necessary to prevent what was probably an imminent collapse of the banking system. At the same time, the separation of the Greek operations of Cypriot banks was a required feature that immediately downsized the banking sector by a significant amount. It was also pursued in an effort to eliminate any potential spillovers operating in either direction. In that context, Greek deposits in Cypriot banks were unaffected.

On April 2, 2013, an agreement at the technical level was reached in respect of a comprehensive policy package to be implemented in a 3-year macroeconomic adjustment programme whose key objectives, measures and outcomes are specified in the MEFP between the IMF and the Republic of Cyprus.

The programme

The authorities' concern, even dissatisfaction, regarding the chosen type of the unconventional financing method of "bailing-in" depositors and particularly the extent to which this took place, is no secret. However, a variety of reasons, some of which are explained in the staff paper, necessitated the use of this alternative. Furthermore, the delays in concluding an agreement between all parties involved, worsened the situation and magnified the size of the financing need that is now seeked out from the uninsured depositors, which the authorities accept some responsibility for. Even so, they would have hoped that the negotiations were dealt with a more sensitive and fair manner for the benefit of Cyprus, the euro area, the EU and for the programme in general.

Nevertheless, despite so harsh realities, the lingering problems and the demoralizing uncertainty overshadowing the island for the past year have finally been addressed. A macroeconomic adjustment programme has now been agreed that aims at restoring financial market confidence, re-establishing sound macroeconomic balances and enabling the economy to return to sustainable growth. To achieve these goals, the programme builds on three pillars:

(i) A financial sector policy that aims to restore financial stability and resume credit to support economic activity. Building on the restructuring and downsizing of its financial institutions, the recapitalization of the whole system will be completed, supervision will be further improved and private sector debt will be restructured. Furthermore, despite several independent positive evaluations with respect to the AML practices (FATF-MoneyVAL, Basel Institute of Governance AML index etc.), the authorities will further strengthen the AML framework to satisfy any remaining concerns for good. Similarly, the independent evaluation in banks by an external auditor and MoneyVal that was requested of Cyprus, has recently been completed.

The results serve to further evidence that some perceptions abroad were highly exaggerated. At the same time it is acknowledged that there is room to improve and the recommendations made will be taken on board.

(ii) An ambitious fiscal consolidation strategy, building on the consolidation efforts initiated in 2012, in particular through measures to reduce current primary expenditure, enhance government revenues, improve the functioning of the public sector and maintain fiscal consolidation in the medium-term. The aim is to correct the government deficit while balancing short-run cyclical concerns and long-run sustainability objectives.

(iii) A broad structural reform agenda, with a view to improving competitiveness and sustainable and balanced growth, in line with country-specific recommendations addressed to Cyprus in 2012, and allowing for the unwinding of macroeconomic imbalances.

Policy developments

Fiscal sector

The Government is committed to working with its international partners in implementing a determined deficit reduction strategy. The strategy tries to balance the need for fiscal correction without hindering economic recovery. Accordingly, the authorities re-confirm their commitment to the fiscal adjustment targets set forth.

A key objective of the fiscal strategy is to achieve a continuous strengthening of the primary budget balance over the programme period, resulting in a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. This constitutes an ambitious but feasible improvement in the primary balance of close to 4 p.p. of GDP over 2013-16 and close to 3 p.p. of GDP over 2017-18. The consolidation schedule is also considered appropriate in addressing the need to balance cyclical considerations and sustainability concerns.

Building on past peer experiences, the authorities are fully cognizant that programme ownership and implementation are key. Confirming their commitment, the majority of the fiscal adjustment measures for the programme had already been enacted by the parliament in December 2012 almost unanimously. These were identified as potential prior actions following the November 23, 2012 staff-level agreement and legislated well before signing the MEFP, without having any assurances at the time for imminent financing. The measures represented around 5% of GDP and included the bulk of fiscal measures for 2012-16 (outlined in the paper), as well as important steps in relation to fiscal-structural reforms. The range of fiscal-structural and structural reforms agreed and detailed in the staff paper include establishing a medium-term budgetary framework, undertaking pension system, health care and welfare system reform measures, enhancing revenue collection and tax administration and ensuring improvement to the public finance management and the functioning of the public sector.

Subsequent to the March 25, 2013 Eurogroup political agreement, new additional fiscal consolidation measures of around 2.2% of GDP for 2013 have been legislated and implemented, namely (i) an increase in the statutory corporate income tax to 12.5%, (ii) an increase in the interest income withholding tax to 30%, (iii) an increase in the bank levy to 0.15% and (iv) a revision of the property tax and of the social housing schemes.

With these, all the remaining prior actions pending at the time the staff paper was issued have now been completed.

Financial sector

The authorities are moving rapidly with the plans for a complete overhaul of the financial sector. Most importantly, on March 22, 2013, the Parliament adopted legislation establishing a comprehensive framework for the recovery and resolution of credit institutions. The new framework allowed the carve-out of the Greek operations of the largest Cypriot banks, the resolution of Cyprus Popular Bank and the transfer of selected assets, insured deposits, interbank liabilities and ELA to the Bank of Cyprus. The upfront actions have addressed immediate concerns while reducing the domestic banking sector from 550 to 350 percent of GDP. Furthermore, the recapitalization of the Bank of Cyprus was done mainly through the conversion of uninsured deposits into equity. The structure implies a minimum of a 37.5% conversion ratio with a maximum of 60% pending the completion of a new independent evaluation of the bank's assets and liabilities. Once the recapitalisation is completed, Bank of Cyprus could then resume normal activity and will also regain its eligible counterparty status for the purpose of participation in regular Eurosystem monetary policy operations.

To preserve the liquidity of the Cypriot banking sector administrative measures on capital flows have also been imposed. However, as restrictions remain in place and depositor uncertainty remains, there is still way to go to rebuild confidence in the viability of the banking system and lay down the conditions for growth.

It must be reiterated that the capital restrictions are an undesirable but necessary constraint. However, as unwelcome as they are – particularly given that they are disrupting economic activity – premature lifting could undermine financial stability. The authorities intend to fully pursue their complete removal at the earliest opportunity. Early lifting would be facilitated by external support in terms of liquidity as well as supporting communication regarding the strength of the restructured banking system. Notwithstanding, after a series of gradual relaxations, the latest decree[1]entails significant relaxations of the measures, further to those pointed out in Box 3.

Recapitalization of the Banking System

In consultation with program partners, PIMCO was commissioned to undertake an independent due diligence of Cypriot financial institutions. The due diligence which was completed in January 2013 covered 22 institutions representing approximately ¾ of the Cypriot banking system's assets. These capital needs are the result of a comprehensive and conservative analysis following a bottom up evaluation of credit portfolios and foreclosed assets, and of the earnings capacity of the banks to absorb losses over the next three years

[1] http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12776

under a base and an adverse scenario.

The final report identified an overall capital shortfall of €5,980 million in the Base Scenario (to reach a Core Tier 1 of 9% by the end of the programme) and €8,867 million in the Adverse Scenario (to reach a Core Tier 1 of 6% by the end of the programme). As regards to the solvency problems of the two largest banks pointed out in the paper, it should be clarified that these translate to a negative capital of €2,060 million under the baseline scenario. It must also be noted that for the restructured institutions, the recapitalization now taking place is completed under a stricter target, aiming to reach 9% under the adverse scenario by the end of the programme. In that context, preliminary estimates point towards a Core Tier 1 ratio of around 18% for the recapitalized structures.

Furthermore, unlike previous exercises in peer countries, PIMCO has used a more conservative methodology in arriving to the final numbers, providing an implicit buffer for a worse than expected macroeconomic environment. Namely, in contrast to comparable stress test exercises where expected loan losses were calculated on an undiscounted basis, the calculation of expected loan losses under this exercise projected recoveries discounted at the original effective rate of the loan. Also very conservative assumptions were used for estimating the recovery amounts on defaulted borrowers including, particularly, the application of a forced sale discount of 25% on the projected declining market value of property collateral.

Outlook

Under the staff-level agreement of November 23, 2012, projections of the economic outlook for 2013 and 2014 were pointing to a prolonged recession with a cumulative loss in output of around 5%, due to declines in domestic demand and investment activity resulting from fiscal consolidation and subdued credit growth. The external sector was set to provide a positive contribution to growth in both years as prospects for the export of goods and services were seen to remain favorable, particularly for tourism and business services.

Following political agreements in the Eurogroup on March 16 and 25, 2013, real GDP is now projected to contract by 12½% cumulatively in 2013-14. This arises largely from the frontloaded banking sector restructuring of the island's two largest banks combined with the extensive bail-in of uninsured depositors. As these two banks constitute more than 70% of the domestic deposit market, the choice of this financing instrument will have severe implications on GDP via numerous channels. First, the loss of working capital by Cypriot businesses held at the two main banks is estimated to be around 50% or close to 100% of their deposits over €100,000, depending on the bank. Similarly, a number of households saw much of their wealth in the form of savings disappear overnight. Second, a liquidity shock is unraveling due to the remaining deposits in these banks being frozen for months; 90%-100% of deposits over €100,000 have either been converted or frozen. Third, the fallout from an irreversibly damaged sector that constituted a significant part of GDP i.e. banking, finance and related services. Fourth, the impact of fiscal consolidation already undertaken and new measures agreed will further hamper domestic demand. Finally, all of the above are amplified by the unprecedented internal and external capital controls required to safeguard financial stability. In turn, these will hinder international capital flows and reduce business volumes in both domestic and internationally oriented companies. Overall, the above channels will sharply reduce private consumption and business investment. Little relief can be expected from exports amid uncertain external conditions and a damaged financial service sector.

Given that the key problems are addressed upfront, a large drag on growth is expected to be lifted. As such, growth is projected to rebound in 2015. The fiscal consolidation is expected to help restoring consumers and investors' confidence in the medium-term. The ongoing deleveraging of both household and corporate balance sheets will over time remove the impediment to a more balanced growth. At the same time, the restoration of a sound and well-capitalized banking system is expected to gradually loosen the tight credit conditions in the economy. However, the medium-term recovery of economic activity depends very heavily on the restoration of confidence, and measures and reforms to directly boost medium-term economic growth are rather sparse in the programme. In this respect, additional policy measures could entail investment projects financed from FDI and European institutions. There is no fallacy; the authorities are well aware of the risks that lie ahead. In these circumstances, any preliminary forecasts come with a high degree of uncertainty. Staff correctly point towards the difficulty in estimating the impact on real GDP and the deflator with sufficient accuracy, the potential creation of a vicious cycle of bankruptcies and unemployment given the systemic nature of these banks as well as the remaining banking sector risks such as litigation risks or risks of longer lasting lack of confidence in the banking sector. These, of course, are inherent with the choice of financing and must, or should, have been expected when that choice was being made.

Nevertheless, it is worth noting that some reprieve may be had from a programme design which builds on past experiences. Furthermore, as explained above, the bank recapitalization exercise was completed under a more conservative methodology relative to those applied in similar exercises in the euro zone. In addition, given the uncertainty surrounding the macroeconomic outlook, a buffer of about 10 percent of GDP has been included in the baseline analysis, leaving space for a larger than expected recession. Finally, it must be noted that no impact has been assumed in staff projections from investments projects related to the energy sector and the prospects of exploitation of natural gas, which should contribute significantly and increasingly to economic growth in the coming years. As such, the authorities expect a higher long-run growth than that envisaged by staff.

Conclusion

Although the agreement with the international partners has been accepted reluctantly by the authorities, given the constraints posed conditioning support, they are fully committed to ensure its resolute implementation. While difficult for the people of Cyprus, the degree of social cohesion in the face of the adjustment so far has been impressive and commendable. This constitutes a powerful assurance of engagement and ownership of the programme. Looking forward, Cyprus is faced with an extremely difficult and challenging path ahead through an extended period of consolidation and repair. However, after a long and tiring period of uncertainty, there is at last a paved path. With the financial support and expertise of Cyprus's international partners, including commitments by the Russian Government on softer terms for the loan repayment for which the authorities are grateful for, the joined efforts now in place will see Cyprus through this difficult time.

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