INTERNATIONAL MONETARY FUND

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CYPRUS

December 2013

SECOND REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFCATION OF PERFORMANCE CRITERIA.

In the context of the Second Review under the Extended Arrangement under the Extended Fund Facility and Request for Modification of Performance Criteria, the following documents have been released and are included in this package:

- The **Staff Report** for the Second Review under the Extended Arrangement under the Extended Fund Facility and Request for Modification of Performance Criteria, prepared by a staff team of the IMF for the Executive Board's consideration on December 20, 2013, following discussions that ended on November 7, 2013, with the officials of Cyprus on economic developments and policies underpinning the IMF Extended arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on December 6, 2013.
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Cyprus.

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

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

*Also included in Staff Report

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

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CYPRUS

December 6, 2013

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

EXECUTIVE SUMMARY

Extended Arrangement: On May 15, 2013, the Executive Board approved a three-year Extended Arrangement under the Extended Fund Facility in the amount of SDR 891 million (563 percent of quota; about €1 billion). Two purchases of amounts equivalent to SDR 74.25 million (about €86 million) each have been made so far, and another purchase of the same amount is proposed to be released upon completion of the second review. The European Stability Mechanism has released €4.5 billion since the program approval (of €9 billion committed).

Recent Economic Developments: The recession through September, though deep, has not been as large as expected. Private consumption has been relatively resilient, economic sentiment continues to improve, and exports, including tourism, have held up. Nevertheless, the situation remains difficult, with unemployment on the rise and disposable incomes falling. Banks are curtailing credit as asset quality continues to deteriorate, and private sector indebtedness remains very high. In this context, the growth forecast for 2013 has been revised upwards modestly, but a deeper contraction in 2014 is now envisaged, consistent with a more gradual private sector deleveraging process.

Policy Implementation: The program is on track. Fiscal performance continued to exceed targets comfortably, and the 2014 budget is more ambitious than envisaged at program approval. All structural benchmarks were met, albeit with a modest delay in one case. Significant progress has been made in restructuring and recapitalizing the banking sector, including with foreign participation in the share capital of one domestic bank. Looking forward, efforts must concentrate on ensuring full implementation of banks' restructuring plans to clean up balance sheets and pave the way for a return of credit to the private sector. Fiscal structural reforms are proceeding, but strong resolve is needed to kick-start the privatization process. The program remains subject to large uncertainty given lingering financial sector vulnerabilities and continued challenges to policy implementation.

Approved By
Philip Gerson and Mark Flanagan

Discussions were held in Nicosia during October 28-November 7. The mission met with the Minister of Finance, the Governor of the Central Bank of Cyprus, other Cabinet Ministers, members of Parliament, leaders of main political parties, union representatives, and representatives of the private sector. Staff worked in conjunction with representatives from the European Commission and the European Central Bank. The IMF team comprised Delia Velculescu (head), Nikita Aggarwal, Luis Cortavarría, Katja Funke, Alejandro Hajdenberg, Yinqiu Lu, Emmanuel Mathias, Jeta Menkulasi, Uffe Mikkelsen, François Painchaud, Jiri Podpiera, Alejandro Simone, Mario Tamez, and Oliver Wuensch. Mr. Vincenzo Guzzo (Resident Representative) assisted the mission. Mr. Kanaris (OED) attended some of the meetings.

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BACKGROUND

1. **The program is on track.** All end-September quantitative performance criteria (PCs) were met with comfortable margins, and all continuous performance criteria were observed. The end-September and end-October structural benchmarks (SBs) on launching the recapitalization offer for Hellenic Bank, amending anti-money laundering (AML) legislation, and assessing the restructuring plan for Bank of Cyprus (BoC) were also met, and the requirements of the benchmark on the adoption of a legal framework for a central credit register were met with a modest delay. Moreover, the end-December structural benchmark on fully recapitalizing Hellenic Bank was met on November 1, without recourse to state aid and with the participation of foreign investors.

2. **Developments in Europe remain supportive of the program.** The modest recovery in the euro zone is providing some upside to Cyprus through increased trade. The pending conclusion of adjustment programs in some eurozone periphery countries may also be contributing to a rebound of market confidence in the area, and likely influenced the recent foreign interest in the recapitalization of Hellenic Bank. The ECB's continued accommodative monetary policy stance, reflected in the recent interest rate cut, as well as its favorable collateral policies for program countries, are supportive of Cyprus's cyclical position and bank liquidity needs. Finally, efforts to advance the banking union are expected to help to provide a stronger supervisory framework for Cypriot banks.

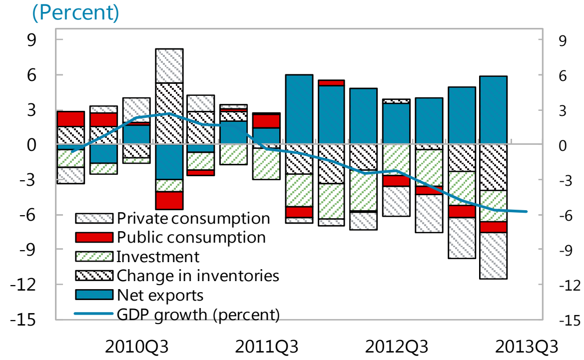
3. **Domestic political support for some elements of the program is, however, sputtering.** The opposition left-wing party (AKEL) continues to strongly criticize the program. But other parties also expressed reservations with parts of the program, including the privatization of some assets and the efforts to facilitate private sector debt restructuring. Labor unions are also mobilizing against austerity measures and privatization, with demonstrations planned in mid-December. Finally, ongoing tensions between the President and Central Bank Governor, and within the top management of the Central Bank of Cyprus (CBC), are complicating decision making and are not conducive to a return of confidence in the financial sector.

RECENT ECONOMIC DEVELOPMENTS

4. **The recession though severe, has been less deep than expected.** In the third quarter, output fell by 0.8 percent quarter-on-quarter (seasonally adjusted) and 5.7 percent year-on-year (y-o-y), bringing the annualized growth decline for the first three quarters to 5.5 percent, against the original program projection of 8.7 percent for 2013. Negative growth rates were recorded in construction and manufacturing, as well as in banking, transport, trade, and other services. While third quarter data on demand components are not yet available, retail sale volumes, which are highly correlated with private consumption, fell by only 2.8 percent y-o-y, pointing to consumption smoothing by households. Indeed, anecdotal evidence suggests that individuals prefer to spend their current income rather than save it through the banks, and dissolution of some provident funds may have provided a windfall, allowing households to dip into their long-term savings. The

contribution of net exports to growth is likely to have been strongly positive in the third quarter, as exports of goods grew and tourism receipts through September were up by about 8 percent relative to 2012, reflecting a shift toward Russian and other non-EU tourists with a higher propensity to spend. At the same time, imports continued to contract, albeit more slowly than in the second quarter. While still low, confidence has continued to improve through November, reaching levels last seen in mid-2012. Other recent indicators point to continued depressed investment, but do not suggest a significant worsening (Figure 1).

Contributions to GDP Growth 1/
(Percent)

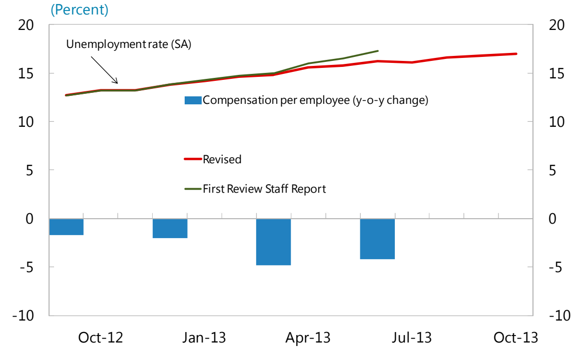


Source: Cystat.
1/ For 2013Q3, only the flash estimate for total GDP growth is available.

5. Unemployment continues to rise, but wages are also adjusting, cushioning some of the impact on jobs.

- The ***unemployment rate*** (harmonized Eurostat definition) reached 17 percent in October (seasonally adjusted), largely driven by the voluntary retirement schemes in BoC and Laiki Bank (which led to more than 1,500 redundancies). This constitutes an increase of close to 1 percentage point relative to end-June figures, which have been revised downward by about 1 percentage point, on account of a larger labor force (and employment) than previously estimated.

Labor market
(Percent)



Sources: Eurostat; and IMF staff estimates.

- Economy-wide ***compensation per employee*** (after statistical revisions) declined by 4.5 percent y-o-y in the first two quarters. In the public sector, reductions for the first half of the year averaged 8.1 percent, capturing wage cuts implemented in the 2013 budget. For the private sector, the average reported wage decline was only close to 2 percent relative to a year ago. However, average changes likely underestimate the magnitude of the overall wage decline, given that those made redundant had lower salaries, which contributed to an initially lower average wage (new employees are also being reportedly hired at lower initial wages). Indeed, a recent study by Cystat shows that when wage

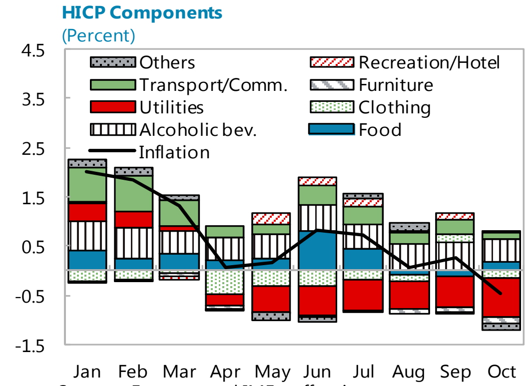
Employment and Wage Developments, June 2013 vs. June 2012
(Percent)

	Change in employment	Matched employees out of employees in 2012 1/	Change in earnings: Before matching	Change in earnings: After matching
Total	-17	68	-1.8	-4.1
Trade	-19	71	-3	-6
Accommodation and food services	-8	67	-2	-2
Manufacturing	-23	67	-1	-5
Construction	-43	48	-1	-9
Professional, scientific and technical activities	-8	77	-3	-4
Financial and insurance activities	-14	79	-6	-1

Source: Cystat.
1/ Matched employees denote employees holding the same job in June 2012 and June 2013.

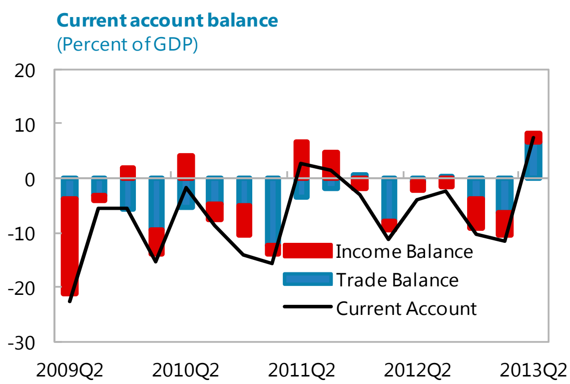
developments are evaluated only for employees who remained in their job, the average decline is more than double that reported. Indications are that wages have continued to adjust in the third quarter, as additional wage cuts of 5-15 percent were agreed in BoC and cuts of 25 percent were negotiated in new collective agreements in the construction sector. Negotiations on further wage cuts are reportedly ongoing in the broader banking sector and in large construction firms.

6. Inflation is moderating. Headline inflation (HICP) reached -0.5 percent in October, the lowest level since October 2009, bringing the year-to-date average inflation to 0.7 percent, half the euro-area average. The decline in prices was largely driven by energy, although other categories (such as clothing and furniture) also registered declines. Core inflation stood at -0.1 percent at end-October.



Sources: Eurostat; and IMF staff estimates.

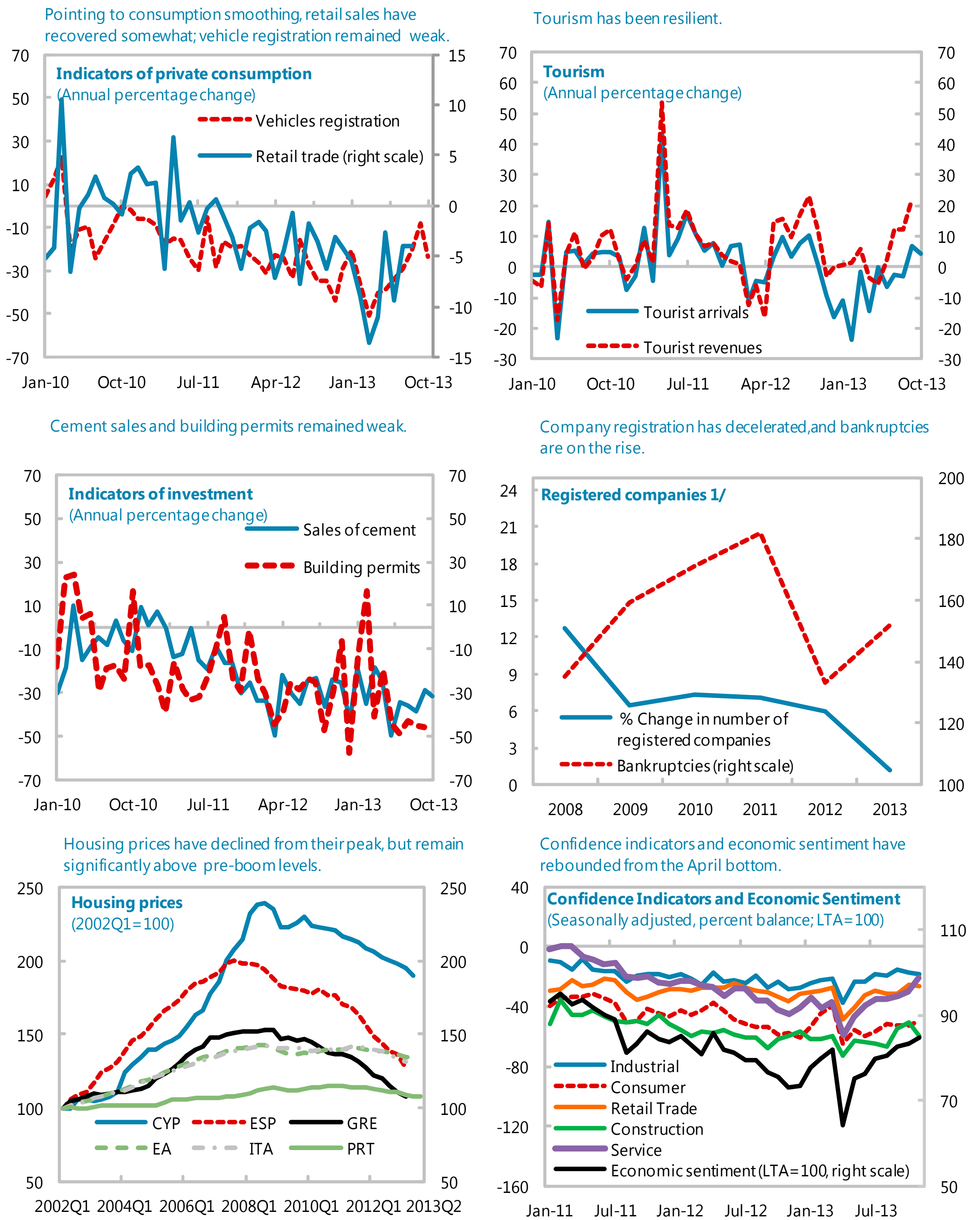
7. The current account moved to a surplus of 7.4 percent of GDP in the second quarter. This compares with deficits of about 11.4 (revised from 12.4) and 4 percent of GDP a quarter and a year ago, respectively. The turnaround was largely driven by an improvement in the trade balance, which registered a surplus of 6.5 percent of GDP on the back of a sharp import compression (of 21 percent y-o-y). The income balance also improved, reflecting lower income paid as external liabilities continued to decline, and a temporary boost in receipts on portfolio equity. As noted above, high-frequency indicators suggest that, in the third quarter, the external adjustment continued, although this was likely driven by an improvement in exports of goods (which grew by 7.4 percent y-o-y) and a rebound in tourism services, while the contraction in imports moderated to 14.4 percent y-o-y.[1]



Sources: Central Bank of Cyprus and IMF staff estimates.

[1] Staff's estimate of exports of goods excludes the one-off transfer of economic ownership of mobile transportation equipment (€24.5 million) that occurred in September. Including the latter, exports of goods increased 14.4 percent in the third quarter.

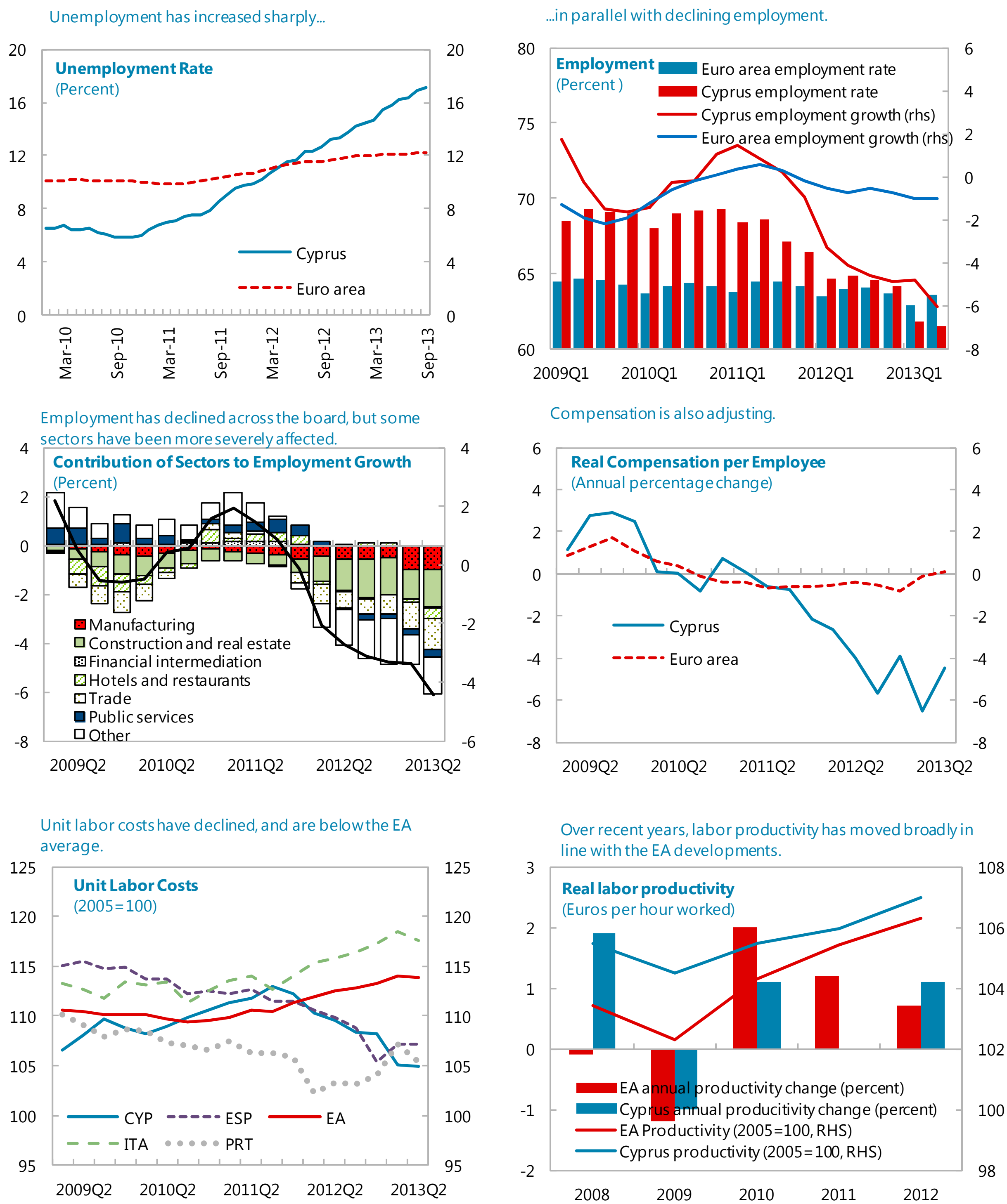
Figure 1. Cyprus: High Frequency Indicators



Sources: CYSTAT; Eurostat; and IMF staff estimates.

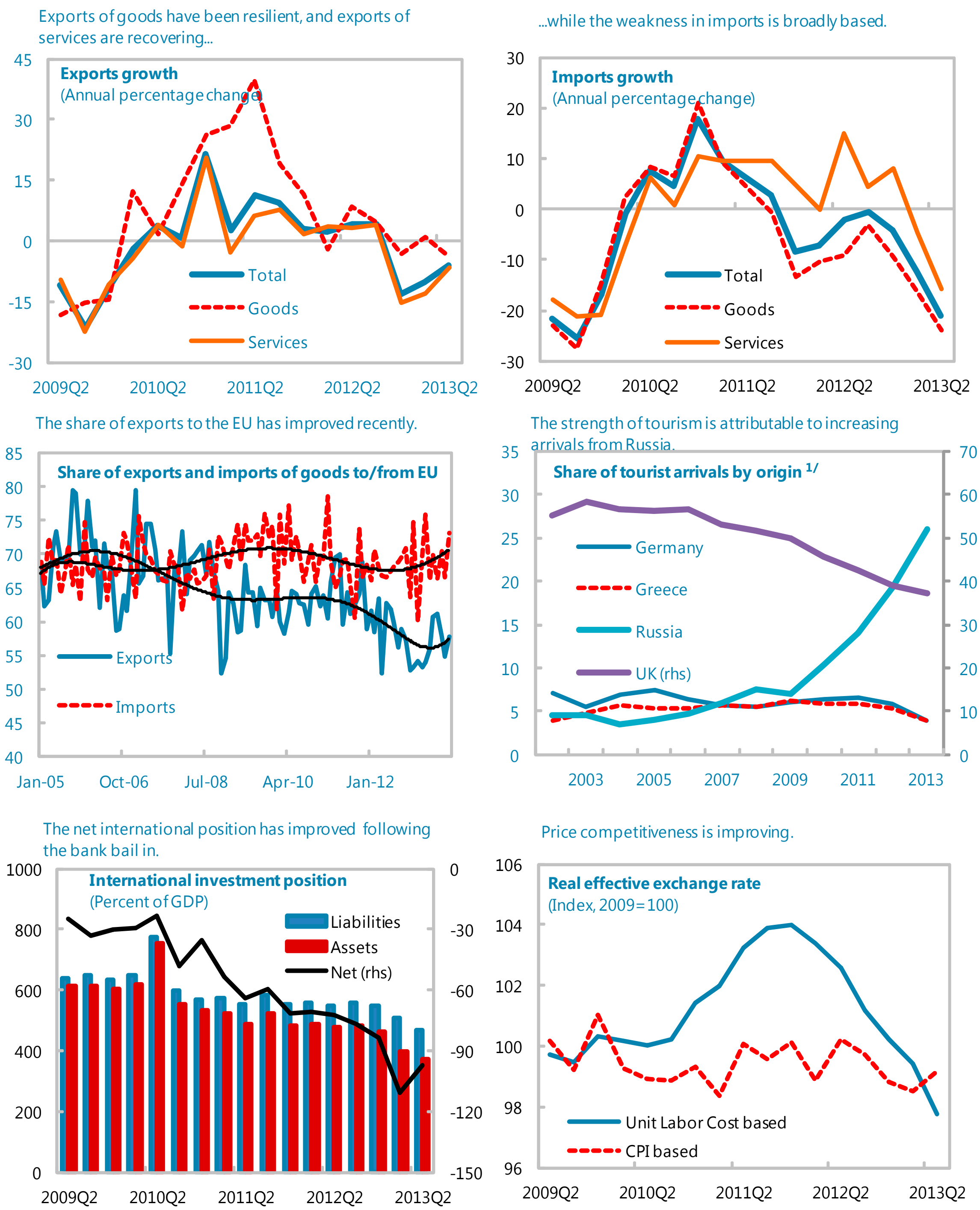
1/ 2013 figures correspond to annualized data through October.

Figure 2. Cyprus: Labor Market



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

Figure 3. Cyprus: External Indicators



1/ For 2013, data up to October.

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

8. Fiscal performance through end-September continued to be better than programmed. The cumulative primary fiscal balance through the third quarter registered a surplus of 0.7 percent of GDP, an over-performance of 3.1 percent of GDP relative to program projections (text table). Revenues were higher than expected by 1.4 percent of GDP, on account of smaller-than-projected declines in direct and indirect tax collections and social contributions, given the relatively better growth outturn. Primary spending was lower than projected by 1.7 percent of GDP, of which about half was due to restraint in intermediate consumption, compensation of employees and social transfers, while the rest reflected a postponement of resolution-related compensation payments to pension funds from September to October. Relative to outturns in percent of GDP a year ago, direct taxes rose, supported by the increase in the corporate income tax, the tax on interest income, and the withholding tax in the broader public sector (as wage cuts in this sector were implemented via increased withholding). Social spending on unemployment benefits and pensions also increased, which was partly compensated by a decline in other current and capital expenditure (text charts). Preliminary data through end-October confirm a continuation of these trends. The government was able to meet financing needs in the third quarter by rolling over short-term debt and using program financing, with deposits remaining broadly unchanged at around €1.5 billion.[2]

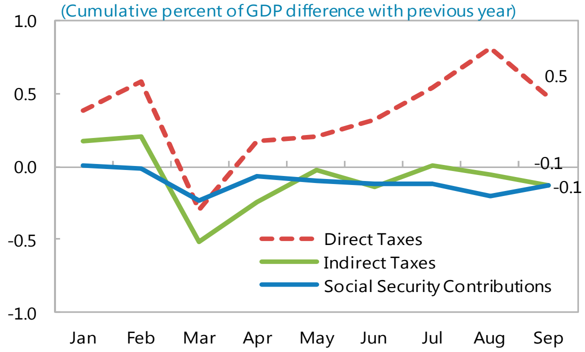
General Government, January-September 2013 1/2/

	(Millions of Euros)		(Percent of GDP)	
	Program 3/	Prelim.	Program 3/	Prelim.
Revenue	**4,663**	**4,894**	**28.4**	**29.8**
Taxes on production and imports	1,673	1,789	10.2	10.9
Current taxes on income and wealth, etc	1,222	1,308	7.4	8.0
Social contributions	1,012	1,106	6.2	6.7
Other revenue	756	691	4.6	4.2
Expenditure	**5,511**	**5,240**	**33.6**	**31.9**
Current expenditure	5,258	4,993	32.0	30.4
Intermediate consumption	585	548	3.6	3.3
Compensation of employees	1,863	1,812	11.3	11.0
Social transfers	1,858	1,820	11.3	11.1
Interest	446	456	2.7	2.8
Subsidies	74	66	0.4	0.4
Other current expenditure	433	291	2.6	1.8
Capital Expenditure	252	248	1.5	1.5
General Government balance	**-848**	**-346**	**-5.2**	**-2.1**
General Government primary balance	**-402**	**110**	**-2.4**	**0.7**
General Government primary spending	**5,065**	**4,784**	**30.8**	**29.1**

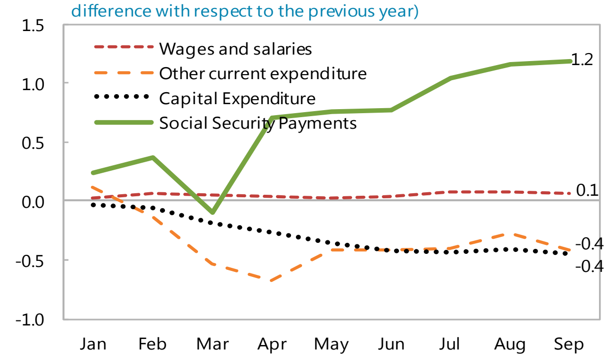
Sources: Ministry of Finance; and IMF staff estimates.
1/ ESA95 classification, cash data.
2/ For clarity of presentation and consistency with the original program forecast, sign-in bonuses are included in other revenues. This differs from Eurostat's statistical practice were sign-in bonuses are treated as a sale of intangible assets and thus as a negative capital expenditure.
3/ First review program projections.

[2] Deposits do not include the September €1.5 billion ESM bond disbursement earmarked for the recapitalization of coops.

Evolution of Tax Revenues 1/
(Cumulative percent of GDP difference with previous year)



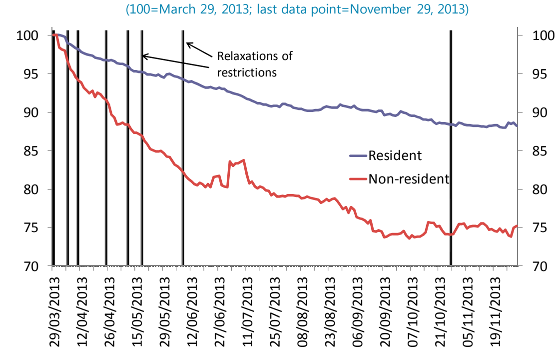
Evolution of Primary Expenditure 1/ (Cumulative percent of GDP difference with respect to the previous year)



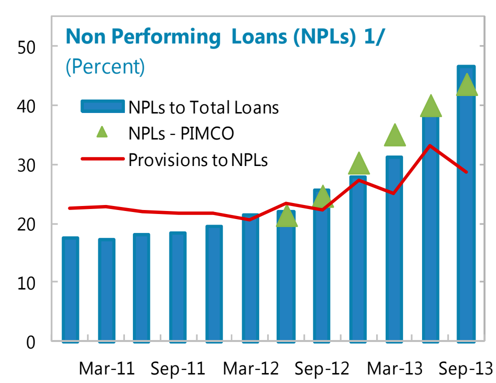
Sources: Ministry of Finance; and IMF staff estimates.
1/ Based on cash data and the national classification which, unlike ESA, do not cover local governments and semi-government entities.

9. Deposit outflows have continued, but there are tentative signs of stabilization. From end-March to end-November, aggregate deposits (excluding bailed-in amounts) declined by about €9.7 billion, or 17 percent of the total. Of this amount, €1.8 billion represent outflows since the exit from resolution of BoC at end-July. However, a significant part of outflows since end-July represents cashless deposit setoffs against loan repayments. System-wide average weekly deposit outflows are now about a quarter of the average observed during April-July, and continue to show signs of stabilization. In October, additional relaxations of restrictions were introduced to further facilitate normal business transactions, with no apparent impact on outflows (Table 9). All banks have been able to fund outflows from own resources, with BoC as the only bank dependent on central bank funding, with ELA of €9.9 billion and ECB funding of €1.35 billion.

Total Deposits, excl. bailed in amounts
(100=March 29, 2013; last data point=November 29, 2013)



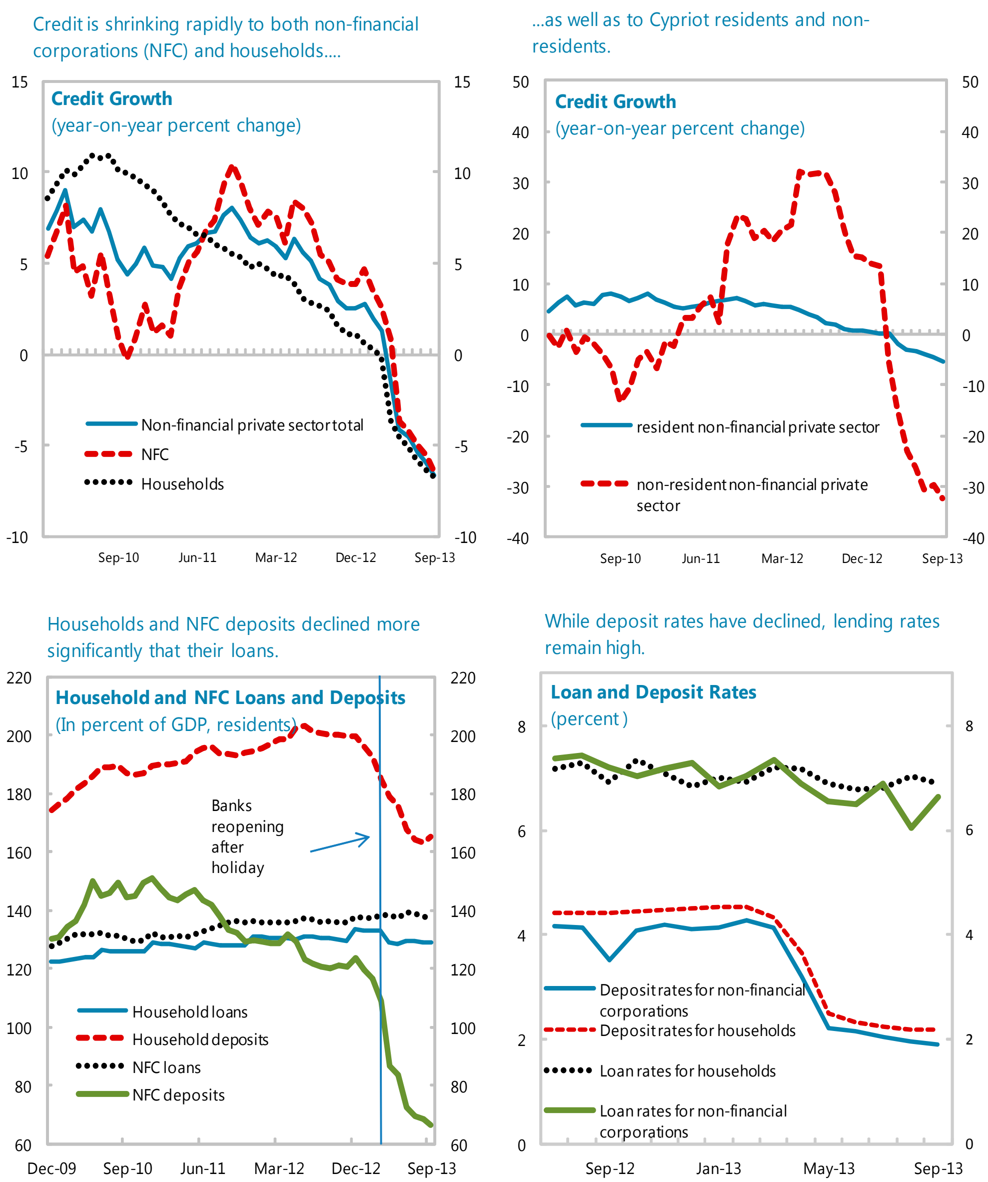
10. Banks are reducing credit, and asset quality is deteriorating with the recession. As the banking sector restructures and the downturn continues, banks are maintaining tight lending standards, as indicated by the lending survey for the second quarter of 2013, which also points to falling private sector credit demand. In October, private non-financial credit contracted by 10.4 percent year-on-year (5.6 percent for residents), with corporate credit falling by 13.3 percent (4.7 percent for residents) and household credit declining by 6.7 percent (6.5 percent for residents). The introduction in late May of higher capital requirements for deposit interest rates above a certain threshold has not had a material impact on lending rates, which remain some 2-3 percentage points above the euro area average. Banks' asset quality continues to



1/ Cypriot operations of the largest domestic banks and coops.

deteriorate, with NPLs of domestic banks reaching 46 percent of gross loans at end-September, broadly in line with the PIMCO projections under the adverse scenario. Corporate and SME loans in the construction and real estate sectors, which account for about 1/3 of total NPLs, have the highest NPL ratio at over 60 percent, compared to 40 percent for the remaining portfolio. Bank profitability has declined, with BoC reporting losses of €1.8 billion through June 2013, and Hellenic Bank posting losses of €90 million through September 2013.

Figure 4. Financial Sector Developments



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

POLICY DISCUSSIONS

11. Discussions focused on the restructuring of the financial sector, the 2014 budget, and accompanying structural reforms. In the financial sector area, the review focused on the restructuring plan of BoC, the recapitalization of Hellenic Bank, and next steps in the recapitalization and restructuring of the cooperative sector. Discussions also highlighted the need to further strengthen the private sector debt restructuring framework and the supervisory, regulatory, and AML implementation frameworks. On the macro-fiscal front, the review assessed compliance of the 2014 draft budget against the revised program targets, in the context of a modestly revised macroeconomic framework. It also evaluated progress and outlined next steps to advance fiscal structural reforms of the welfare system, revenue administration, and public financial management, and kick-start the privatization process.

A. Macroeconomic outlook and risks

12. The macroeconomic framework was modestly adjusted to reflect recent developments, with a slightly stronger 2013, a weaker 2014, and a still somber medium-term:

- The ***2013 output*** contraction was revised down by 1 percentage point to 7.7 percent, in light of the better-than-expected outturn. This reflects mainly an upward revision to private consumption on the basis of consumption smoothing evidence, including retail sales volumes through end-August. Public consumption was also adjusted to account for government sales, fixed capital, and social transfers, which were previously excluded from the definition. On the supply side, a reduction in the negative contribution of financial sector services to GDP, given a slower-than-initially projected deleveraging, is expected to more than compensate for a slightly worse-than-expected deterioration in construction and professional services, according to recent indicators in these sectors. The authorities were of the view that the outturn for 2013 may be better even than the revised projection but, in light of uncertainty, a conservative approach has been maintained.

- The ***2014 output*** contraction was revised up by close to 1 percentage point to 4.8 percent, maintaining the cumulative contraction for 2013-14 at close to 13 percent. The private saving rate is expected to increase from 10.5 percent to 14.5 percent between 2012 and 2014, with private consumption falling by close to 17 percent, while investment contracts by about 40 percent during this period. With the private sector expected to devote a larger share of income toward debt repayment, its indebtedness is projected to fall by €7.5 billion, which, given a falling output, translates into a decline in the ratio to GDP of 14 percentage points during 2012-2014.

Selected Economic Indicators

	2013 1st Review	2013 Revised	2014 1st Review	2014 Revised
	(Percent change, unless otherwise indicated)			
Real GDP	-8.7	-7.7	-3.9	-4.8
Consumption	-11.6	-9.2	-5.2	-6.3
Private consumption	-12.4	-10.7	-5.7	-6.7
Public consumption	-8.9	-4.1	-3.7	-5.2
Fixed investment	-29.5	-28.5	-12.0	-14.0
Inventory accumulation 1/	0.0	-0.6	0.0	0.0
Foreign balance 1/	5.2	5.1	1.7	2.2
HICP (period average)	1.0	0.8	1.2	1.0
Unemployment rate EU stand. (percent)	17.0	16.7	19.5	19.8
Employment growth (percent)	-7.8	-6.3	-3.7	-4.4
	(Percent of GDP)			
National saving	8.4	10.1	9.1	10.9
Government	-3.2	-2.6	-4.3	-3.5
Private	11.6	12.7	13.4	14.4
Current account balance	-2.0	-1.4	-0.6	0.3

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

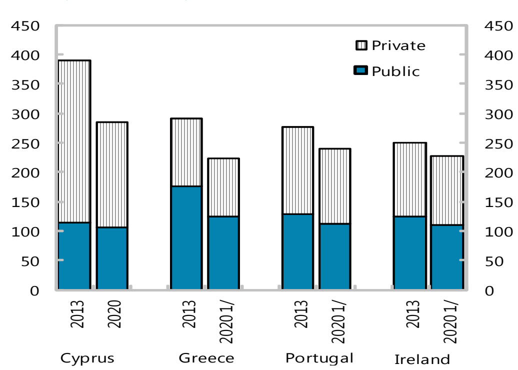
Sectoral Breakdown of GVA in 2013

Sector	Construction	Professional services	Financial and insurance services	Tourism	Administrative and education	GDP growth
Jan-Oct (or latest) GVA growth (percent y-o-y) 1/	-32.1	-3.2	-4.9	2.8	-0.3	
Sector's growth in 2013 (percent y-o-y)	-32.1	-2.3	-7.9	2.8	-0.3	
Sector's implicit share in GDP (percent)	19	12	19	10	14	
GDP growth contribution (ppts)	-6.1	-0.3	-1.5	0.3	0.0	-7.7
Memo Item:						
Projection from the First Review (ppts)	-5.7	0.0	-2.7	0.0	-0.4	-8.7

1/ Sales of cement (latest: Oct); GVA of professional activities (June); GVA of financial and insurance activities (June); average of growth rates of tourist arrivals and revenues (Sep); and GVA of public administrative activities and education (June) are used to estimate the respective sectoral GVA growth.

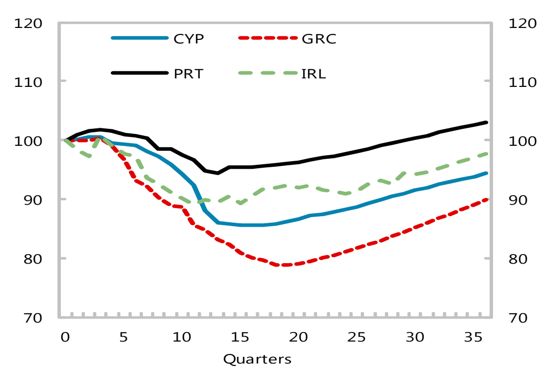
- ***Medium-term output*** is projected to remain depressed. The fall in GDP is expected to be steeper, and the subsequent recovery slower, than in most other eurozone program countries, reflecting the deep banking crisis and the substantial need for deleveraging, given Cyprus's high indebtedness. In line with experience elsewhere, the deleveraging process is expected to unfold gradually during 2015–20, with the private sector saving rate falling only slowly. As a result, private consumption and investment were slightly revised down, and by 2020 are projected to remain some 10 and 50 percent, respectively, below their pre-crisis peak levels in 2008.

Private and Public Debt
(Percent of GDP)



1/ Private debt is as of 2015 for Ireland, 2016 for Greece, and 2018 for Portugal. Public debt is as of 2018 for Ireland.
Sources: IMF staff forecast.

Real GDP
(Four quarters prior recession = 100)



Sources: Haver and WEO

- ***Long-run growth*** projections, which remain unchanged, point to a net output loss a decade after the crisis of about 4 percent, which is somewhat smaller than that projected for Greece, but larger than those for Ireland and for Portugal, and is substantially larger than estimates from other financial crises (Box 1).

- The ***unemployment*** rate for 2013 has been revised down to 16.7 percent (from 17 percent), on account of data revisions and recent developments. Similarly, the 2013 ***inflation*** forecast has been reduced from 1 to 0.8 percent based on recent data.

- The ***current account*** balance projection has been revised up by about 1 percent of GDP compared to the first review. In the short term, revisions mainly reflect changes to the net income projection, on account of a lower effective return on Cypriot liabilities (including deposits and equity) and a somewhat higher return on external assets. In the medium term, revisions mainly reflect an improvement in the trade balance owing to lower domestic demand (due to more gradual deleveraging) and increased external competitiveness of Cypriot companies (consistent with the observed wage reductions in the tradable sector).

13. Risks to the medium-term outlook remain tilted to the downside. While the 2013 growth outlook may be better than projected, the private sector's deleveraging could be more protracted, liquidity conditions for companies may tighten further, and consumers may exhaust liquidity buffers. These, combined with a continued contractionary fiscal impulse, could lead to a deeper and more prolonged recession, as well as a slower recovery over the medium term. Delays in the removal of payment restrictions would negatively affect activity, while their premature removal may jeopardize financial sector stability. Tensions between the executive branch and the central bank, if unresolved, could prolong the uncertainty and prevent the return of confidence. Should confidence in the banking sector take longer to recover, this could strain bank liquidity and the ability of the financial sector to support the recovery. Negative feedback loops and a tightening of bank-sovereign links could reemerge, posing risks to growth and debt sustainability. On the upside, a faster recovery in the eurozone could support Cypriot exports, renewed external market interest in the European periphery could boost investment, and eventual exploitation of gas reserves could boost long-term growth (although this may take time, as additional testing is needed to confirm Cyprus's proven gas reserves).

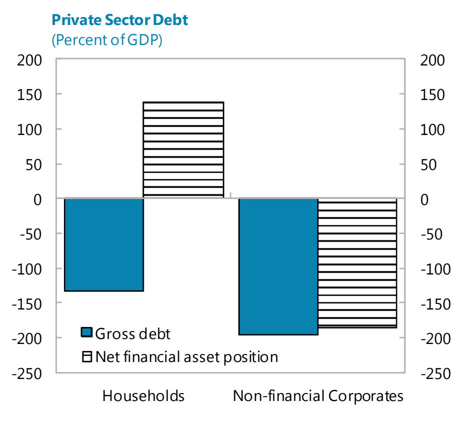
Box 1: Private Sector Balance Sheet Adjustment and the Impact on Growth

Given the high level of debt of private sector debt, deleveraging needs are significant. Private sector debt is among the highest in the euro area. Most of this debt consists of bank credit, which stood at about 280 percent of GDP at end 2012 (Figure 5). In line with the literature, a number of empirical and model-based benchmarks are developed to determine a "sustainable" level of private sector debt, including: (i) corporate and household debt-to-GDP ratios in 2004, when Cyprus joined the EU and before the start of the lending and housing boom; (ii) euro area thresholds identified in IMF (2013); (iii) thresholds identified by Cecchetti et al. (2011), above which private sector indebtedness was found to affect growth; and (iv) a household debt service to income ratio of ¼ (a commonly accepted prudent lending standard) and a historical corporate leverage ratio of 0.7 during 2004-07. Measured against these benchmarks, Cyprus's deleveraging needs are estimated to average at about 45 percent of GDP for corporates, and about 55 percent of GDP for households.

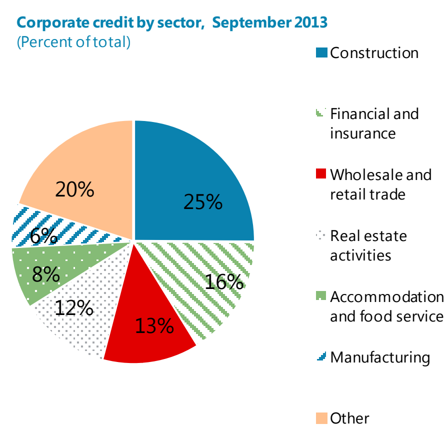
Sustainable Debt Levels and Implied Deleveraging Needs (Percent of GDP)

	Bank credit (2012)	"Sustainable" levels of debt				Implied deleveraging needs
		Indebtedness in 2004	EA thresholds IMF(2013)	Cecchetti et al. (2013)	NFC leverage of 0.7; hh debt service to income ¼	
NFC	142	84.6	98	90	110	32–57
Households	136	72.5	48	85	90	46–88

Deleveraging has already started in Cyprus and is expected to continue through the next decade. Between end-2012 and end-September 2013, domestic corporate and household credit contracted by 3 and 7 percent of GDP, respectively (when measured against constant 2012 GDP, the contraction was 7 and 10 percent of GDP, respectively). Households will need to save more, consume less, and use a larger share of their income to pay down debt. As a result, their saving rate is expected to increase significantly in the short-run. Their large positive net financial asset position (138 percent of GDP, excluding housing assets), however, is expected to help to cushion this large adjustment and support a modest increase in consumption over the medium term. Corporates, on the other hand, have limited buffers, given a negative net financial asset position (of -195 percent of GDP). Their adjustment is expected to be concentrated in the construction, real estate, financial and insurance sectors, which together account for more than half of total corporate credit. Other business services and tourism, which have relatively low indebtedness, are expected to support the modest recovery over the medium-run. Bank measures facilitating voluntary debt workouts will be key to supporting an orderly deleveraging process.



Source: Central Bank of Cyprus



Box 1: Private Sector Balance Sheet Adjustment and the Impact on Growth (concluded)

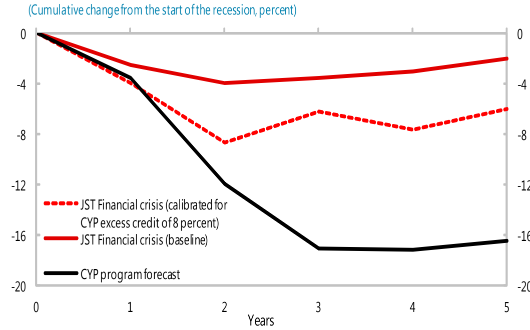
Deleveraging is expected to pose a drag on growth over the next 5-10 years. In line with a growing literature that associates deleveraging processes with lower growth, Cyprus's recovery is expected to be affected by the need to return debt to lower levels. The results found in the literature crucially depend on the duration of the deleveraging process and on the elasticity of GDP growth to credit growth. For households, the assumptions on the duration of deleveraging range between 7 (April 2012 WEO) and 10 years (Cuerpo et. al., 2013); for corporates, deleveraging is generally assumed to take less time, as the maturity of corporate debt is shorter than for households (IMF, 2013 assumes 5 years). The current analysis focuses on bank debt, although corporates also have some liabilities from non-residents. Elasticity estimates range from 0.011 to 0.025. Using these assumptions, the growth impact of deleveraging in Cyprus could be around 0.2-0.4 percentage points per year over 5-10 years.

Impact of Deleveraging on Output

	Duration of deleveraging (year)	Annual amount of deleveraging (percent of GDP)	Elasticity (bps per 10 pps debt GDP ratio)	Annual GDP impact (pps)	Total GDP impact (pps)
NFC	5	9	11 (IMF 2013)	0.1	0.5
			17-22 (Levine, et al., 2000)	0.2	0.8–1
			25 (Andersen, 2003)	0.2	1.1
Households	10	6.5	13 (IMF 2013)	0.1	0.9
			17-22 (Levine, et al., 2000)	0.1	1.1–1.4
			25 (Andersen, 2003)	0.2	1.6

As a result, output per capita is expected to be significantly lower compared to the pre-crisis period. A recent empirical study by Jorda et al. (2011), which looks at recessions during the past century, suggests that financial sector crises combined with large deleveraging needs result in much weaker recovery phases compared to normal recessions. The study quantifies the negative impact on growth due to a financial crisis following a build-up of excessive credit. The empirically estimated model coefficients were used to estimate potential output loss for Cyprus (dotted line in the chart), on the basis of an estimated level of average yearly excess credit of 8 percent of GDP in 2006-08 relative to the average during the preceding decade (using the study's methodology). Both the cross-country results of the original study and the calibrated growth path for Cyprus are substantially better than the program's growth projection. While this difference may be explained, in part, by the absence of other factors at play, such as the impact of the large fiscal adjustment underway, it also provides comfort on the conservativeness of projections.

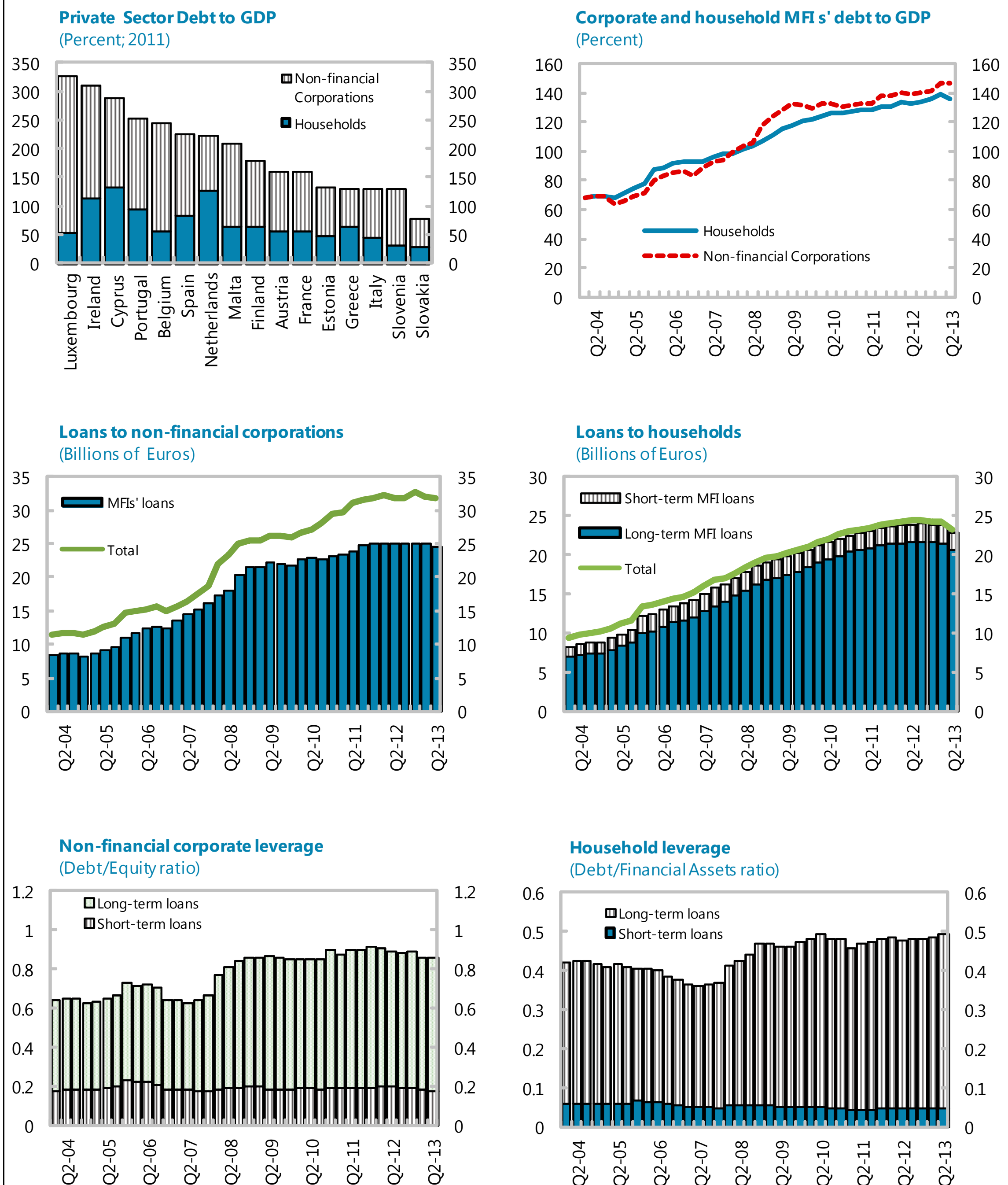
Real GDP per capita
(Cumulative change from the start of the recession, percent)



Sources: JST (Jorda et al., 2011) and CYP program.

References: "Indebtedness and Deleveraging in the Euro Area", IMF, Euro Area Policies, 2013 Selected Issues Paper; "When Credit Bites Back," Jorda, Schularick, and Taylor, 2011, NBER Working Paper No. 17621.; "Financial Intermediation and Growth: Causality and Causes," Levine, Loayza, and Beck, 2000, Journal of Monetary Economics No. 46; "The Influence and Effects of Financial Development on Growth," Andersen, 2003, Working Paper Chr. Michelsen Institute; "Reassessing the Impact of Finance on Growth," Cecchetti and Kharroubi, 2012, BIS Working Paper 38; "Indebtedness, Deleveraging Dynamics, and Macroeconomic Adjustment," Cuerpo, Drumond, Lendvai, Pontuch, and Raciborski, 2013, European Commission Economic Paper 477; "World Economic Outlook," IMF, April 2012; "Creditless Recoveries" Abiad, Dell'Ariccia, and Li, IMF Working Paper 58, 2011.

Figure 5. Cyprus: Private Sector Indebtedness



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

B. Debt Sustainability

14. Public debt baseline projections remain broadly unchanged. Debt is expected to peak at 126 percent of GDP in 2015 and to decline gradually toward 105 percent of GDP by 2020, as economic activity recovers and the primary fiscal surplus improves. The 2013 debt ratio was revised down slightly to 113.7 percent of GDP, as the authorities have rolled over slightly less short-term debt than programmed, given their comfortable cash position and the better-than-expected fiscal performance, as well as a desire to minimize interest payments. Nominal GDP movements did not materially affect the ratio, as a downward revision in the 2012 deflator offset the relative expected improvement in the growth outturn for this year. For 2014, debt was revised down to about 122 percent of GDP to reflect reprogramming of ESM disbursements, including due to lower fiscal needs, which more than offset a lower projected nominal GDP. The re-profiling of ESM disbursements (also including the program buffer, which may not be used) resulted in a slightly higher debt ratio in 2016.

15. Public debt sustainability remains vulnerable to shocks (Annex I). Vulnerabilities arise due to the currently high debt level, uncertain medium-term growth prospects, and still large contingent liabilities from the financial sector. A stress analysis indicates that debt dynamics are particularly susceptible to growth shocks: a deeper or more protracted recession would lead to a debt ratio of 130-145 percent of GDP by 2020. Such a shock, if also associated with a fiscal shock (higher interest rates and a lower primary surplus) would result in an unsustainable debt ratio of about 160 percent of GDP by 2020; similarly, when combined with higher financial sector needs (twice as large as identified needs for the coops), the shock would exhaust the program buffer and result in a debt ratio of close to 170 percent of GDP by the end of the program period, falling to a still very large debt ratio of about 150 percent of GDP by 2020. Such developments would likely require additional financing measures and commitments from European partners to protect Cyprus's debt sustainability. Moreover, given significant needs to finance debt repayments after the program period (including to repay the Laiki recapitalization bond of €2.3 billion (principal plus capitalized interest) coming due in mid-2017 and about €5.6 billion of existing medium- and long-term debt maturing during 2016-2020), additional official resources may be needed if market access is not successfully restored by then.

16. External debt has been revised down, but remains vulnerable to shocks (Annex II). In the short run, gross external debt is expected to decline from about 450 percent of GDP at end-2012 to 355 percent of GDP at end-2013. This is due to the sharp drop in non-resident deposits (including due to the bail in) and bank loan repayments, financed by the liquidation of banks' external assets. In the long run, external debt is expected to continue to fall, reaching about 300 percent of GDP by 2020. The improvement in the gross external debt projection compared to the first review (by about 50 percent of GDP) mainly reflects the continued reduction of liabilities by Cypriot financial institutions, as well as the improved current account forecast. Cyprus's international investment position (IIP) is also expected to gradually improve over the projection period, reaching 85 percent of GDP by 2020, largely reflecting the revision in the current account balance. External debt sustainability remains highly dependent on continued external adjustment and the prospective economic rebound, and remains vulnerable to interest rate shocks.

C. Financial Sector Policy

While important progress has been made in the implementation of the banking sector strategy, there was agreement that more work needs to be done to (i) complete the recapitalization and restructuring of financial institutions; (ii) clean up banks' balance sheets by restructuring loans of troubled borrowers; (iii) gradually restore the normal functioning of the payment system; (iv) enhance banking supervision to prepare the ground for the single Supervisory Mechanism (SSM) in the region; and (vi) strengthen AML implementation.

17. Discussions focused on the need for BoC to implement fully its newly finalized restructuring plan (MEFP¶5). This is critical to restore confidence not only in the bank, but also—given that the bank holds about 50 percent of total financial sector assets—in the entire banking sector. The plan, which is fully endorsed by the bank's new Board of Directors and its recently appointed CEO, has several aims: (i) revamping domestic core business and working out non-performing loans;(ii) separating non-core activities in a special unit managing the bank's portfolio of large construction and real estate loans; (iii) normalizing funding conditions; (iv) strengthening risk management capacity; and (v) streamlining operational costs and maintaining adequate capitalization (Box 2). Following discussions with staff, the CBC, with external consultancy support, completed its assessment of the plan (thus meeting the end-October structural benchmark) against four key criteria: (i) overall soundness and consistency of the strategy with macro-prudential objectives; (ii) realism of prudential financial indicators and assumptions underpinning the medium-term projections; (iii) robustness to shocks; and (iv) consistency with European guidelines on bank viability. The discussions highlighted several important considerations:

- **Liquidity support:** Staff stressed the need for flexibility on ELA collateral policies, to ensure that adequate liquidity support can continue to be provided given the expected deterioration of asset quality. At the same time, it was agreed that use of government guaranteed bank bonds will need to be considered only as a last resort to safeguard financial stability. There was agreement on the desirability of gradually reducing the bank's large ELA exposure while maintaining deleveraging assumptions within the bounds of the agreed macroeconomic scenario. Indeed, the funding plan assumes only moderate loan book deleveraging, along with reliance on divestment of non-core or non-viable operations abroad and cash from maturing government debt securities.

- **Addressing NPLs:** Staff concurred with the proposed separation of non-core activities (i.e., the large construction and real-estate loans) in a designated internal unit, as the alternative of a separate asset management company would not have been feasible at this time, given the lack of funding options and implicit risks to the sovereign. As to the workout of NPLs through both the core and non-core parts of the bank, staff stressed the need for (i) appointing experienced external managers, (ii) approving clear policies that allow tailor-made solutions for large exposures and the use of a general approach for small borrowers while preserving payment, and (iii) ensuring adequate incentives (including for compensation) to maximize recovery values.

- **Preparing for contingencies:** Staff welcomed the inclusion of a sensitivity analysis (including higher interest rates, funding costs, NPLs, probabilities of default, and recovery rates) demonstrating the restructuring plan's resilience under a relatively stringent stress scenario. Discussions highlighted that the bank's success in reducing operating costs below 50 percent of net income would prove to be critical to support profitability going forward. This objective was seen as achievable, given that ¾ of the needed cost reductions have already materialized. Moreover, it was agreed that the plan prudently focuses on increasing the capital ratio over time, rather than maximizing the return on equity, appropriately balancing the need to increase provisions on legacy assets. Nevertheless, high implementation risks remain, especially regarding the bank's capacity to maintain liquidity buffers at prudent levels, find alternative private funding sources, deleverage through sales of foreign operations, recover cash from domestic bond repayments, and deal effectively with non-performing loans, suggesting that alternative strategies may need to be found down the road if such risks materialize.

- **Boosting confidence:** Staff and the authorities agreed on the importance of periodic communication to markets on progress made by the bank's management and board in the implementation of the restructuring plan. The CBC agreed to formally monitor the bank's progress on the basis of key performance indicators and operational targets to ensure that any deviations from the plan associated with unexpected changes in the program's macro-assumptions are addressed and communicated to the public on a timely basis. In this regard, as a **prior action** for the completion of the review, the CBC committed to discuss with the bank and approve a set of quarterly targets and the terms of a quarterly progress report.

Box 2. Bank of Cyprus Restructuring Plan

Following BoC's full recapitalization at end-July, its new management team recently finalized its restructuring plan, which aims to improve the quality of the bank's balance sheet, strengthen its capital position, and ensure its profitability. The plan will guide the bank's activities through 2017.

Key assumptions:

- Macroeconomic assumptions: in line with the program framework.
- Forecasted loan losses: comparable to those identified under PIMCO's adverse scenario and KPMG fair valuation, spread over 2013-17, and with significant front-loading.
- Loan growth: decline in gross loans through end-2015 as a result of the planned disposal of foreign activities, and then broadly constant through 2017 as new lending gradually recovers.

Key pillars:

- **Revamping core business lines.** The main business policies include:
  - *Focus on domestic activities*: Plans to resume lending are aligned with improvements in macroeconomic conditions. Overseas operations will be orderly disposed of by selling them to private investors;
  - *Support effective arrears management*. Dedicated internal units will manage small troubled debtors. The initial focus is on restructuring and rescheduling borrowers with high likelihood of returning to performing status (such as those that became non-performing after March).
- **Setting up an internal unit to manage non-core activities**. Selected large and complex corporate exposures, with exposure in the construction and real estate sectors and high probability of becoming distressed or delinquent, will be managed by a special projects division. This will be staffed with external

Box 2: Bank of Cyprus Restructuring Plan (concluded)

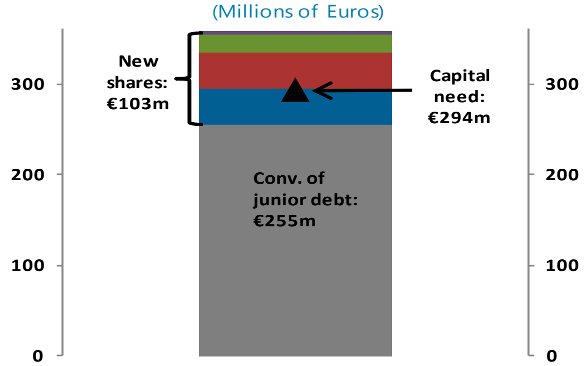
expertise, with the aim to maximize value by developing individual restructuring strategies for the corporations through operational and financial restructuring including new management, sale of non-core assets, equity partnerships, securitization, structured sales, new financing to complete projects, etc.

- **Strengthening risk management capacity.** Risk policies will be reformulated to:
  - streamline risk management capacities and processes;
  - redefine risk appetite, including explicit capital targets and portfolio compositions;
  - centralize credit approval processes;
  - adopt prudent limits, including for loan-to-value, debt-to-income, new FX exposures, collateral coverage and sector concentration; and
  - adopt provisioning standards in line with the new CBC guidelines.
- **Improving operational efficiency.** The plan aims to attain a cost reduction of about 50 percent compared to 2012. Already, about ¾ of this target has been realized through a staff voluntary redundancy scheme.
- **Normalizing funding conditions.** Reliance on central bank financing is expected to be reduced gradually, mainly through the use of cash stemming from maturing government debt securities in the bank's investment portfolio, divestment of operations abroad, limited access to covered bond markets from 2014, and recoveries from NPLs, along with limited loan book deleveraging.
- **Enhancing further the bank's capital position**. The restructuring plan focuses on restoring confidence in the bank through strengthening the bank's capital position. This would be achieved through lower risk-weighted assets (as a result of higher loan loss provisions, loan deleveraging, and disposal of non-core assets), but also generation of profits as a result of new lending activities that will gradually recover towards 2016. The cost cutting measures in the restructuring plan will lead to a significant reduction in the bank's cost income ratio.

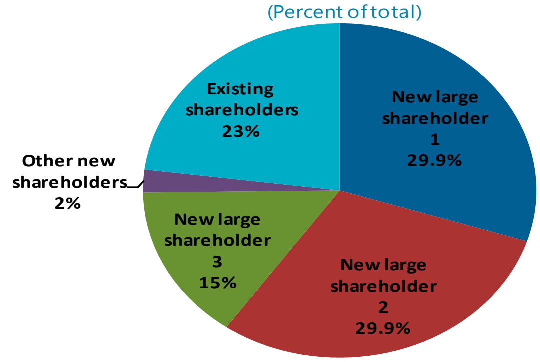
18. The authorities intend to strengthen the governance of legacy Laiki's shareholding in BoC (MEFP¶6). Legacy Laiki, which remains under resolution pending the sale of its foreign subsidiaries, is the single largest shareholder of BoC, with an equity stake of 18 percent. In this context, staff stressed the need to insulate the management of Laiki's shares in BoC from any potential risk of political interference in its operations via the Resolution Authority (which was recently expanded to include not only the CBC, but also the Ministry of Finance and the Securities and Exchange Commission). The authorities considered that the immediate distribution of shares to creditors may not help to maximize value, as this would prevent the sale of the entire stake to a potential strategic investor, while liquidation could lead to fire-sales of foreign subsidiaries. Consequently, to ensure the proper governance of these shares pending disposal of legacy Laiki's assets according to a roadmap now under preparation, by using provisions contained in the Resolution Law, the authorities intend to entrust through the resolution authority the voting rights of the shares to a well-recognized independent consulting or auditing firm or international institution (end-January 2014 **structural benchmark**).

19. The mission welcomed the full recapitalization of Hellenic Bank with private funds (MEFP¶7)**.** The authorities met the end-September structural benchmark on launching an offer for participation in the bank's capital via equity participation and conversion of junior debt into Tier I convertible instruments. Following the successful completion of the offer at end-October, the bank was fully capitalized on November 1st (thus meeting early the end-December structural benchmark) through the sale of shares worth about €100 million, bought largely by two private domestic firms and one foreign investor, and conversion of junior debt amounting to about €255 million. Consequently, the bank's Core Tier I capital reached 9.5 percent, and is expected to remain above the capital requirements based on the PIMCO due diligence exercise through the program period. Looking forward, the authorities and staff agreed on the need to ensure the bank can adapt to the new circumstances by revising its business strategy and practices.

New capital
(Millions of Euros)



New ownership structure
(Percent of total)



Source: Central Bank of Cyprus.

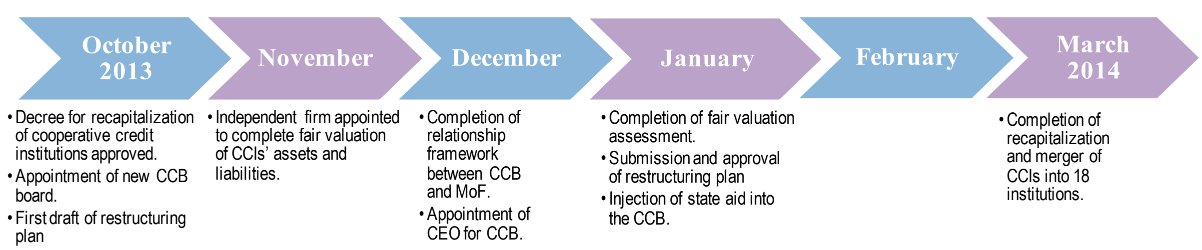
20. Understanding was reached on next steps to complete the recapitalization and restructuring of the cooperative credit sector (MEFP¶8). Staff welcomed initial steps taken, including the establishment of a unit in the Ministry of Finance to manage the state's future stake in the sector, the merger of 38 cooperative credit institutions (CCIs) into nine entities, the appointment of a new board for the Cooperative Central Bank (CCB), and the finalization of the first draft of the restructuring plan for the sector. However, given delays in the appointment of a CEO for the CCB and the need to undertake a fair value assessment to determine the state's stake in the sector, the injection of public funds into the sector has been delayed (€1.5 billion program funds have been deposited in a designated CBC account for this purpose). In this context, the authorities and staff agreed on the need to move speedily to complete the recapitalization and restructuring of the sector, while providing adequate information to depositors to boost confidence. Discussions focused on the key steps for the next 3-6 months:

- ***Strengthening governance arrangements:*** The authorities agreed to complete, as a **prior action**, the relationship framework between the CCB and the MOF management unit to ensure that the sector can operate on a commercial basis within the boundaries of the restructuring plan, while minimizing political interference in the CCB's daily business decisions. The framework will establish the terms governing the relationship between the institutions, related to: (i) the corporate governance of the bank; (ii) the development and approval of the restructuring plan; (iii) material obligations of the sector's management under the restructuring plan; and (iv) monitoring the implementation of the restructuring plan and the bank's ensuing risk profile.

- ***Recapitalizing the CCB via state aid*:** Staff and the authorities reached an understanding on the two key preconditions to inject public funds in the sector. First, the restructuring plan, which has been approved by the CCB's Board, also needs to be endorsed by the future CEO (whose appointment needs to be completed expeditiously, but following due processes) and to include quarterly targets for performance monitoring before being submitted to the European Commission for state aid approval. Second, staff welcomed the authorities' decision to subject the consolidated balance sheet of the CCB and CCIs to an independent fair value assessment. The submission of the restructuring plan and the completion of the fair value assessment are an end-January 2014 **structural benchmark.**

- ***Enhancing the communication strategy*.** Despite the prospect of its full recapitalization with public funds and without recourse to depositor involvement, some market participants still appear concerned about the sector's stability and prospects. In this context, discussions highlighted the need for keeping depositors informed on progress made in the implementation of key milestones in the sector's recapitalization and restructuring strategy. To this end, the CCB board will publish a short-term roadmap with key steps through the next six months to build market credibility toward the restructuring strategy.

- ***Finalization of the restructuring and recapitalization of the sector*:** The authorities are proceeding with the mergers of individual CCIs according to the restructuring plan. Completion of remaining mergers of 58 CCIs into 9 institutions is expected to be finalized by end-March 2014 (existing **structural benchmark**), at which point the capitalization of the new entities will also be completed, aiming to maintain a CT1 ratio of 9 and 4 percent at the sector and individual level, respectively.



21. The success of banks' and coops' restructuring strategies depends critically on progress with private sector debt restructuring (MEFP ¶9). The authorities and staff agreed that dealing with troubled borrowers decisively is essential to clean up banks' balance sheets and pave the way for a restoration of credit to the economy. However, as experience from other countries suggests, this is a complex process which requires deep changes to banks' and individuals' behavior and culture and can take significant time (Box 3). In this regard, it will be important to provide adequate and balanced incentives, including a strong legal framework, to promote mutual cooperation between borrowers and creditors and discourage strategic defaults, while minimizing political interference in the process. Discussions focused on the following principles and steps:

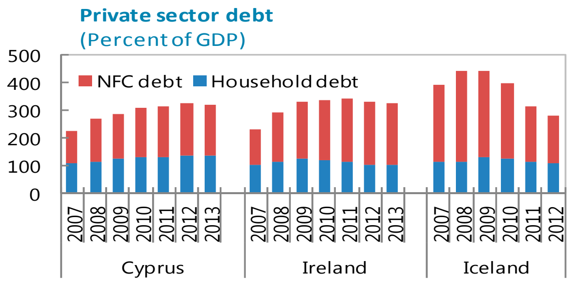
- ***Targeted case-by-case approach to debt restructuring.*** The recapitalization of the financial sector on the basis of PIMCO's stress scenario provides banks with buffers to deal with prospective losses, including due to limited recovery from NPLs. While using part of this buffer to grant across-the-board write-downs could help to alleviate the private sector's debt burden more rapidly, this uniform approach is likely to be insufficient for some borrowers and unnecessary for others, damaging the payment culture and opening the door for strategic defaults. In turn, this could lead to further increases in NPLs, exhausting capital buffers and putting the banks' solvency at risk. In this context, and given no fiscal room to absorb additional bank costs, it was agreed to pursue a targeted approach, recognizing that this may (unavoidably) lead to a more gradual private sector deleveraging. Under this approach, banks will focus on restructuring the debts of troubled but viable borrowers, classified according to the degree of insolvency or cash-flow mismatch, using tailored modalities, including term extensions, temporary interest rate reductions, or limited principal discounts.

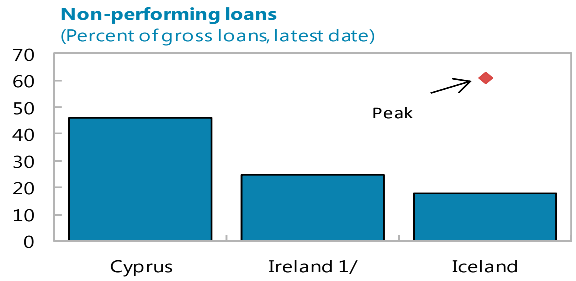
- ***Effective negotiation framework and arrears management strategy.*** While the CBC finalized a new code of conduct (CoC) for banks and a general loan arrears framework in line with international best practice, it was agreed that more needs to be done to ensure that these are adequately complied with and incorporated within the banks' own restructuring strategies, to facilitate the start of the debt restructuring process. In this regard, staff called for decisive action focused on key large troubled borrowers, to send a strong signal to the markets about the need to address NPLs. Looking forward, staff also stressed the need to define and monitor key performance indicators on debt restructuring (e.g. number of loans restructured, cash collections, etc.), which will start in the first quarter of 2014. Given that banks' success with debt restructuring also depends on having proper IT support and appropriate staffing and expertise, the CBC will complete an onsite assessment of the operational capacity of banks' loan workout units (end-March 2014 **structural benchmark**).

- ***Strengthening the legal framework.*** Notwithstanding some initial delays, the authorities will complete the assessment of the insolvency law for corporates and individuals before the end of 2013. This will help to identify potential legal and implementation impediments for effective debt restructuring and lead to the development of an action plan and timetable to address these during the next review. While the authorities were ready to complete legislation to allow for the creation of mediation services, staff noted that this may be better addressed in the context of the broader review of the legal framework.

Box 3: Private Sector Debt Restructuring: Lessons from Ireland and Iceland

Iceland and Ireland entered the crisis with large private sector debt and subsequently accumulated significant non-performing loans (NPLs). Private sector indebtedness increased rapidly in the decade preceding the global crisis, peaking at more than 500 percent of GDP in Iceland and 300 percent in Ireland. As the crisis hit, NPLs rose rapidly, reaching about 60 and 25 percent in Iceland and Ireland, respectively. By comparison, Cyprus's private sector indebtedness stands at close to 300 percent in 2013, and NPLs reached 46 percent of total loans and could rise up to 60 percent under PIMCO's stress scenario.





1\ Excluding NAMA assets (including them would bring the ratio to 37percent)

Sources: Eurostat, CBC, Central Bank of Iceland, Central Bank of Ireland, and IMF country reports.

To address over-indebtedness and high NPLs, Iceland and Ireland took a number of measures (text table). Iceland's strategy included, among other elements, a generalized rescheduling of inflation and exchange rate indexed household debt (which was becoming unsustainable as the currency depreciated and inflation rose at the onset of the crisis), fast-track write downs of deeply underwater mortgages, and tax incentives for corporates. This approach was supported by significant buffers in the newly-resolved banks. Ireland introduced an arrears management framework for the banks and the established a government sponsored asset management company (AMC) funded with government participation. Irish banks provided some selective debt relief, including through forbearance on mortgage loans, although write-downs have been relatively limited so far. Both countries complemented their strategies with a reformed insolvency framework, aimed at facilitating court-administered solutions. Despite these efforts, results have been slow to materialize: in Iceland, it took banks about five years to address the bulk of troubled loans, while in Ireland, after three years, the banks are yet to decisively initiate loan workouts.

Cyprus is only starting the deleveraging process, which is likely to take time. Learning from these experiences, and taking into account domestic considerations—including limited bank capital buffers, lack of fiscal space to back a more generalized approach or an AMC, but also no need to protect borrowers from devaluation, as was the case in Iceland— the Cypriot authorities acted decisively by establishing upfront an Arrears Management Framework and a Code of Conduct for borrowers and creditors. This now needs to be implemented by the banks in the context of their restructuring plans. Banks are also strengthening internal loan-workout processes by establishing specialized units (including, for BoC, a unit dealing exclusively with the large real-estate portfolio). The Cypriot authorities are also planning to review and strengthen the insolvency framework and strengthen incentives to facilitate voluntary workouts. Bank recapitalization has been based on conservative and forward-looking estimates of capital needs, so that well-targeted restructuring efforts through a case-by-case approach can be implemented without putting excessive stress on bank profitability and capitalization.

Debt Restructuring Measures in Ireland and Iceland

	Ireland	**Iceland**
Court-administered debt restructuring	A new personal insolvency framework was established providing for automatic discharge from bankruptcy after three years. New processes include arrangements for the settlement of unsecured debt over 5 years and a personal insolvency arrangement for the settlement of secured debt up to €3 million and unsecured debt over a six-to-seven year period. The negotiation process, during which the borrower is protected against actions of creditors for at least 70 days, is governed by a personal insolvency practitioner appointed by the borrower. Settlements need the approval of a qualified majority of creditors.	To protect from the risk of immediate defaults due to increasing debt linked to inflation or the exchange rate, given the sharp initial devaluation, and repayment schedules were adjusted. For households, the Bankruptcy Law was also amended to make it easier and cheaper for households to file for consolidation of unsecured debt and to shorten the discharge period for two years in the event of bankruptcy. Also, a law on mitigation of residential mortgage payments was enacted. Specifically, after reduction of debt by sale of non-essential assets and excess cash, mortgages were split into a collateralized (100 percent loan-to-value) and an unsecured part. Debtors were obliged to service the collateralized loans in full, while servicing of the unsecured debt was reduced based on the actual servicing capacity of the borrower. If the borrower was able to fulfill all obligations over a 3-5 year period, the remaining unsecured debt was renegotiated.
Out-of-court debt restructuring	Measures initially focused on establishing a clear arrears management framework for the whole banking sector, specifying the strategies for voluntary debt restructuring in particular of mortgage debt of cooperative borrowers through term extensions, interest rate reductions, or splitting of mortgages into a part that the borrower continues to service and a part that is being put under holiday payment for several years. Subsequently, main mortgage lenders were given targets for resolving mortgage arrears against which they report on publicly. For larger property and development loans, an AMC ("NAMA") was established to offload the exposures from the banks' balance sheets and to allow for targeted resolution of such cases.	A sector agreement for household debt restructuring mimicked but simplified the court administered framework and provided for more generous write-downs. If the borrower was able to fulfill all obligations over a three year period, the remaining unsecured debt was cancelled. An Ombudsman provided households with legal and financial advice and appointed supervisors to represent them in negotiations. For SMEs, a voluntary restructuring framework was introduced with case-by-case review of cash flows and viability. The framework provided guidelines for asset valuation, unified selection of restructuring tools across banks and an arrangement for arbitration between creditors only. Banks committed to key performance targets against which they reported to the authorities. Tax impediments to restructuring were removed by exempting write-offs from tax up to a certain limit and restructuring tax arrears.
Write-downs	Some limited write-downs have been allowed for individuals without any income or assets, subject to supervision during three years.	Debt write-downs (through generalized and case-by-case approaches, as described above) corresponded to 12 and 50 percent of GDP for households and companies, respectively, at end 2012. The predefined write-down amount prevented borrowers from holding out while waiting for more favorable conditions.

22. **The authorities reiterated their commitment to their published milestone-based roadmap for lifting payment restrictions and capital controls** (MEFP ¶11)**.** With the assessment of BoC's restructuring plan and the recapitalization of Hellenic Bank completed, only the recapitalization of the cooperative sector on the basis of the submission of its final restructuring plan remains to be achieved before the second phase of relaxations can begin, provided that bank liquidity and deposit trends are assessed as supportive of further relaxations. Next relaxation steps entail the abolition of remaining restrictions requiring the automatic renewal of fixed-term deposits and the elimination of

limits for the free transfer of deposits within the domestic banking system. Given that market participants do not appear to be well-informed of progress toward milestones and key next steps, staff highlighted the importance of strengthening market confidence through effective communication. Moreover, staff and the authorities agreed on the need to fine-tune the impact assessment analysis of relaxation measures on banks' liquidity and expanding methodologies—including through independent analyses and surveys—to assess market confidence before the second phase of relaxation of restrictions can proceed.

23. The authorities intend to take further steps to improve supervision and regulation (MEFP ¶12). Progress to date includes the passage of legislation to establish a credit register (meeting the requirements of an end-September structural benchmark with a two month delay), the integration of CCI supervision into the CBC, the issuance of guidelines on loan origination and reporting of NPLs, including instructions on how to assess income of borrowers and instituting repayment ability (as opposed to collateral) as the overriding criterion for the approval of new credit. Discussions focused on several key topics:

- ***Asset impairment and provisioning.*** It was agreed that aligning current accounting and disclosure practices on loan quality and provisioning to best practices will take time, as it requires the development of proper IT facilities by banks. A two-step approach for implementation of the new guidelines was therefore formulated. In a first step, banks will enhance disclosure practices associated with non-performing loans, in accordance with the new guidelines. In a second step, they will be required to adopt the full guidelines for asset impairment and provisioning for the 2014 financial statements.

- ***Caps on lending rates.*** The authorities and other interlocutors highlighted the lack of liquidity in the economy as the key impediment to the recovery taking hold, and called for caps on lending rates to help to boost lending. While agreeing with the need to facilitate credit flows to the economy, staff argued against initiatives to cap lending rates, as these would introduce distortions in the pricing of risk, impeding rather than facilitating credit (unless banks found ways to circumvent them, in which case they would be ineffective). Rather, staff stressed that the resumption of credit depended critically on the implementation of bank restructuring strategies and a cleanup of their balance sheets.

- ***Integration of the regulatory framework into broader European initiatives.*** In the context of the upcoming establishment of the SSM, staff agreed with the authorities that the adoption of prompt corrective actions (initially planned for end-December 2013) would be extended to end-June 2014. Moreover, it was agreed to postpone the assessment of the supervisory framework's compliance with best practices until there is clarity on the degree of responsibility of national authorities for the implementation of the Basel Core Principles for effective bank supervision.

- ***CBC work planning and governance.*** It was agreed that the CBC should complete its work plan and main objectives for 2014 to ensure that budgetary and staff resources are sufficient to meet operational and strategic targets. Staff also called for strengthening the governance of the central bank by clarifying the allocation of tasks and responsibilities within the CBC's top management.

24. The authorities will strengthen implementation of the anti-money laundering (AML) framework (MEFP ¶13)**.** The AML legal framework was revised on September 5, thus meeting the end-September **structural benchmark.** Discussions highlighted that progress is being made with improving supervision of professions (i.e. lawyers, accountants and administrative services providers) by reforming supervisory frameworks and increasing staffing of professional regulatory bodies. At the same time, the financial intelligence unit is engaged in increasing its international exchange of financial intelligence. To address remaining shortcomings in the supervision of banks' compliance with AML requirements, including due to capacity constraints, the CBC will strengthen the effectiveness and adequacy of the AML/CFT supervisory function (end-February **structural benchmark**) by developing an onsite supervisory plan aiming to gradually resume onsite inspections next year and boosting staffing. The CBC also agreed to finalize the follow-up work on the findings of the Deloitte audit by end-January.

D. Fiscal policy

Discussions focused on setting 2013-14 targets to account for the significant over-performance to date and ensuring that the 2014 budget remains consistent with the program's revised macroeconomic projections.

25. The end-year primary deficit target was revised down by 0.7 percent of GDP (MEFP ¶14). In light of the significant revenue over-performance to date as a result of the better-than-expected macroeconomic outturn, revenue projections were adjusted upward by 0.6 percent of GDP. At the same time, the execution of capital expenditure was revised down by 0.1 percent of GDP than previously estimated. As a result, the primary deficit target (cash basis) was conservatively revised down to 2.6 percent of GDP from 3.3 percent of GDP. In addition, in light of slightly lower compensation payments to the Laiki pension fund in October compared to first review estimates, the authorities requested that the adjustor be modified to include the additional compensation to take place later this year or early next year (the adjustor already includes the possibility for additional resolution-related compensation to other pension funds, as established during the first review).

26. It was agreed that the 2014 budget remains in line with the revised 2014 program target (MEFP ¶15). Given a net effect of 0.7 percent of GDP due to the revised higher tax base for 2013 and expected one-off revenues (including dividends and central bank profits), which more than offset the effect of a deeper recession in 2014, staff and the authorities concurred with revising down the primary deficit target for 2014 to 3.3 percent of GDP from 4.2 percent of GDP. This includes measures of 2.1 percent of GDP already approved in 2013 which take effect in 2014, but also an additional 0.3 percent of GDP of consolidation measures beyond those required under the program—including a further rationalization of allowances and overtime and the introduction of income criteria to target social pensions—which the authorities introduced to confirm their commitment and advance the adjustment that will be required in the outer years to put debt on a sustained downward path (Box 4). While cautioning about the potentially negative impact of the additional consolidation on growth, staff agreed with the limited new measures, which do not compromise the delivery of services to those most vulnerable and were assessed not to imply an excessive fiscal impulse (Box 4). Finally, while staff assessed the 2014 budget to be broadly in line with the revised fiscal targets, the authorities agreed to amend the budget to explicitly reflect the new macroeconomic framework and revised targets as a **prior action**.

27. The authorities requested revisions to public debt and government guarantee ceilings for 2013-14 (MEFP ¶16)**.** In line with their intention to roll over less short-term debt than anticipated given the comfortable cash position, the authorities have requested a modest downward revision to the end-2013 and Q1 2014 debt ceilings. They have also proposed to include an adjustor to the 2014 debt ceiling to address the uncertain disbursement path of an EIB loan to finance projects already included in the budget. As to the ceilings on government guarantees, they have requested to modify the December 2013 guarantee ceiling downward by €120 million to: (i) exclude a pre-existing guaranteed EIB loan related to the Vassilikos power plant, given uncertainty on whether it will be disbursed this year or next, and instead introduce an adjustor; and (ii) allow for a small increase in guarantees to accommodate needs of ongoing sewerage projects. However, they proposed to increase the 2014 ceiling by a similar amount to accommodate new EIB loans to domestic banks and guaranteed by the state. It was agreed that the limited size of the envisaged schemes do not materially alter the outlook for debt sustainability, while they would facilitate the provision of credit to SMEs, which is a critical obstacle to economic recovery given the tight liquidity conditions and the difficulty for companies to obtain trade credit.

Box 4. The 2014 budget and the 2013-2014 Fiscal Impulse

The 2014 budget contains 2.1 percent of GDP in measures approved at the outset of the program, and 0.3 percent of GDP in new permanent measures. The main measures approved in 2013, include a reduction in public sector wages and allowances and rationalization of social transfers on the expenditure side and an increase in VAT rates and pension contributions on the revenue side. In addition, the authorities have proposed 0.3 percent of GDP in new measures, including: a further rationalization of allowances and overtime of public employees and targeting of the social pension through the introduction of income criteria on the spending side; a reduction in exemptions on pension contributions of previously exempted groups, and increased taxation of lottery winnings on the revenue side.

Fiscal measures for 2014
(Percent of GDP)

Approved Measures	**2.4**
Revenues	1.6
Increase in the VAT standard and reduced rates	0.4
Increases in excise rates	0.2
Increase in pension contributions	0.5
Increase in the witholding tax on interest from 15 to 30 percent	0.1
Increase in the bank levy from 0.095 to 0.15	0.1
*Reduction in exemptions of pension contributions and increased taxation of lottery winnings **	0.1
Other	0.2
Expenditure	0.8
Reduction of nominal wage and allowances	0.4
*Further reduction in allowances and overtime **	0.1
Rationalization of social transfers	0.2
*Targeting of the social pension **	0.1

Source: IMF staff estimates.
* New 2014 budget measures.

The overall fiscal adjustment is larger than what the measures alone would suggest. Measures included in the 2014 budget, together with other tightening underway for 2014 reflecting a reduction in the number of early retirees and reductions in capital spending as projects come to an end, bring the total consolidation effort to 3.5 percent of GDP in 2014. Considering the fiscal consolidation of 4.5 percent of GDP in the 2013 budget, together with additional tightening due to reductions in discretionary spending (i.e. goods and services and capital spending) and a larger than expected reduction in public employment, the total fiscal adjustment amounts to 9.4 percent of GDP for 2013-14.

The underlying negative fiscal impulse is estimated at 1.6 and 4.2 percent of GDP for 2014 and 2013-14 combined. The fiscal impulse provides a measure of the net impact of fiscal policy on the economy. The primary balance change as a percent of GDP in the two years was decomposed into four components: (i) net impact of one-off measures, which include dividends, central bank profits, and licensing fees associated with gas exploration; (ii) total fiscal adjustment, including both program measures and additional tightening; (iii) estimated macro shock, which was derived by excluding from the nominal fiscal projection the impact of one offs and total fiscal adjustment for revenues and social transfers; and (iv) net impact of nominal GDP on ratios, capturing purely the denominator effect and derived as the residual of the components above. Given the large recession underway, automatic

Box 4. The 2014 budget and the 2013-2014 Fiscal Impulse (concluded)

stabilizers, capturing the non-permanent effects of the crisis, are estimated to reflect 50 percent of the macro shock (compared to a ratio of about 70 percent for a normal recession[1]). After accounting for automatic stabilizers as defined above, the negative net fiscal impulse is estimated at 1.6 percent of GDP for 2014, and 4.2 percent of GDP for 2013-14. An illustrative comparison with other program cases suggests that the adjustment in Cyprus is slightly less than the estimated adjustment in the first two years of program in Ireland (4.7 percent of GDP) and in Portugal (6.5 percent of GDP), despite a deeper recession in Cyprus. The fiscal impulse methodology for Cyprus will continue to be kept under review as uncertainties about potential output narrow, such that, with time, it could be replaced with more standard structural fiscal balance measures.

Estimated Fiscal Impulse
(In percent of GDP, unless otherwise stated)

	2013	2014	Total
Change in the Primary Deficit (+ means reduction) (A=B+C+D+E)	0.6	-0.7	-0.1
Net impact of one-offs (B)	1.5	-0.3	1.2
Fiscal adjustment (C)	5.9	3.5	9.4
Program revenue measures	2.1	1.6	3.8
Program expenditure measures	2.4	0.8	3.2
Other tightening 1/	1.3	1.1	2.4
Estimated macro shock (D)	-6.5	-3.8	-10.3
Revenue	-6.0	-3.0	-8.9
Social transfers	-0.6	-0.8	-1.4
Net impact of nominal GDP change on ratios	-0.3	-0.1	-0.4
Estimated fiscal impulse of automatic stabilizers (F=D/2)	3.3	1.9	5.2
Net estimated fiscal impulse (+means contractionary) (C-F)	2.6	1.6	4.2
Memorandum item:			
Ratio of fiscal adjustment over the macro shock (C/D)	89.8	92.9	90.9

Source: IMF staff estimates

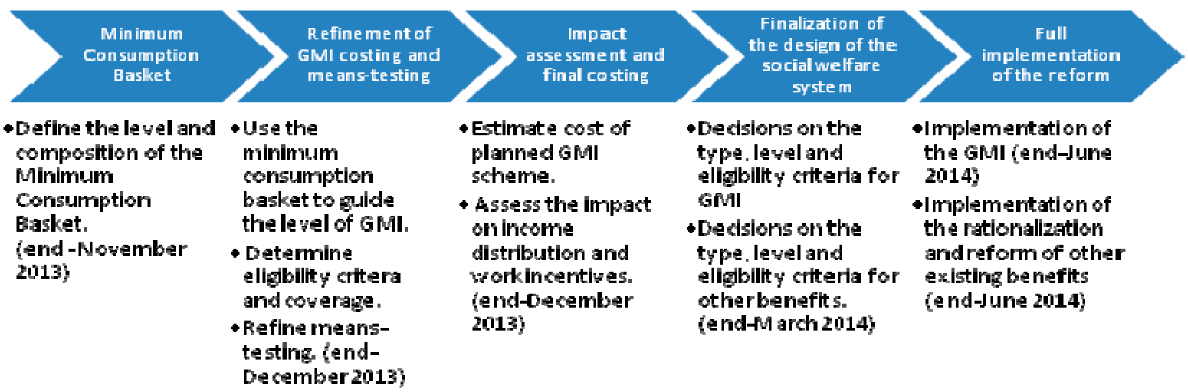
1/ In 2013, this includes the end of large investment projects, tight control over goods and services spending, and a higher reduction of government employment than anticipated including due to an early retirement rush. In 2014, this includes a reduction in early retirements and further reduction in the capital budget due to the end of projects.

1/ See for example IMF Working Paper 10/285, "Estimating Potential Output with a Multivariate Filter."

E. Structural fiscal reforms

Discussions focused on progress to date and next steps to advance the authorities' ambitious structural reform agenda, aimed at: (i) improving social protection of vulnerable groups, (ii) enhancing tax compliance and the efficiency of tax administration, (iii) strengthening budget processes; and (iv) privatizing state owned enterprises.

28. The authorities are introducing a comprehensive welfare reform to protect those most vulnerable during the downturn (MEFP ¶17). Discussions focused on actions needed to advance the reform, which introduces a General Minimum Income (GMI) scheme aimed at ensuring an adequate protection of vulnerable groups, including by expanding coverage of social assistance to the working poor and those who have exhausted their unemployment benefits. The GMI will be financed through consolidating, streamlining and better targeting other social benefits to ensure that overall spending on welfare benefits remains within the fiscal envelope set out in the 2014 budget. Discussions focused on methodological refinements needed to define the level of basic needs and the composition of the minimum consumption basket as well as on the establishment of a micro-dataset based on the latest household budget survey, which will inform the final costing of the GMI. The micro-dataset will be updated for current labor market conditions and changes in the social protection benefits. The authorities will finalize the design of the social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits by end-March 2014 (**structural benchmark**) so as to fully implement the reform by June-2014 (existing **structural benchmark)**.



29. The authorities are taking steps to improve revenue collections and advance the reform of revenue administration (MEFP ¶18)**.** These are key to support ongoing fiscal consolidation efforts and ensure that primary surpluses can be achieved and maintained over the long run to preserve debt sustainability.

- **Short-term measures**: The authorities reiterated their commitment to combating tax evasion associated to a large informal economy (which is double the size of the OECD average) and underreporting of personal income (3/4 of the self-employed taxpayers declared an income under the taxable threshold in 2011). In this regard, they are preparing a work program of targeted joint audits by the Internal Revenue Department (IRD) and VAT Services (VS), based on information from multiple data bases and focused on high compliance risk areas and large taxpayers, as well as drafting legal amendments (to be passed in December), aiming to increase collection enforcement powers of the revenue administration and establishing self-assessment of taxpayers (existing end-December **structural benchmark**).

Tax Evasion and Revenue Administration Performance
(Percent)

VAT Gap (2006)	
Cyprus (2009 estimate)	14
EU-25 average	12.0
Shadow economy (percent of GDP, 2012)	
Cyprus	26
EU 27	18.4
Tax debt to annual net revenue (2011)	
Cyprus	34.0
OECD average	11.4

Sources: OECD 2013; Schneider 2012; PWC 2009.

- **Long-term reform of the revenue administration:** The reform seeks to generate efficiency gains by integrating the IRD, responsible for direct taxes, VS, responsible for VAT, into a single function-based tax administration. The reform was endorsed by the Council of Ministers in October, and a governance structure—including a High level Steering Committee and Executive Committee—has been established to oversee its implementation. A reform project team is complete, and the authorities are working on drafting the reform implementation plan, with the help of Fund TA. Given the complexity of this reform, its implementation is expected to be completed within the next 2-3 years.

30. Progress is being made with the reform of public financial management (MEFP ¶19). The authorities completed the drafting of the Fiscal Responsibility and Budget Systems Law (FRBSL), to be adopted by end-December 2013 (existing **structural benchmark**). The law provides the legal basis for the efficient management of public investment projects (including PPPs), sets up a Fiscal Council, and establishes transparent management of natural resource revenues through the budget. Progress is also being made on improving the monitoring of general government finances and fiscal risks: (i) the Treasury department has assumed responsibility for the monthly collection and reporting of key financial indicators for the general government, with the first report having been finalized; (ii) the authorities are working to amend legislation to assign responsibility for monitoring the stock of guarantees to the Public Debt Management Office and are preparing a "Statement of state-owned enterprises and semi-government entities" to be included as an Appendix to the 2014 budget.

31. Staff urged the authorities to accelerate their privatization efforts (MEFP ¶20)**.** Staff noted that the aim of privatization is not only to ensure adequate financing by raising €1.4 billion by 2018, but also to realize efficiency gains from the transfer of assets from the public to the private sector. The authorities noted the need to maximize value by avoiding fire sales, and stressed the importance of maintaining flexibility in the modality of privatization so as to ensure that the public interest is protected. Discussions focused on the need for the government to finalize and approve as soon as possible the privatization plan, aiming to specify the portfolio of state-owned assets eligible for privatization and provide an estimate of expected receipts and a timetable for individual transactions, including preparatory steps (such as needed changes to the regulatory framework or unbundling of network activities). Approval of the plan is a prior action for the ESM disbursement. Given the significant lead times needed to prepare assets before they can be privatized once the economy recovers, the authorities also committed to speed up efforts to complete the legal and institutional framework for privatization in early 2014.

PROGRAM MODALITIES AND FINANCING

32. Program conditionality for the second review has been largely met, and new conditionality has been established (MEFP Tables 1-3).

- **Prior actions.** The authorities have implemented three prior actions for completion of the second review: (i) approval by the CBC of BoC's proposed set of quarterly targets for the next

12 months and the terms of the quarterly report on progress relative to targets; (ii) finalization of an agreement between the Ministry of Finance and the CCB on the terms of a relationship framework; and (iii) submission to Parliament of amendments to the 2014 budget in line with the program's revised macro-fiscal framework. Staff views these actions as macro critical since they are instrumental to restore confidence in the banking sector and ensure the consistency of fiscal policy with macroeconomic developments.

- **Quantitative performance criteria (PCs):** All end-September and continuous PCs have been met (MEFP, Tables 1 and 2). Modifications of four end-December PCs are proposed: (i) the general government primary balance; (ii) the general government primary expenditure; (iii) the stock of general government debt; and (iv) the accumulation of government guarantees. The proposed changes to (i)-(ii) reflect tighter fiscal targets given the revised macroeconomic scenario and correct the adjustor on the accommodation of budgetary compensation of Laiki pension funds (¶6 and 8). The proposed change to the ceiling on government debt is mainly due to a lower expected short-term debt level in 2013 and is complemented with the introduction of an adjustor allowing the debt ceilings for Q4 2013 and Q1 2014 to accommodate the proceeds of direct loans included in the 2014 budget to be spent in the course of 2014 (TMU ¶10). The ceiling on accumulation of guarantees will be adjusted to accommodate government guaranteed loans from the EIB to support SMEs and better fit the timing of disbursements of other ongoing projects. An adjustor will be included in the TMU for Q4 2013 and Q1 2014 to lift the guarantees ceiling if the EIB loan to EAC for the Vassilikos power plant materializes. Quantitative PCs are also proposed for end-March 2014.

- **Structural benchmarks:** All but one of the program benchmarks have been met, with the remaining one being implemented with a two month delay (MEFP, Table 2). Several new benchmarks are proposed (MEFP, Table 3): (i) Resolution authority to instruct the special administrator to entrust the voting rights of legacy Laiki's shares in BoC to a well recognized and independent consulting or auditing firm (end-January 2014); (ii) submission of the CCB final restructuring plan to the European Commission and completion of an independent fair value assessment of the CCB and CCIs assets (end-January 2014); (iii) establishment of an effective and well resourced AML/CFT unit (end-February 2014); (iv) completion by the CBC of an in-situ assessment of the degree of operational capacity of the bank's loan workout units (end-March 2014); and (v) approval by the Council of Ministers of the final design of the reformed social welfare system (end-March 2014).

33. Risks to the program are still significant:

- **The impact of the banking crisis on the economy remains uncertain**. Confidence in the banking system remains weak and may take time to recover, delaying a return of deposit growth and associated credit growth. The deleveraging process could be more protracted, leading to a more prolonged recession and to a slower recovery which could negatively affect bank asset quality and profitability resulting in additional capital needs. Such needs could also be uncovered by the asset quality review to be undertaken next year in the context of broader European initiatives. Delays in the removal of payment restrictions would negatively affect activity, while a premature removal may jeopardize financial sector stability.

- **Policy implementation could become more challenging**. Prolonged tensions between the executive branch and the central bank, and within the top management of the bank, may lead to delays in policy implementation in the critical financial sector area. Moreover, rising unemployment and deteriorating social conditions could call into question the fiscal consolidation path, and vested interests may impede structural reforms and privatization efforts.

- **Litigation risks remain**. A number of legal claims for compensation related to resolution losses in Laiki and BoC have been filed at the Supreme Court and in district courts, and prospective legal claims related to the recapitalization of Hellenic bank through conversion of junior debt into Tier I instruments cannot be excluded. If successful, such claims could require the payment of compensatory damages which could increase the fiscal cost of the bank restructuring.

34. There are factors mitigating these risks. BoC and Hellenic Bank are now fully capitalized above minimum requirements and under prudent assumptions, providing some margin for additional deterioration of asset quality. At the same time, the program buffer remains sizeable and could cover comfortably additional fiscal needs even under a severe growth shock, or, alternatively, more than a doubling of state aid needs for the coop sector, if needed. The buffer also provides a cushion for debt sustainability: if not used, this would lead to lower debt levels. As to short-run liquidity concerns, the roadmap to gradually relax restrictions provides predictability, while the re-profiling of deposit maturities and the possibility of additional government guarantees allows for some room for maneuver. Implementation risks are being mitigated by stepping up technical assistance, and the authorities have had success with limiting litigation risks so far, with recent applications for injunctions having been denied by district courts.

35. Financing assurances for the program remain in place. In particular, the program is expected to be fully financed through the next year and there are good prospects that there will be adequate financing thereafter. Financing needs in 2014 are projected at €3 billion. Planned disbursements from the ESM/IMF of about €2.5 billion, together with expected distribution of profits from the Central bank (€400 million expected to be distributed by end-March, MEFP ¶21), and deposits of around €850 million at end-2013 ensure adequate financing prospects for the next 12 months. In addition, preparations for the privatization of public assets are ongoing and the authorities have identified the assets and will initiate an independent appraisal needed to complete the swap of about €1 billion of debt held by the CBC for state-owned assets by mid-2014.

36. Capacity to repay the Fund remains adequate (Table 7). Debt service to the Fund as a percentage of exports or GDP is expected to remain manageable. It is expected to peak at less than 2 percent in 2020, while outstanding credit to the Fund is expected to peak at 563 percent of quota in 2016. External and public debt (as a percentage of GDP) are expected to peak in 2014 and 2015, respectively (Annex II). However, external and fiscal adjustment, coupled with a resumption of economic growth, is expected to put debt firmly on a downward trend (Table 9, and Annex I). While Cyprus's capacity to repay the Fund seems robust, banking system related shocks (Annex I) could undermine it.

STAFF APPRAISAL

37. The authorities have established a good early track record of policy implementation, and the challenge is to maintain the momentum going forward. In the context of better than expected macroeconomic outcomes, the authorities have exceeded fiscal targets with comfortable margins and met the requirements of all program structural benchmarks. Still, the economic contraction has been severe and the outlook remains difficult, with unemployment rising and the recession expected to continue through next year. Against this background, and given resistance to reforms from vested interests, maintaining the pace of policy implementation could become more challenging.

38. Significant progress has been made with restructuring and recapitalizing the financial sector. Bank of Cyprus, now under new management, has put in place a restructuring plan aiming to return the bank to profitability. Hellenic Bank was fully recapitalized without public support and with significant foreign direct investment, ahead of the program deadline. The restructuring of the cooperative sector has started, with a number of mergers already completed in accordance with the draft restructuring plan. To restore confidence in the financial sector, the authorities will need to closely monitor progress and ensure that banks can adequately implement their restructuring plans and adapt to changing circumstances, as needed.

39. Key next steps are to finalize the recapitalization and restructuring of coops. Strengthening governance arrangements, finalizing the restructuring plan, and completing a fair value assessment of coops are key preconditions for the injection of state aid in the sector. The authorities also need to continue with completing the consolidation of the sector to ensure the viability of remaining institutions. The success of the strategy depends critically on keeping the public well informed about the objectives of the strategy and progress toward these.

40. Decisive action to deal with non-performing assets is essential to restore credit to the economy. Banks have significant legacy non-performing loans and face a continued deterioration of asset quality given the economic downturn. At the same time, private sector indebtedness remains very high. Dealing with troubled borrowers and cleaning up banks' balance sheets is, therefore, key to facilitate an orderly deleveraging and pave the way for the economic recovery. In this regard, the authorities need to ensure than an adequate private sector debt restructuring framework is in place, by providing strong incentives to promote mutual cooperation and discourage strategic defaults, while avoiding political interference (via imposition of interest rate caps) with prudent allocation of credit. Banks also need to set clear policies and targets and report on progress with debt restructuring.

41. Payment restrictions need to continue to be relaxed in line with the authorities' roadmap, while safeguarding financial stability. There has been progress toward achieving key milestones in the banking sector strategy, and the authorities are committed to meeting remaining milestones. To ensure that adequate conditions are in place for additional relaxations in line with the roadmap, the authorities will need to strengthen their communication to markets and fine-tune their analysis of confidence and liquidity trends. Adequate liquidity from the Eurosystem is also critical.

42. The authorities need to continue to strengthen supervision, regulation, and the AML framework. They have taken steps to correct shortcomings that had allowed vulnerabilities to build up in the run up to the crisis. These steps include the integration of supervision of banks and coops, setting up a credit register, and strengthening reporting guidelines. Looking forward, the authorities will need to build on these efforts and prepare for the integration of the supervisory and regulatory framework into broader European initiatives. Furthermore, they need to strengthen the supervision of banks' compliance with the recently-enhanced AML/CFT legal framework.

43. The authorities are pursuing prudent fiscal policies, targeting lower deficit levels than originally envisaged. Fiscal targets through end-September were met with significant margins, helped by better-than-anticipated macroeconomic outturns and continued prudent execution of the 2013 budget, which includes a significant consolidation effort. In this context, the end-year fiscal targets were tightened somewhat, locking in some of the over-performance during the first nine months of this year. The 2014 budget is appropriately conservative and includes a small amount of additional high quality permanent measures beyond program requirements. Continued prudent execution of the budget is needed to ensure that next year's revised targets will be met.

44. Fiscal efforts need to be complemented with steps to advance structural reforms and jump-start the privatization process. Protecting vulnerable groups during the downturn should remain a high priority. In this regard, staff welcomes the authorities' renewed commitment to implementing a generalized minimum income scheme with broad coverage and adequate targeting in the first half of next year. To support the ongoing fiscal consolidation, further steps need to be taken to improve budget processes and strengthen revenue collections by combating tax evasion and modernizing the tax administration to achieve efficiency gains. Finally, privatization efforts need to be accelerated not only to secure financing targets but also to improve overall economic efficiency.

45. Given still significant risks, there is no room for implementation slippages. A more protracted recession, with knock on effects on the fiscal and financial sectors, could lead to additional financing needs and put debt sustainability at risk. Reform fatigue and prolonged internal tensions could impede key reforms and prevent a needed increase in confidence. The program buffer provides a cushion against additional financing needs, and the authorities need to ensure the timely allocation of central bank profits and proceed with the planned debt-to-asset swap to secure financing and debt targets. Ultimately, continued impeccable policy implementation remains critical to setting in motion a virtuous cycle of confidence and growth.

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

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
									Projections				
Real Economy						(Percent change, unless otherwise indicated)							
Real GDP	3.6	-1.9	1.3	0.4	-2.4	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Domestic demand	8.0	-7.0	1.9	-1.5	-4.2	-12.4	-7.2	0.4	1.6	2.5	2.7	2.5	2.4
Consumption	7.4	-4.6	1.4	1.0	-2.6	-9.2	-6.3	0.3	1.5	2.2	2.5	2.3	2.2
Private consumption	7.8	-7.5	1.5	1.3	-2.5	-10.7	-6.7	1.3	2.8	3.5	3.1	2.6	2.4
Public consumption	6.1	6.8	1.0	-0.3	-3.1	-4.1	-5.2	-3.2	-3.1	-2.2	0.6	0.8	1.3
Fixed investment	6.0	-9.7	-4.9	-8.7	-19.6	-28.5	-14.0	1.2	3.1	4.7	4.5	4.2	3.9
Inventory accumulation 1/	0.9	-1.5	1.8	-0.7	1.4	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.0	2.0	5.1	2.2	0.5	0.3	0.0	-0.4	-0.5	-0.5
Exports of goods and services	-0.5	-10.7	3.8	4.4	-2.7	-5.8	-2.9	1.7	2.7	3.3	3.3	3.3	3.3
Imports of goods and services	8.5	-18.6	4.8	-0.2	-6.4	-16.0	-8.0	0.8	2.3	3.7	4.5	4.7	4.7
Potential GDP growth	2.4	1.7	1.6	1.7	-1.5	-7.4	-4.6	0.0	0.6	1.4	1.6	1.7	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.6	-3.8	-3.0	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	0.8	1.0	1.5	1.7	1.7	1.8	1.9	2.0
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	-0.3	1.0	1.5	1.7	1.7	1.8	1.9	2.0
Unemployment rate EU stand. (percent)	3.7	5.4	6.3	7.9	11.9	16.7	19.8	19.0	17.7	16.0	14.6	13.2	12.0
Employment growth (percent)	2.2	-0.3	-0.2	0.3	-4.1	-6.3	-4.4	0.8	1.7	2.2	2.0	1.8	1.6
Public Finance							(Percent of GDP)						
General government balance	0.9	-6.1	-5.3	-6.3	-6.4	-5.9	-6.6	-5.2	-2.0	-1.1	-0.4	-0.5	-0.8
Revenue	43.1	40.1	40.9	39.9	40.0	41.2	40.6	40.0	40.6	41.3	41.7	42.0	42.1
Expenditure	42.1	46.2	46.2	46.3	46.4	47.1	47.2	45.2	42.6	42.4	42.1	42.5	42.9
Primary Fiscal Balance	3.8	-3.6	-3.0	-4.0	-3.3	-2.6	-3.3	-2.1	1.2	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.5	86.6	113.7	122.1	126.2	122.7	116.6	112.2	108.5	105.3
Balance of Payments							(Percent of GDP)						
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.4	0.3	0.2	0.0	-0.3	-0.7	-1.0	-1.4
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.7	3.9	4.0	4.1	4.0	3.6	3.3	3.0
Exports of goods and services	45.0	40.2	41.3	42.9	42.9	44.2	45.3	45.5	45.7	46.1	46.5	47.1	47.8
Imports of goods and services	56.4	45.7	47.5	47.2	46.0	42.5	41.4	41.5	41.6	42.1	42.8	43.8	44.8
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.2	-15.5	-15.5	-15.6	-15.8	-16.2	-16.6	-17.1
Services balance	21.0	19.9	20.6	20.1	18.7	19.0	19.4	19.5	19.7	19.8	19.8	19.9	20.1
Income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.5	-3.1	-3.4	-3.7	-3.9	-4.0	-4.0	-4.1
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.2	-0.7	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.8	0.8	0.7	0.5	0.4	0.3	0.3	0.2
Financial account, net	16.1	10.9	9.5	4.4	4.8	-29.9	-16.9	-14.5	-3.1	0.0	0.8	1.4	2.0
Direct investment	-5.2	13.2	0.4	0.7	6.8	0.2	0.5	4.3	4.7	3.1	3.0	4.0	4.0
Portfolio investment	-74.2	-101.1	-11.1	32.2	30.1	59.2	3.2	-4.2	-3.1	-2.6	-2.5	-2.5	-4.2
Other investment	93.8	98.2	19.0	-28.8	-32.4	-89.4	-20.7	-14.6	-4.7	-0.5	0.3	-0.1	2.2
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	0.0	0.0	29.5	15.8	13.6	2.6	0.0	-0.3	-0.6	-0.8
European Union	0.0	0.0	0.0	0.0	0.0	27.9	13.6	11.4	2.1	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	1.6	2.2	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	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	8.6	10.0	13.2	8.2	10.1	10.9	11.2	11.4	11.4	11.2	11.2	10.9
Government	4.9	-0.6	-0.1	-1.8	-2.6	-2.6	-3.5	-2.2	1.0	2.2	3.0	2.9	2.5
Non-government	2.8	9.2	10.0	15.0	10.8	12.7	14.4	13.4	10.4	9.2	8.2	8.3	8.4
Gross capital formation	23.3	19.4	19.8	16.6	15.0	11.5	10.6	11.0	11.4	11.7	11.9	12.2	12.3
Government	5.0	5.1	5.0	5.0	5.5	5.6	5.0	4.7	4.3	4.2	4.1	4.3	4.5
Private	18.3	14.3	14.8	11.6	9.5	5.9	5.6	6.3	7.1	7.6	7.8	7.8	7.8
Foreign saving	-15.6	-10.7	-9.8	-3.4	-6.9	-1.4	0.3	0.2	0.0	-0.3	-0.7	-1.0	-1.4
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	17.9	17.7	16.4	15.8	16.2	16.8	17.5	18.2	18.9	19.6

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

1/ Contribution to growth.

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

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
									Projections				
Revenue	43.1	40.1	40.9	39.9	40.0	41.2	40.6	40.0	40.6	41.3	41.7	42.0	42.1
Current revenue	43.0	40.0	40.8	39.9	39.9	41.2	40.6	40.0	40.6	41.3	41.7	41.9	42.1
Tax revenue	30.6	26.4	26.5	26.4	25.9	26.4	26.2	26.2	26.7	27.0	27.2	27.2	27.3
Indirect taxes	17.7	15.2	15.4	14.6	14.9	14.7	14.9	15.0	15.3	15.5	15.7	15.7	15.7
Direct taxes	12.9	11.2	11.1	11.7	11.1	11.7	11.4	11.2	11.3	11.4	11.5	11.5	11.6
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.8	9.1	8.7	9.1	8.8	8.7	8.8	8.9	8.9	9.0
Other current revenue	4.6	4.9	5.4	4.8	4.8	6.1	5.3	5.0	5.2	5.5	5.7	5.8	5.8
Sales	2.9	2.4	2.6	2.4	2.7	2.6	2.6	2.7	2.9	3.1	3.2	3.2	3.2
Other	1.8	2.5	2.8	2.3	2.1	3.5	2.7	2.3	2.3	2.4	2.5	2.6	2.6
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.1	46.2	46.2	46.3	46.4	47.1	47.2	45.2	42.6	42.4	42.1	42.5	42.9
Current expenditure	38.2	40.7	40.9	41.7	42.6	43.8	44.1	42.2	39.6	39.0	38.8	39.1	39.5
Wages and salaries	14.6	16.2	15.8	16.1	15.9	16.0	15.5	14.9	14.2	13.9	13.8	13.7	13.6
Goods and services	5.0	5.4	5.6	5.3	4.9	5.2	5.5	5.3	5.0	4.5	4.4	4.4	4.4
Social Transfers	12.2	13.5	14.4	14.7	15.2	15.7	16.8	16.2	15.0	14.5	14.2	14.4	14.5
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Interest payments 2/	2.8	2.6	2.2	2.4	3.2	3.3	3.3	3.1	3.2	4.1	4.3	4.5	4.8
Other current expenditure	3.1	2.9	2.5	2.8	2.9	3.1	2.5	2.2	1.7	1.5	1.4	1.7	1.8
Capital expenditure	4.0	5.5	5.2	4.5	3.8	3.3	3.1	3.1	3.0	3.3	3.3	3.4	3.4
Overall balance 3/	0.9	-6.1	-5.3	-6.3	-6.4	-5.9	-6.6	-5.2	-2.0	-1.1	-0.4	-0.5	-0.8
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.4	-5.9	-6.6	-5.2	-2.0	-1.1	-0.4	-0.5	-0.8
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.4	-5.9	-6.6	-5.2	-2.0	-1.1	-0.4	-0.5	-0.8
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.7	13.7	-3.4	1.1	-1.7	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.6	4.9	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	1.1	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.5	8.8	3.6	1.1	-1.7	-2.3	0.0	0.0	0.0
Other assets	0.2	0.3	0.0	-0.4	0.1	0.0	-8.9	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.7	15.1	19.6	3.2	6.3	0.3	-1.2	0.4	0.5	0.8
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	-9.0	-5.6	-6.7	1.4	1.2	4.3	4.6	5.0
Loans	3.0	-0.3	0.0	4.0	12.7	28.6	8.8	13.0	-1.0	-2.4	-3.9	-4.1	-4.2
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance	3.8	-3.6	-3.0	-4.0	-3.3	-2.6	-3.3	-2.1	1.2	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.5	86.6	113.7	122.1	126.2	122.7	116.6	112.2	108.5	105.3

Sources: Eurostat; and IMF staff estimates.

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

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

3/ Projections for 2015-18 include 4 percent of GDP in unspecified additional fiscal measures as agreed under the program. It is assumed that 70 percent of the measures are on the spending and the rest on the revenue side.

Table 3. Cyprus: Calculation of Gross Financing Requirements and Sources of Financing, 2013–17
(Millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**5,800.5**	**3,821.6**	**3,621.6**	**2,128.6**	**3,899.9**
Government	3,556.4	3,014.4	2,969.9	1,929.5	3,899.9
Fiscal deficit ("+" = financing need)	1,028.7	1,077.4	849.2	341.9	196.4
Debt maturities	2,527.6	1,937.0	2,120.7	1,587.6	3,703.5
Medium- and long-term	1,600.5	1,009.9	1,193.6	660.5	2,776.4
Domestic 1/	142.7	379.4	284.2	436.6	2,666.3
Foreign	1,457.9	630.5	909.4	223.9	110.2
Short-term	927.1	927.1	927.1	927.1	927.1
Domestic	927.1	927.1	927.1	927.1	927.1
Foreign	0.0	0.0	0.0	0.0	0.0
Banks recapitalization/support	1,500.0	0.0	0.0	0.0	0.0
Market financing	**957.1**	**927.1**	**927.1**	**1,192.5**	**3,499.9**
Government	957.1	927.1	927.1	1,192.5	3,499.9
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	957.1	927.1	927.1	1,192.5	3,499.9
Medium- and long-term	30.0	0.0	0.0	265.4	2,572.8
Short-term	927.1	927.1	927.1	927.1	927.1
Net financing requirement	**4,843.4**	**2,894.5**	**2,694.5**	**936.1**	**400.0**
Government	2,599.3	2,087.3	2,042.8	737.0	400.0
Fiscal deficit	1,028.7	1,077.4	849.2	341.9	196.4
Debt maturities	1,570.5	1,009.9	1,193.6	395.0	203.6
Medium- and long-term	1,570.5	1,009.9	1,193.6	395.0	203.6
Short-term	0.0	0.0	0.0	0.0	0.0
Official Financing Sources and Financial Buffers	**4,843.4**	**2,894.5**	**2,694.5**	**936.1**	**400.0**
Domestic Financing Sources	**0.0**	**400.0**	**500.0**	**500.0**	**400.0**
Official financing sources	**4,843.4**	**2,494.5**	**2,194.5**	**436.1**	**0.0**
IMF	258.4	344.5	344.5	86.1	0.0
ESM	4,585.0	2,150.0	1,850.0	350.0	0.0

1/ Domestic maturities in 2017 include the repayment of the Laiki recapitalization bond.
Source: IMF staff estimates.

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections							
						(Millions of Euros)							
Current account balance	-2,679	-1,808	-1,711	-602	-1,217	-230	51	35	-2	-53	-131	-190	-272
Trade balance (Goods and Services)	-1,954	-929	-1,084	-763	-546	287	614	652	688	695	664	628	591
Goods balance	-5,556	-4,291	-4,665	-4,349	-3,856	-2,825	-2,446	-2,503	-2,616	-2,765	-2,948	-3,143	-3,357
Exports	1,190	1,002	1,137	1,411	1,440	1,458	1,491	1,534	1,591	1,672	1,758	1,851	1,951
Imports	-6,746	-5,293	-5,802	-5,760	-5,296	-4,283	-3,937	-4,037	-4,207	-4,437	-4,706	-4,994	-5,308
Services Balance	3,602	3,362	3,581	3,585	3,310	3,113	3,060	3,155	3,304	3,460	3,611	3,771	3,948
Exports	6,538	5,779	6,049	6,262	6,167	5,802	5,657	5,829	6,076	6,381	6,708	7,061	7,443
Imports	-2,936	-2,417	-2,468	-2,676	-2,857	-2,689	-2,597	-2,674	-2,773	-2,921	-3,097	-3,290	-3,495
Current income, net	-662	-685	-379	357	-456	-410	-494	-550	-615	-674	-726	-758	-808
Current transfers, net	-63	-193	-116	-196	-215	-107	-69	-68	-74	-73	-68	-60	-55
Private	23	-107	-56	-101	-155	-91	-59	-54	-54	-52	-55	-50	-48
Public	-86	-86	-60	-94	-60	-16	-9	-13	-20	-21	-13	-10	-7
Capital account, net	6	50	36	46	23	295	127	107	87	67	47	47	47
Financial account, net	2,765	1,835	1,647	781	847	-4,908	-2,673	-2,337	-521	-8	141	257	390
Direct investment	-890	2,224	65	132	1,197	40	79	702	785	540	546	757	786
Portfolio investment	-12,722	-17,039	-1,934	5,753	5,340	9,729	510	-676	-513	-460	-456	-474	-823
Other investment	16,085	16,558	3,313	-5,146	-5,748	-14,677	-3,261	-2,363	-794	-88	51	-25	427
Reserves (- inflow; + outflow)	291	93	200	43	57	0	0	0	0	0	0	0	0
Program financing	...	...	...	...	0	4,843	2,494	2,194	436	-7	-57	-115	-165
European Union	...	...	...	...	0	4,585	2,150	1,850	350	0	0	0	0
IMF	...	...	...	...	0	258	344	344	86	-7	-57	-115	-165
Errors and omissions	-92	-78	31	-225	346	0	0	0	0	0	0	0	0
						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.4	0.3	0.2	0.0	-0.3	-0.7	-1.0	-1.4
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.7	3.9	4.0	4.1	4.0	3.6	3.3	3.0
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.2	-15.5	-15.5	-15.6	-15.8	-16.2	-16.6	-17.1
Exports	6.9	5.9	6.5	7.9	8.1	8.9	9.4	9.5	9.5	9.6	9.7	9.8	9.9
Imports	-39.3	-31.4	-33.3	-32.2	-29.9	-26.1	-24.9	-25.0	-25.1	-25.4	-25.8	-26.4	-27.0
Services balance	21.0	19.9	20.6	20.1	18.7	19.0	19.4	19.5	19.7	19.8	19.8	19.9	20.1
Exports	38.1	34.3	34.8	35.0	34.8	35.3	35.8	36.1	36.3	36.5	36.8	37.3	37.9
Imports	-17.1	-14.3	-14.2	-15.0	-16.1	-16.4	-16.5	-16.5	-16.5	-16.7	-17.0	-17.4	-17.8
Current income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.5	-3.1	-3.4	-3.7	-3.9	-4.0	-4.0	-4.1
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.2	-0.7	-0.4	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
Private	0.1	-0.6	-0.3	-0.6	-0.9	-0.6	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.8	0.8	0.7	0.5	0.4	0.3	0.3	0.2
Financial account, net	16.1	10.9	9.5	4.4	4.8	-29.9	-16.9	-14.5	-3.1	0.0	0.8	1.4	2.0
Direct investment	-5.2	13.2	0.4	0.7	6.8	0.2	0.5	4.3	4.7	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.2	-101.1	-11.1	32.2	30.1	59.2	3.2	-4.2	-3.1	-2.6	-2.5	-2.5	-4.2
Other investment 2/	93.8	98.2	19.0	-28.8	-32.4	-89.4	-20.7	-14.6	-4.7	-0.5	0.3	-0.1	2.2
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	...	...	...	0.0	29.5	15.8	13.6	2.6	0.0	-0.3	-0.6	-0.8
European Union	...	...	...	...	0.0	27.9	13.6	11.4	2.1	0.0	0.0	0.0	0.0
IMF	...	0.0	0.0	0.0	0.0	1.6	2.2	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	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, 2012-20
(Millions of Euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
GROSS FINANCING REQUIREMENTS	**60,086**	**61,352**	**32,869**	**30,722**	**29,027**	**28,348**	**28,739**	**28,505**	**28,293**
Current account deficit ("-" = CA surplus)	1,217	230	-51	-35	2	53	131	190	272
Medium- and long-term debt amortization	5,800	12,140	4,406	4,205	4,064	4,057	4,811	4,958	5,414
Public sector	593	1,009	462	314	146	92	773	840	1,213
Banks	4,380	10,056	2,331	2,295	2,289	2,287	2,310	2,339	2,368
Other private	827	1,075	1,613	1,597	1,629	1,678	1,728	1,780	1,833
Short-term debt amortization	53,069	48,982	28,513	26,552	24,961	24,231	23,741	23,242	22,442
Public sector	8,290	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522
Central Bank	7,992	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522
General government and SOEs	298	0	0	0	0	0	0	0	0
Banks	43,727	40,414	20,747	19,346	18,473	18,426	18,600	18,824	19,054
Other private	1,053	1,075	1,021	970	1,067	1,227	1,411	1,623	1,867
EU and IMF	0	0	0	0	0	7	57	115	165
SOURCES OF FINANCING	**60,086**	**56,509**	**30,374**	**28,527**	**28,591**	**28,348**	**28,739**	**28,505**	**28,293**
Capital account (net)	23	295	127	107	87	67	47	47	47
Foreign direct investment (net)	1,197	40	79	702	785	540	546	757	786
CYP investment abroad	219	0	-158	-162	-335	-524	-546	-567	-589
Foreign investment in CYP	979	40	237	864	1,120	1,064	1,093	1,324	1,375
New borrowing and debt rollover	54,254	35,234	30,260	28,987	28,605	28,157	28,424	27,782	28,449
Medium and long-term borrowing	5,271	6,721	3,709	4,026	4,374	4,416	5,182	5,339	6,270
General Government	2,120	30	0	0	224	110	773	840	1,678
Banks	1,084	2,927	2,176	2,270	2,277	2,377	2,422	2,453	2,484
Other private	2,067	3,764	1,532	1,756	1,873	1,929	1,987	2,047	2,108
Short-term borrowing	48,982	28,513	26,552	24,961	24,231	23,741	23,242	22,442	22,179
Public sector	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522	212
Central Bank	7,494	6,744	6,235	5,421	4,578	3,729	2,795	1,522	212
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	20,747	19,346	18,473	18,426	18,600	18,824	19,054	20,007
Other private	1,075	1,021	970	1,067	1,227	1,411	1,623	1,867	1,960
Other	4,612	20,940	-93	-1,270	-886	-416	-278	-81	-989
Of which: Net errors and omissions	346	0	0	0	0	0	0	0	0
FINANCING GAP	**0**	**4,843**	**2,494**	**2,194**	**436**	**0**	**0**	**0**	**0**
ESM	0	4,585	2,150	1,850	350	0	0	0	0
IMF	0	258	344	344	86	0	0	0	0
ROLLOVER RATES									
General government	238%	3%	0%	0%	153%	120%	100%	100%	138%
Central bank	94%	90%	92%	87%	84%	81%	75%	54%	14%
Private	89%	54%	93%	97%	101%	103%	103%	103%	106%
Banks	86%	47%	93%	96%	100%	101%	102%	102%	105%
Non-financial corporates	167%	223%	95%	110%	115%	115%	115%	115%	110%

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

Table 6. Cyprus Monetary Survey, 2008–20
(Billions of Euros, unless otherwise indicated, end of period)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Aggregated Balance Sheet of Other Monetary Financial Institutions (MFIs)													
Assets	118.1	139.4	135.0	131.4	128.1	90.5	89.2	88.0	88.3	89.2	90.5	92.0	93.7
Claims on Central Bank of Cyprus	1.3	3.1	2.3	2.9	3.9	2.4	2.4	2.4	2.4	2.5	2.6	2.7	2.8
Claims on Cypriot resident other MFIs	3.3	5.4	5.6	5.0	4.6	3.4	3.2	3.3	3.4	3.6	3.7	3.9	4.0
Claims on Cypriot resident non MFIs	47.2	50.3	54.0	58.2	60.6	54.2	50.6	48.7	48.6	48.8	49.2	49.7	50.5
General government	3.7	4.6	4.5	5.3	6.5	5.5	5.7	6.0	6.1	6.0	6.0	6.1	6.1
Private sector excluding brass plates 1/	39.4	42.7	46.5	48.6	49.3	45.4	41.7	39.5	39.3	39.6	39.9	40.4	41.1
Households	19.1	20.6	22.5	23.5	23.9	21.7	20.5	19.7	19.6	19.5	19.5	19.6	19.9
Non-financial corporations	19.7	21.5	23.3	24.1	24.4	22.8	20.4	19.0	19.0	19.4	19.7	20.0	20.4
Non-bank financial intermediaries	0.6	0.6	0.7	1.0	1.0	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Brass plates 2/	4.1	3.0	3.0	4.4	4.8	3.2	3.2	3.2	3.2	3.2	3.2	3.3	3.3
Claims on non-residents	63.4	76.9	69.3	61.3	55.9	26.2	27.1	27.7	27.9	28.4	29.1	29.8	30.4
Other assets	2.9	3.8	3.8	3.9	3.2	4.4	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Liabilities	118.1	139.4	135.0	131.6	128.1	90.5	89.2	88.0	88.3	89.2	90.5	92.0	93.7
Liabilities to the Central Bank of Cyprus and Eurosystem	4.7	7.6	5.5	5.5	9.8	11.3	10.6	9.9	9.1	8.3	7.8	7.5	7.4
Liabilities to Cypriot resident other MFI	3.3	5.3	5.5	4.9	4.5	3.3	3.1	3.2	3.3	3.5	3.6	3.8	3.9
Deposits of Cypriot resident non MFIs	39.5	41.0	45.4	43.7	43.3	31.4	30.3	30.4	31.4	32.6	33.9	35.1	36.3
General government	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Private sector excluding brass plates	33.4	34.5	36.8	37.4	37.5	28.5	27.4	27.5	28.5	29.7	31.0	32.2	33.4
Households	23.4	24.6	25.4	26.0	26.4	22.1	21.2	21.3	22.1	23.0	24.0	24.9	25.9
Non-financial corporations	6.3	6.1	6.7	6.7	5.7	3.6	3.5	3.5	3.6	3.8	4.0	4.1	4.3
Non-bank financial intermediaries	3.6	3.9	4.7	4.6	5.4	2.8	2.7	2.7	2.8	2.9	3.0	3.2	3.3
Brass plates	5.7	6.1	8.1	5.8	5.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Deposits of non-residents	51.7	66.6	60.6	56.5	51.3	27.2	26.3	25.7	25.7	26.1	26.5	26.9	27.3
Debt securities	5.6	4.8	2.4	2.6	1.7	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital and reserves	10.0	10.8	12.8	11.3	15.1	15.3	16.8	16.8	16.8	16.8	16.8	16.8	16.8
Other liabilities	3.4	3.3	2.8	7.1	2.4	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Money and Credit													
General government sector credit, net	4.5	5.3	5.2	5.3	7.2	5.1	5.3	5.6	5.6	5.6	5.6	5.6	5.6
Private sector credit excluding brass plates	39.5	42.7	46.5	48.6	49.3	45.4	41.7	39.5	39.3	39.6	39.9	40.4	41.1
Brass plates credit	4.1	3.0	3.0	4.4	4.8	3.2	3.2	3.2	3.2	3.2	3.2	3.3	3.3
Cypriot resident broad money (M2)	40.6	42.2	46.6	45.0	44.6	32.8	31.7	31.9	32.9	34.2	35.5	36.8	38.1
Cypriot resident narrow money (M1)	9.1	10.4	10.6	11.1	11.5	8.8	8.8	8.9	9.5	10.1	10.6	11.1	11.5
						(Percent of GDP)							
General government sector credit, net	26.4	31.6	30.1	29.4	40.4	31.0	33.3	34.4	33.5	31.8	30.6	29.6	28.7
Private sector credit excluding brass plates	230.0	253.6	267.2	272.1	278.1	276.5	264.4	244.1	234.7	226.6	219.2	213.5	209.3
Brass plates credit	23.9	17.5	17.4	24.3	27.0	19.6	20.1	19.7	19.1	18.5	17.8	17.3	16.7
Cypriot resident broad money (M2)	236.7	250.2	267.4	251.7	251.9	199.9	200.8	197.1	196.5	195.7	195.0	194.4	193.8
Cypriot resident narrow money (M1)	53.0	61.8	61.2	62.2	64.8	53.7	55.8	55.1	56.4	57.6	58.1	58.5	58.8
						(Annual percentage change)							
General government sector credit, net	...	17.4	-1.6	0.4	36.2	-29.0	3.3	5.9	0.8	-1.0	0.3	0.5	0.8
Private sector credit excluding brass plates	...	8.3	8.8	4.6	1.3	-7.9	-8.1	-5.4	-0.3	0.7	0.8	1.2	1.9
Brass plates credit	...	-28.1	2.3	44.0	9.9	-32.9	-1.3	0.4	0.6	0.7	0.7	0.6	0.6
Cypriot resident broad money (M2)	...	3.9	10.4	-3.4	-0.8	-26.5	-3.5	0.5	3.4	3.9	3.8	3.5	3.5
Cypriot resident narrow money (M1)	...	14.5	2.3	4.4	3.2	-23.2	-0.1	1.1	6.2	6.5	5.1	4.5	4.4
Memorandum items:													
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	...	3.4	6.5	1.7	0.3	-23.9	-3.9	0.2	3.7	4.3	4.2	3.9	3.9
Brass plates deposits (y-o-y percent change)	...	6.2	33.8	-28.3	-9.4	-54.0	-1.3	0.2	0.3	0.4	0.3	0.3	0.3

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

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

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

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

(Millions of SDRs)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Existing and prospective Fund credit									
Disbursement	0.0	222.8	297.0	297.0	74.3	0.0	0.0	0.0	0.0
Stock	0.0	222.8	519.8	816.8	891.0	884.8	835.3	736.3	594.0
Obligations	0.0	1.6	4.8	10.6	17.4	24.3	70.6	118.1	156.8
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	10.6	17.4	18.1	21.1	19.1	14.5
Stock of existing and prospective Fund credit									
In percent of quota	0.0	140.8	328.5	516.3	563.2	559.3	528.0	465.4	375.5
In percent of GDP	0.0	1.5	3.8	5.8	6.1	5.8	5.2	4.4	3.5
In percent of exports of goods and services	0.0	20.4	47.2	73.0	78.0	74.9	68.5	58.4	45.6
Obligations to the Fund from existing and prospective Fund credit									
In percent of quota	0.0	1.0	3.0	6.7	11.0	15.4	44.7	74.6	99.1
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.2	0.4	0.7	0.9
In percent of exports of goods and services	0.0	0.1	0.4	0.9	1.5	2.1	5.8	9.4	12.0

Source: IMF staff estimates.

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

Table 8. Cyprus: Schedule of Reviews and Purchases

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

Source: IMF staff estimates.

Table 9. Cyprus: Restrictive Measures on Transactions

(Euros)

	27-Mar	2-Aug	22-Nov
Cash withdrawals (per day per person)			
Natural person	300	300	300
Legal person	300	500	500
Cashless payments/transfers w/o justification (per day per account)			
To other credit institutions in Cyprus			
Natural person (per month)	5,000	15,000	15,000
Legal person (per month)	5,000	75,000	75,000
For the purchase of goods and services w/o mandatory justification (per transaction) 2/	5,000	300,000	no limitation
To institutions abroad			
Transactions within normal business w/o Committee's approval	5,000	500,000	1,000,000
Payments via debit or credit card (per month)	5,000	No limit	No limit
Exports of euro notes or foreign currency per person per journey	1,000	3,000	3,000
Monthly transfer of deposits/funds abroad regardless of the purpose	5,000	5,000	5,000
Opening of new accounts is prohibited except: to deposit funds from abroad, for term deposits created with cash for a minimum of three months, for loans related to new customer credit facilities	Yes	No 1/	No 1/
It is prohibited to add new beneficiaries in a current account and cash cheques	Yes	Yes	Yes
Transactions of international customers of foreing banks exempted from restrictions	No	Yes (15 banks)	Yes (16 banks)
Termination of fixed term deposits prior to maturity	Only to repay a loan within same institution	Additional transactions allowed	Additional transactions allowed

1/ Or subject to prior approval by the committee.
2/ But a credit institution still reserves the right to request justifying documents.
Source: Central Bank of Cyprus / Ministry of Finance Cyprus

Table 10. Cyprus: Selected Reforms - Measures Completed

Measures	Completion time	Macrofinancial implications
Strengthening public finances		
Implemented a reform of the COLA wage indexation mechanism in the public sector by extending its freeze to the end of the program and limiting its application to 50 percent of the price index thereafter	December 2012	Strengthen fiscal sustainability
Adopted the 2013 and medium term budget with consolidation measures for 2013-16 of about 7 percent of GDP	December 2012	Strengthen fiscal sustainability
Reformed the General Social Insurance Scheme and to government pension scheme, and freeze public sector pensions	January 2013	Reduce implicit government liability
Legislated a medium-term budget framework, including rolling three-year budget projections		Strengthen fiscal sustainability
Rolled over and extended the maturity of €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and rolled over the €1.9 billion recapitalization bond of Laiki	June 2013	Facilitate government financing
Resolving, recapitalizing, and restructuring weak financial sector institutions		
Independently assessed banking sector capital needs	February 2013	Identify capital shortfall for banking system
Adopted a modern bank resolution law	March 2013	Minimize fiscal costs
Completed resolution of Laiki and disposed of Greek operations	March 2013	Strengthen financial sector stability
Conducted independent fair valuation of Laiki and BoC assets, and completed BoC recapitalization and exit from resolution	July 2013	Strengthen financial sector stability
Performed assessment of capital needs and viability of all CCIs	June 2013	Identify capital shortfall
Recapitalized Hellenic Bank from private sources	October 2013	Strengthen financial sector stability
Enhancing the supervisory and regulatory framework		
Harmonized NPL classification to best practice	September 2013	Strengthen financial sector stability
Unified supervision of CCIs and banks under the CBC	September 2013	Protect consumers
Passed legislation to prohibit banks and coops from lending to their independent board members and removing board members in arrears on debts to their banks	September 2013	Strengthen oversight of bank credit-risk management practices
Established the legal framework for a credit register	November 2013	Allow banks to make better informed loan decisions
Revamping corporate and household debt-restructuring framework		
Finalized a code of conduct for banks and a loan arrears framework	September 2013	Assist debt restructuring
Strengthening the AML framework		
Amended legislation to provide the widest possible range of cooperation to foreign counterparts	December 2012	Strengthen the sustainability of the business model
Conducted an audit by Deloitte and assessment by Moneyval of AML implementation practices by the banks	August 2013	Strengthen the sustainability of the business model
Amended legislation to improve transparency of companies and trusts	September 2013	Strengthen the sustainability of the business model

Table 11. Cyprus: MEFP Commitments for the Financial Sector

Measures	Deadline	Rationale
Resolving, recapitalizing, and restructuring weak institutions		
Banks under restructuring to be required to publish quarterly reports describing main developments regarding their restructuring	End-December 2013	Enhance transparency
Prepare a quarterly report on the main activities of the team monitoring BoC's compliance with its quarterly targets on key financial and operational indicators	End-December 2013	Strengthen financial sector stability
Inject the state funds in the CCB in exchange for common shares	After approval of restructuring plan by the EC	Enhance the viability of the CCI sector
Resolution Authority to instruct the Special Administrator to entrust the voting rights of legacy Laiki equity stake in BoC to an independent consulting or auditing firm	End-January 2014	Strengthen financial sector stability
Present a detailed roadmap for the full disposal of legacy Laiki's assets	End-January 2014	Strengthen financial sector stability
Complete a fair value assessment of the CCB's and CCI's assets and submit the final restructuring plan of CCIs to the EC	End-January 2014	Enhance the viability of the CCI sector
Merge the CCIs into up to 18 institutions which will be recapitalized	End-March 2014	Enhance the viability of the CCI sector
The CBC will require Hellenic Bank to submit a business plan through end-2015, including capital and funding plans	End-March 2014	Strengthen financial sector stability
CBC to finalize a detailed action plan to exercise the supervision of the cooperative credit sector by end-September 2013 and be fully operational by end-March 2014	End-September 2013; End-March 2014	Enhance supervisory power
Enhancing the supervisory and regulatory framework		
CBC to increase minimum CT1 capital requirement to 9 percent	End-December 2013	Ensure adequate capital
CBC to issue guidelines on asset impairment and provisioning and the treatment of collateral in provisioning	End-December 2013	Enhance transparency
Clarify tasks and responsibilities and ensure adequate staffing	End-January 2014	Ensure adequate supervision
CBC to complete its annual supervisory program for 2014	End-January 2014	Ensure adequate supervision
CBC to require banks to submit the 2014 work program of their internal audit departments	End-January 2014	Ensure adequate supervision
Amend, as necessary, the resolution law	End-January 2014	Ensure effectiveness of the resolution authority
Regulatory and supervisory frameworks for CCIs to be harmonized with those of commercial banks	End-March 2014	Maintain prudent level of risks
New prudential regulations covering underwriting standards, proper loan-collection practices, and appropriate collateral valuation practices to enter into force	End-March 2014	Ensure conservative implementation of accounting and provisioning treatment
Submit legislation to Parliament to introduce early corrective measures	End-June 2014	Enhance supervisory power
CBC to request a standalone assessment against the "Basel Core Principles for Effective Banking Supervision" to be completed	End-2015	Assess supervisory effectiveness
Revamping corporate and household debt-restructuring framework		
CBC to perform a review of the legislation and prepare a report on impediments in the private debt restructuring framework and measures to address them	End-December 2013	Identify impediments in private sector debt restructuring
Pass legislation to expand the role of the Financial Ombudsman to mediate debt-restructuring negotiations between banks and borrowers	End-January 2014	Assist debt restructuring
Submit to Parliament measures to address impediments in the private debt restructuring framework	End-February 2014	Assist debt restructuring
Complete an assessment of the degree of operational capacity of the banks' loan workout units to implement their arrears management plans.	End-March 2014	Assist debt restructuring
Complete a second round of inspections to verify banks' compliance with the Code of Conduct for voluntary negotiations between banks and their borrowers	End-May 2014	Assist debt restructuring
Credit register to be operational	End-September 2014	Allow banks to make informed loan decisions
Implement a framework for seizure and sale of loan collateral	End-December 2014	Facilitate debt restructuring
Normalizing financial flows		
Appoint a panel of experts to study market conditions for relaxation of controls	End-January 2014	Normalize financial flows
Issue a report to inform actions for 2nd phase of relaxation of administrative restrictions	End-January 2014	Normalize financial flows
Strengthening the AML framework		
MOF to commission and complete a third party assessment of the functioning of the Registrar of Companies and appropriately resource the department of the Registrar	End-December 2013	Identify resource implication
Complete follow-up on auditor's findings on possible breaches on compliance with AML requirements by banks	End-January 2014	To address shortcomings in the AML framework implementation
Adopt a plan to strengthen the effectiveness and adequacy of resources for the AML/CFT supervisory function	End-February 2014	To address shortcomings in the AML framework implementation
Registrar to revise its pricing policy on access to basic information on all Cyprus-incorporated companies	End-June 2014	Make available basic information free of charge while ensuring budget neutrality
CBC and relevant AML supervisors to develop and implement the necessary risk-based tools for off-and onsite AML supervision of financial institutions (by end-June 2014), lawyers and accountants (by end-September 2014), and trust and company service providers (by end-December 2014)	End-June 2014; End-September 2014; End-December 2014	Enhance supervision

Table 12. Cyprus: MEFP Commitments for the Fiscal Sector

Measures	Deadline	Rationale
Social welfare system and social insurance		
Complete the costing of the guaranteed minimum income (GMI) scheme and refine the means testing mechanism	End-December 2013	Ensure adequate social protection and eliminate duplicate benefits
Approval by Council of Ministers of design of social welfare reform system	End-March 2014	Ensure adequate social protection and eliminate duplicate benefits
Adopt the legal framework for the new social welfare system	End-May 2014	Improve the targeting of social assistance, consolidate welfare programs, and streamline administration
Implement a new social welfare system	End-June 2014	
Revenue administration		
Reform plan on revenue administration to be approved by the government	End-December 2013	Increase efficiency of revenue administration
Adopt short-term measures to fight tax evasion	End-December 2013	Increase collection enforcement powers
Public financial management		
Amend the Public Debt Management Law to assign responsibility for monitoring the stock of guarantees to the Public Debt Management Office, while ensuring adequate staffing	End-December 2013	Allow more regular assessment of risks stemming from government guarantees
Adopt a law on fiscal responsibility and budget systems	End-December 2013	Strengthen public financial management
Include a statement of SOEs and semi-government entities as an appendix to the budget	End-December 2013	Strengthen public financial management
Modify systems and procedures and publish a circular to announce that government orders are subject to pre-commitment validation	End-March 2014	Avoid budget overruns
Privatization		
Adoption by the Council of Ministers of a privatization plan with the aim of achieving proceeds of at least €1.4 billion by end-2018	End-December 2013	Facilitate the privatization process
Complete the full inventory of assets with the highest commercial value	End-December 2013	Facilitate the privatization process
Adopt the legal and institutional framework for privatization to support the privatization process	End-January 2014	Support the privatization process
Reduce program financing needs		
An allocation of central bank profits of EUR €0.4 (in line with the CBC duties under the Treaties and the Statute) to be distributed	2014	Reduce financing needs
CBC to decide asset swap so as to contribute approximately EUR €1bn to the reduction of public debt	End-June 2014	Reduce public debt

Annex 1. Public Sector Debt Sustainability Analysis

This appendix updates Cyprus' debt sustainability assessment to reflect revisions in macroeconomic projections and the new debt sustainability analysis (DSA) framework. The overall assessment remains that full implementation of the program can place Cyprus's debt on a sustainable trajectory. However, high debt levels, uncertain growth prospects, and exposure to contingent liabilities from the financial sector make the debt trajectory highly vulnerable to shocks. In particular, a sizeable deterioration in growth and/or potential additional needs in the banking sector that would exhaust the program buffer would require additional financing measures and commitments from European partners to protect the sustainability of Cyprus's public sector debt.

1. The baseline debt projection remains broadly unchanged. The debt ratio was revised down slightly to 113.7 percent of GDP in 2013, as the authorities have rolled over slightly less short-term debt than programmed, given their comfortable cash position and the better-than-expected fiscal performance, as well as a desire to minimize interest payments. Nominal GDP movements did not materially affect the ratio, as a downward revision in the 2012 deflator offset the relative expected improvement in the growth outturn for this year. For 2014, debt was revised down to about 122 percent of GDP to reflect reprogramming of ESM disbursements which more than offset a lower projected nominal GDP. The re-profiling of ESM disbursements resulted in a slightly higher debt ratio in 2016. The primary balance is expected to improve gradually to a primary surplus of 4 percent of GDP by 2018, with revisions in 2013 mainly due to a stronger revenue outlook and in 2014 due to the revised higher tax base for 2013, expected one-off revenues, and 0.3 percent of GDP in additional measures, which more than offset the effect of a deeper recession.

General Government Debt
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Baseline (First Review)	85.8	114.1	123.0	125.7	121.7	115.9	111.7	108.1	105.0
Revised Baseline	86.6	113.7	122.1	126.2	122.7	116.6	112.2	108.5	105.3

Source: IMF staff estimates

2. The baseline debt projections and gross financing needs are highly vulnerable to shocks (Figure 1). As expected given its high debt and gross financing needs, which exceed pre-defined benchmarks above which the risk of debt distress increases (85 and 20 percent of GDP respectively), almost all DSA tests point to Cyprus as a high risk country. Indeed, under adverse shocks, fan charts and specific stress tests suggest that debt could reach 130-150 percent of GDP by 2020[1]. Moreover, several indicators such as still high spreads and external financing needs point to a high risk classification. Only two risk indicators are considered to be in the low risk category: the share of short-term debt and the share of debt in foreign currency.

[1] The parameters of the asymmetric distribution were calibrated to capture the predominance of downside risks in the medium term on growth and the primary balance due to a prolonged deleveraging and fiscal adjustment fatigue. Upside growth shocks were limited to 1 percent in line with the current growth revision and upside primary balance shocks were limited to twice the current revision for 2014.

3. Indicators do not point to major concerns on the realism of the baseline scenario (Figure 2). The growth and deflator projection errors relative to other program countries appear to remain within the inter-quartile range. Moreover, current developments do not provide evidence of optimism given a data-driven upward growth revision envisaged for 2013. Going forward, as indicated in Box 1, both the cross-country results of the original Jorda et al. (2011) study and the calibrated growth path for Cyprus using the paper's methodology are substantially better than the program's growth projection providing comfort on the conservativeness of projections. The available data on primary balance projections for 2011 and 2012 suggest that they have remained close to the median with respect to comparator groups and do not point to any significant bias.

4. Other indicators of the realism of the projected fiscal adjustment point to a more mixed assessment but Cyprus's recent strong track record provides some comfort. (Figure 3). The level of cyclically adjusted primary balance is borderline realistic and the three year adjustment is considered ambitious. However, as discussed in Box 4, the authorities have already implemented measures estimated at around 7 percent of GDP in 2013 and 2014 confirming evidence discussed in IMF 13/125 showing that such large primary balance adjustments are not without precedent. Moreover, these results should be interpreted with extreme caution, given the unusually high uncertainty around the estimation of the structural fiscal balance, including on the output gap, in the case of the current unprecedented deep recession.

5. Vulnerability indicators of the debt structure should not be overemphasized. The large external financing needs reflect mainly the need to pay maturing short-term debt and large uninsured foreign bank deposits. The recent reprogramming of uninsured deposit maturities in the context of the Bank of Cyprus restructuring and the capital controls mitigate the risks of abrupt outflows, although some risk of outflows remains while controls are gradually phased out. The relatively low and fixed interest rate of official liabilities mitigates interest rate and financing risks. Finally, bond yields and spreads movements are imperfect indicators of market perception, given the small and highly illiquid markets.

6. The sensitivity analysis points to a high vulnerability of debt to adverse macro-fiscal shocks (Figure 5, top and Figure 5 continued). Where relevant, interaction effects of growth and primary balance movements with interest rates are assumed to be zero, given that Cyprus does not have market access and most new debt will be official in the coming three years. The main risks analyzed include:

- **Growth risk:** This remains the largest macro-fiscal risk to debt sustainability. Assuming a decline in growth by two historical standard deviation (i.e. about 5.2 percentage points) for 2014 and 2015, a deterioration in non-interest revenue of 0.4 percent per percentage point of growth reduction, recovering to baseline levels in two years thereafter, and a corresponding decline of 0.25 percentage points per point of growth of the deflator, leads to an increase in debt to 159 percent of GDP by 2016 and 147 percent by 2020.

- **Primary balance risk:** A reduction in the planned fiscal adjustment in 2015-2018 by 50 percent is considered, which could reflect reform fatigue settling in. This would imply an average worsening of the primary balance in 2015-2018 of about 1 percent of GDP, increasing the debt ratio to 126 percent of GDP in 2016 and to 114 percent of GDP by 2020.

- **Interest rate risk:** While significant official financing in the coming years considerably reduces interest rate risk, ESM financing and new market financing after the program are still a function of market conditions. A shock increasing the real interest rate by slightly over 3 percentage point each year during 2013-2020 would lead the debt to reach 125 percent of GDP in 2016 and 120 percent of GDP in 2020.
- **Combination of macro-fiscal risks:** A combination of growth, interest rate, and primary balance shocks above could occur simultaneously and would lead the debt to reach 162 percent of GDP in 2016 and remain broadly around that level in 2020.
- **Inflation risk** (Figure 5, customized shock 2): Deflator growth could be lower than envisaged in the baseline if downward wage pressures pass through to prices faster than anticipated. In this case, debt would increase to 126 percent of GDP in 2016 and to 114 percent of GDP in 2020.
- **Medium-term growth risk** (Figure 5, customized shock 3): A slower and prolonged deleveraging could lead to a more protracted recession. In combination with a lower deflator (0.25 ppt per point of growth), this would lead debt to increase to 134 percent of GDP in 2016, and remain broadly around that level in 2020.
- **Risks related to the asset swap, additional CBC dividends, and privatization proceeds**. Materialization of these risks would fully exhaust the buffer and lead to an increase in 2020 debt by about 5 percent of GDP.

7. Banking-system related shocks pose high contingent liability risks (Figure 5, bottom). The debt impact of three possible contingent liability shock scenarios have been analyzed:

- **Scenario 1** (subsumed in baseline): This involves an additional €1.5 billion (about 13 percent of GDP) financial sector needs, corresponding to an increase in the sector-wide identified needs by about 100 percent, or more than a doubling of the needs of coops (given that Bank of Cyprus was recently subjected to two asset quality reviews and a stress test, its capitalization is likely adequate on a forward looking basis). The additional capital needs are not assumed to be related to an actual deterioration in the macroeconomic outlook. Given that such an amount can be covered by the existing buffer, it will have no implications for financing or debt sustainability.
- **Scenario 2** (customized shock 1, Figure 5): This scenario adds an additional €1.5 billion to scenario 1, for a total increase in the sector-wide identified needs by about 200 percent. Such a shock would increase debt to 130 percent of GDP in 2016 and to 117 percent of GDP in 2020.
- **Scenario 3** (contingent liabilities shock, Figure 5): This scenario adds a 2 standard deviation real GDP growth shock to scenario 2 above, suggesting that additional capital needs will materialize due to a deterioration of the macroeconomic outlook. Such a shock would have the most pronounced effects, leading to an increase in debt to 166 percent of GDP in 2016 and to 153 percent of GDP in 2020.

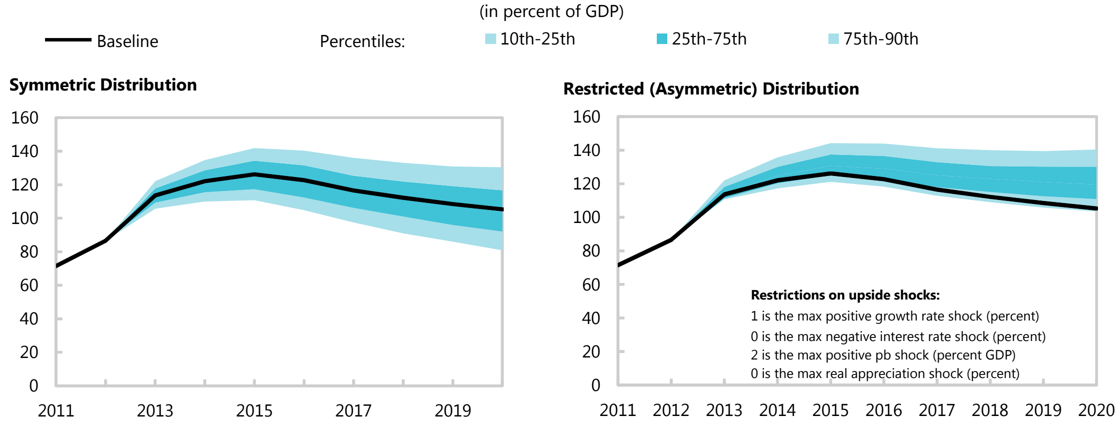
Figure A1.1. Cyprus: Public DSA Risk Assessment

Heat Map

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

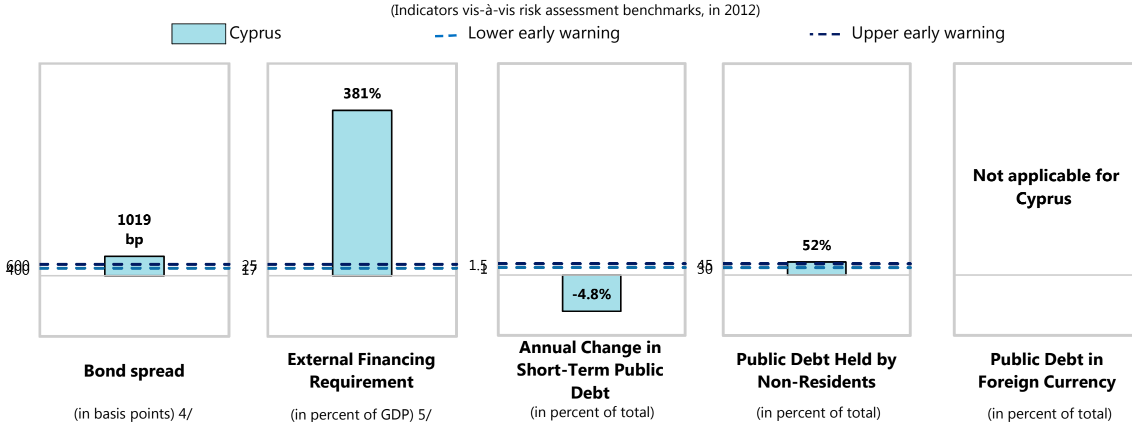
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2012)



Source: IMF staff.

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

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

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

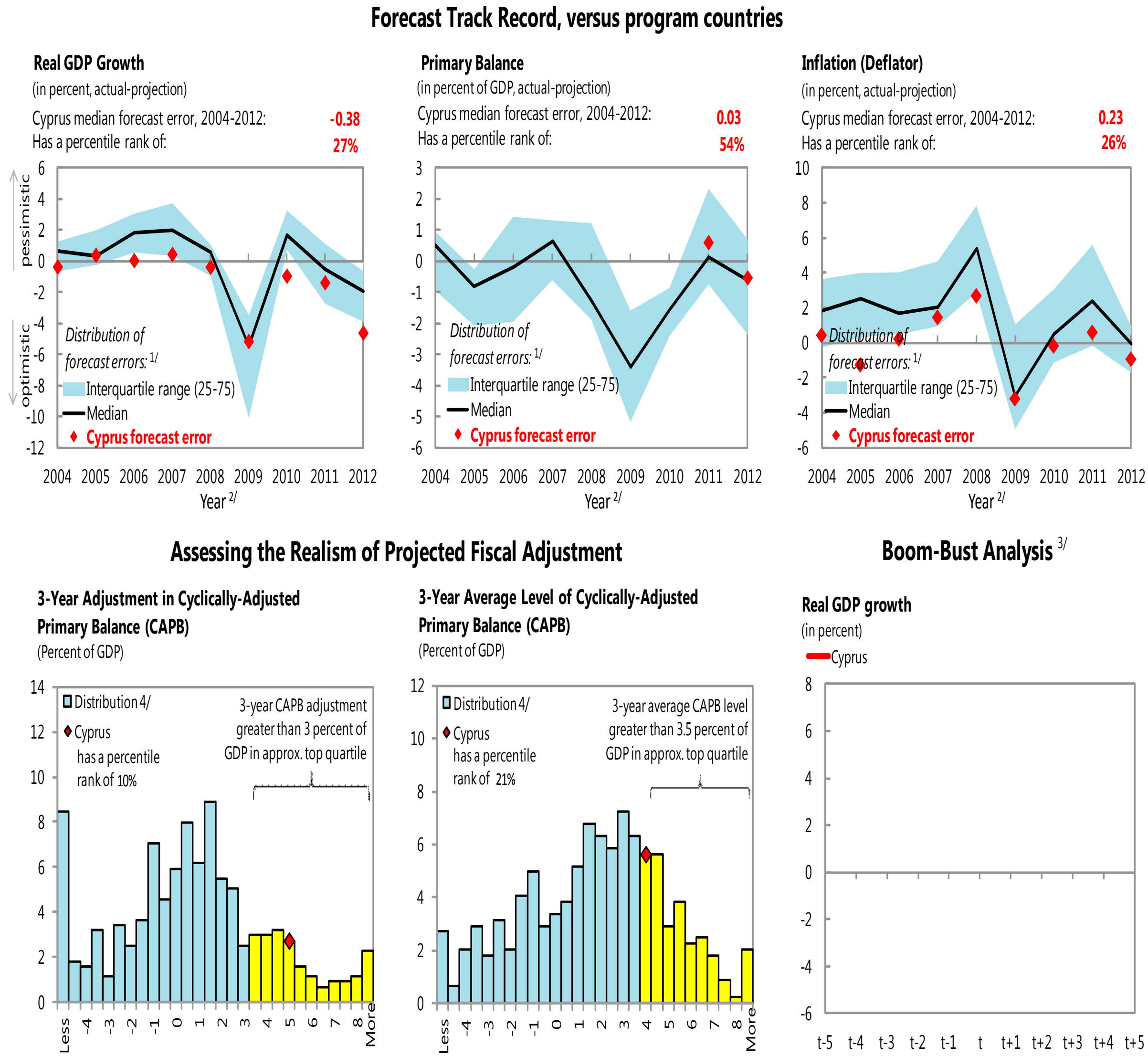
Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 06-Jul-13 through 04-Oct-13.

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

Figure A1.2. Cyprus: Public DSA-Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Cyprus.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A1.3. Cyprus: Public Sector Debt Sustainability Analysis (DSA)-Baseline Scenario

(In percent of GDP unless otherwise indicated)

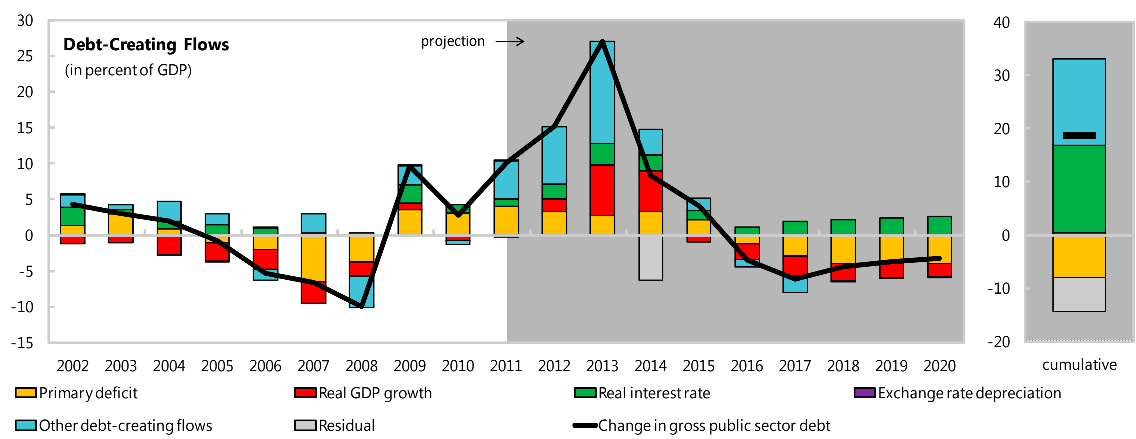
Debt, Economic and Market Indicators [1/]

	Actual			Projections							
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	63.5	71.5	86.6	113.7	122.1	126.2	122.7	116.6	112.2	108.5	105.3
Public gross financing needs	14.2	18.0	18.9	21.4	18.9	18.5	11.8	22.9	10.6	14.5	16.3
Real GDP growth (in percent)	2.7	0.4	-2.4	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation (GDP deflator, in percent)	3.0	2.3	1.6	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Nominal GDP growth (in percent)	5.8	2.7	-0.9	-7.3	-3.9	2.4	3.7	4.3	4.2	3.9	3.9
Effective interest rate (in percent) [4/]	5.1	4.0	4.4	3.5	2.8	2.6	2.7	3.5	3.9	4.1	4.6

As of October 04, 2013		
Sovereign Spreads		
EMBIG (bp) 3/		912
5Y CDS (bp)		1026
Ratings	Foreign	Local
Moody's	Caa3	Caa3
S&Ps	CCC	CCC
Fitch	B-	CCC

Contribution to Changes in Public Debt

	Actual			Projections									
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-0.1	10.2	15.1	27.1	8.4	4.1	-3.5	-6.2	-4.4	-3.7	-3.2	25.6	
Identified debt-creating flows	-0.1	10.1	15.1	27.1	14.8	4.1	-3.5	-6.2	-4.4	-3.7	-3.2	31.9	
Primary deficit	-0.2	4.0	3.3	2.6	3.3	2.1	-1.2	-3.0	-4.0	-4.0	-4.0	-0.1	0.8
Primary (noninterest) revenue and gra	40.6	39.9	40.0	41.2	40.6	40.0	40.6	41.3	41.7	42.0	42.1	245.4	
Primary (noninterest) expenditure	40.4	43.9	43.2	43.9	44.0	42.1	39.4	38.3	37.8	38.0	38.1	245.3	
Automatic debt dynamics [5/]	-0.5	0.8	3.8	10.1	7.9	0.3	-1.2	-0.9	-0.3	0.3	0.8	15.8	
Interest rate/growth differential [6/]	-0.5	0.8	3.8	10.1	7.9	0.3	-1.2	-0.9	-0.3	0.3	0.8	15.8	
Of which: real interest rate	1.2	1.0	2.1	2.9	2.2	1.3	1.0	1.8	2.2	2.3	2.6	11.4	
Of which: real GDP growth	-1.7	-0.3	1.8	7.2	5.7	-1.0	-2.3	-2.7	-2.5	-2.0	-1.9	4.3	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.6	5.4	8.1	14.3	3.6	1.7	-1.0	-2.3	0.0	0.0	0.0	16.3	
Net privatization/asset sales proceed	0.0	0.0	0.0	0.0	-2.5	-3.1	-3.0	-2.3	0.0	0.0	0.0	-10.9	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	0.6	5.4	8.1	14.3	6.1	4.8	2.0	0.0	0.0	0.0	0.0	27.2	
Residual, including asset changes [8/]	0.0	0.0	0.0	0.0	-6.3	0.0	0.0	0.0	0.0	0.0	0.0	-6.3	



Source: IMF staff estimates.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

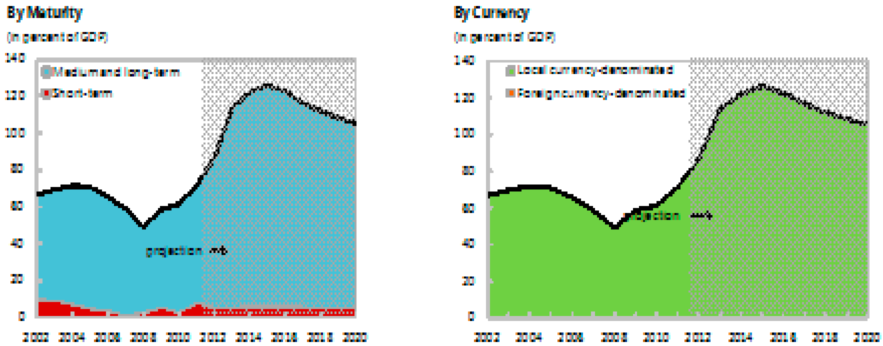
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

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

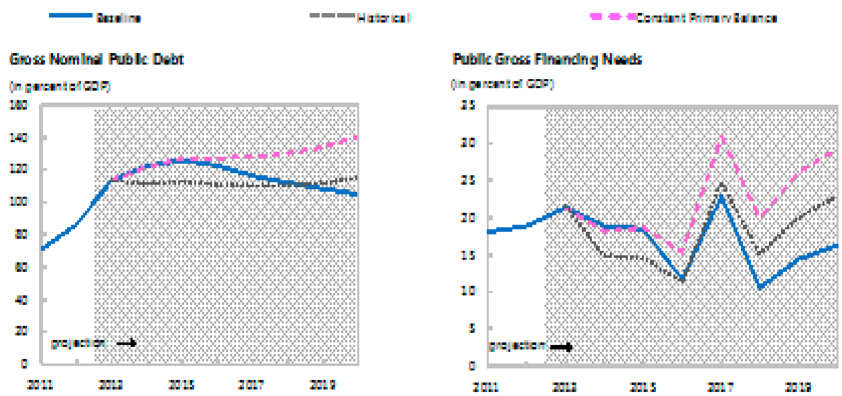
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1.4. Cyprus Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions
(Percent)

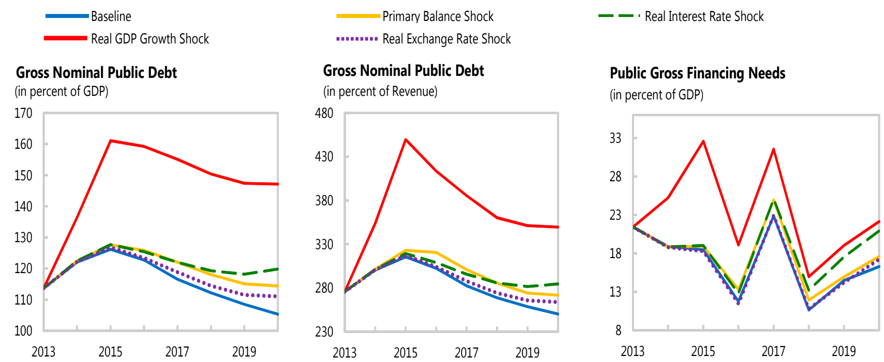
Baseline Scenario	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-2.6	-4.3	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.5	2.8	2.6	2.7	3.5	3.9	4.1	4.6
Constant Primary Balance Scenario								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	3.5	2.7	3.5	3.4	3.3	3.5	3.5	4.1

Historical Scenario	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-7.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary Balance	-2.6	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	3.5	2.7	2.5	2.5	3.3	3.5	3.5	4.1

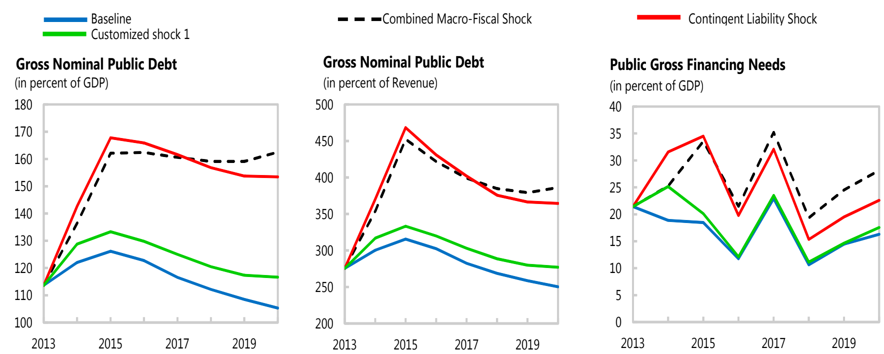
Source: IMF staff estimates.

Figure A1.5. Cyprus Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

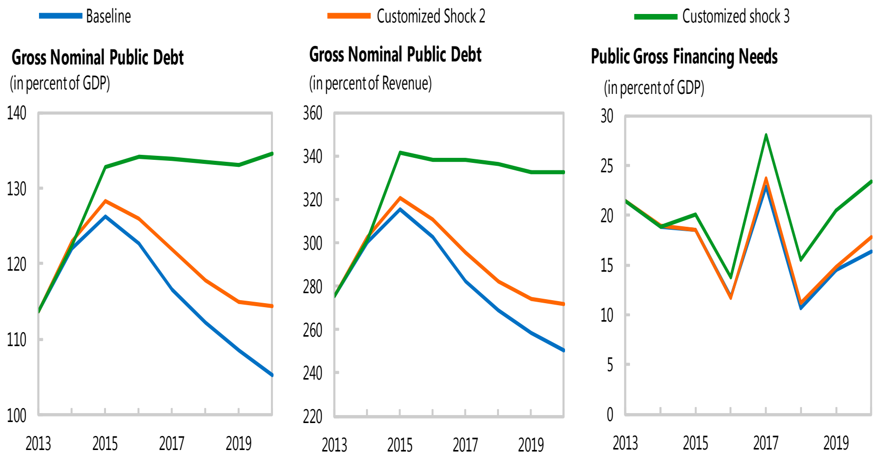
(Percent)

	2013	2014	2015	2016	2017	2018	2019	2020
Primary Balance Shock								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-3.3	-2.7	-0.4	2.1	3.5	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.4	3.2	3.4	3.4	4.0
Real Interest Rate Shock								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-3.3	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	3.1	3.4	4.3	4.9	5.1	6.0
Combined Shock								
Real GDP growth	-7.7	-10.1	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	-0.3	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-8.6	-12.4	-1.2	1.8	3.5	4.0	4.0
Effective interest rate	3.5	2.7	3.2	3.6	4.5	5.1	5.3	6.1
Customized shock 1								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.0	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-9.7	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.4	3.2	3.3	3.4	3.9

	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock								
Real GDP growth	-7.7	-10.1	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	-0.3	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-8.6	-12.4	-0.9	2.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.5	3.2	3.3	3.4	3.9
Real Exchange Rate Shock								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	1.2	1.5	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-3.3	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.4	3.2	3.3	3.4	3.9
Contingent Liability Shock								
Real GDP growth	-7.7	-10.1	-4.4	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	-0.3	0.2	1.8	1.9	1.9	1.9	2.0
Primary balance	-2.6	-14.9	-12.4	-0.9	2.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.5	3.1	3.3	3.4	3.8

Figure A1.5 (continued). Cyprus Public DSA - Stress Tests

Additional Stress Tests



Underlying Assumptions

(Percent)

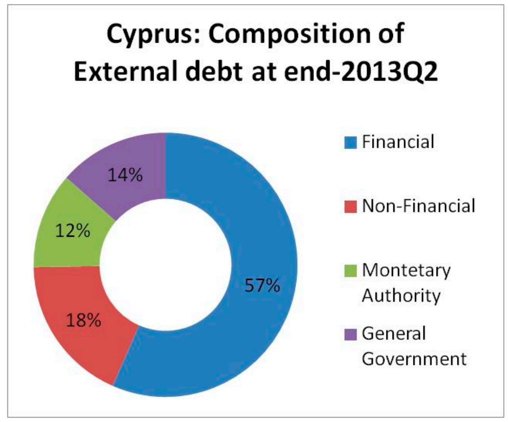
	2013	2014	2015	2016	2017	2018	2019	2020
Customized shock 2								
Real GDP growth	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8
Inflation	0.4	0.6	0.9	0.9	1.4	1.6	1.8	2.0
Primary balance	-2.6	-3.3	-2.1	1.2	3.0	4.0	4.0	4.0
Effective interest rate	3.5	2.7	2.5	2.4	3.2	3.4	3.4	3.9

	2013	2014	2015	2016	2017	2018	2019	2020
Customized shock 3								
Real GDP growth	-7.7	-4.8	-2.0	-0.5	0.6	1.2	1.6	1.8
Inflation	0.4	1.0	0.8	1.2	1.5	1.7	1.9	2.0
Primary balance	-2.6	-3.3	-3.2	0.3	1.3	1.9	2.0	2.4
Effective interest rate	3.5	2.7	2.6	2.5	3.3	3.5	3.6	4.1

Source: IMF staff estimates.

Annex 2. External Sector Debt Sustainability Analysis

1. Cyprus's external debt has declined rapidly recently.[1] It dropped from about around 450 percent of GDP at end-2012, to roughly 370 percent of GDP by end-2013Q2. The decline reflects mainly a reduction in the external debt of Cyprus's banking system, which declined from about 280 percent of GDP to 210 percent over the same period. Claims on the financial sector, in turn, mostly comprised short-term debt in the form of deposits. Given the decline, the banking sector accounts now for less than 60 percent of Cyprus's external debt, instead of almost ¾ at end-2012.



2. While external debt is expected to continue declining under the baseline scenario it will remain fairly elevated over the entire projection period. In particular, external debt is expected to contract significantly and decline from 355 percent of GDP at end-2013 to about 300 percent by end-2020. The expected decline reflects substantial external adjustment combined with the resumption of economic activity.

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

- 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.
- 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 nonresident 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.

Table A2.1. Cyprus: External Debt Sustainability Framework, 2008-2020
(Percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	447.4	544.1	491.9	468.2	448.5			**355.8**	**369.3**	**364.0**	**352.2**	**338.0**	**324.5**	**311.2**	**301.0**	**-3.4**
Change in external debt	100.3	96.7	-52.3	-23.6	-19.8			-92.7	13.5	-5.3	-11.8	-14.3	-13.4	-13.3	-10.2	
Identified external debt-creating flows (4+8+9)	-12.2	51.6	20.6	-39.0	36.9			25.3	16.0	-6.8	-10.5	-10.0	-8.9	-8.4	-7.1	
Current account deficit, excluding interest payments	6.6	2.1	0.9	-5.4	-4.2			-10.1	-11.9	-11.8	-11.7	-11.4	-10.9	-10.5	-9.9	
Deficit in balance of goods and services	11.4	5.5	6.2	4.3	3.1			-1.7	-3.9	-4.0	-4.1	-4.0	-3.6	-3.3	-3.0	
Exports	45.0	40.2	41.3	42.9	42.9			44.2	45.3	45.5	45.7	46.1	46.5	47.1	47.8	
Imports	56.4	45.7	47.5	47.2	46.0			42.5	41.4	41.5	41.6	42.1	42.8	43.8	44.8	
Net non-debt creating capital inflows (negative)	20.0	7.0	1.8	-7.2	-12.8			-12.1	-1.1	-3.5	-4.1	-2.6	-2.5	-3.5	-3.2	
Automatic debt dynamics 1/	-38.8	42.5	17.8	-26.4	53.9			47.5	29.0	8.5	5.3	3.9	4.5	5.6	6.0	
Contribution from nominal interest rate	9.0	8.6	8.9	8.8	11.1			11.5	11.5	11.5	11.8	11.7	11.6	11.5	11.3	
Contribution from real GDP growth	-10.7	8.9	-7.2	-2.0	12.5			36.0	17.5	-3.0	-6.4	-7.8	-7.2	-5.9	-5.3	
Contribution from price and exchange rate changes 2/	-37.1	24.9	16.1	-33.2	30.3			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	112.5	45.1	-72.8	15.3	-56.7			-117.9	-2.5	1.5	-1.3	-4.2	-4.5	-4.9	-3.1	
External debt-to-exports ratio (in percent)	993.3	1352.4	1191.4	1091.1	1044.8			804.9	815.6	799.2	770.0	733.5	698.0	660.5	629.5	
Gross external financing need (in billions of US dollars) 4/	52.1	81.2	109.4	85.3	79.0			55.0	44.1	41.7	39.9	39.4	40.3	40.3	40.0	
in percent of GDP	206.5	346.0	473.6	343.1	346.5	5-Year	5-Year	252.7	206.9	188.8	172.3	161.5	157.1	151.2	144.5	
Scenario with key variables at their historical averages 5/								**355.8**	**367.6**	**384.4**	**398.8**	**410.2**	**421.3**	**428.4**	**437.6**	**5.7**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation									
Real GDP growth (in percent)	3.6	-1.9	1.3	0.4	-2.4	0.2	2.4	-7.7	-4.8	0.9	1.9	2.3	2.2	1.9	1.8	
GDP deflator in US dollars (change in percent)	12.0	-5.3	-2.9	7.2	-6.1	1.0	8.1	3.5	2.8	2.9	2.9	2.9	2.9	1.9	2.0	
Nominal external interest rate (in percent)	3.0	1.8	1.6	1.9	2.2	2.1	0.6	2.5	3.2	3.2	3.4	3.5	3.6	3.7	3.8	
Growth of exports (US dollar terms, in percent)	10.4	-17.0	1.0	12.0	-8.4	-0.4	12.3	-1.6	0.2	4.4	5.3	6.1	6.2	5.3	5.4	
Growth of imports (US dollar terms, in percent)	21.5	-24.6	2.2	7.0	-10.7	-0.9	17.5	-11.8	-4.6	4.1	5.1	6.4	7.1	6.2	6.3	
Current account balance, excluding interest payments	-6.6	-2.1	-0.9	5.4	4.2	0.0	4.9	10.1	11.9	11.8	11.7	11.4	10.9	10.5	9.9	
Net non-debt creating capital inflows	-20.0	-7.0	-1.8	7.2	12.8	-1.8	12.8	12.1	1.1	3.5	4.1	2.6	2.5	3.5	3.2	

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.

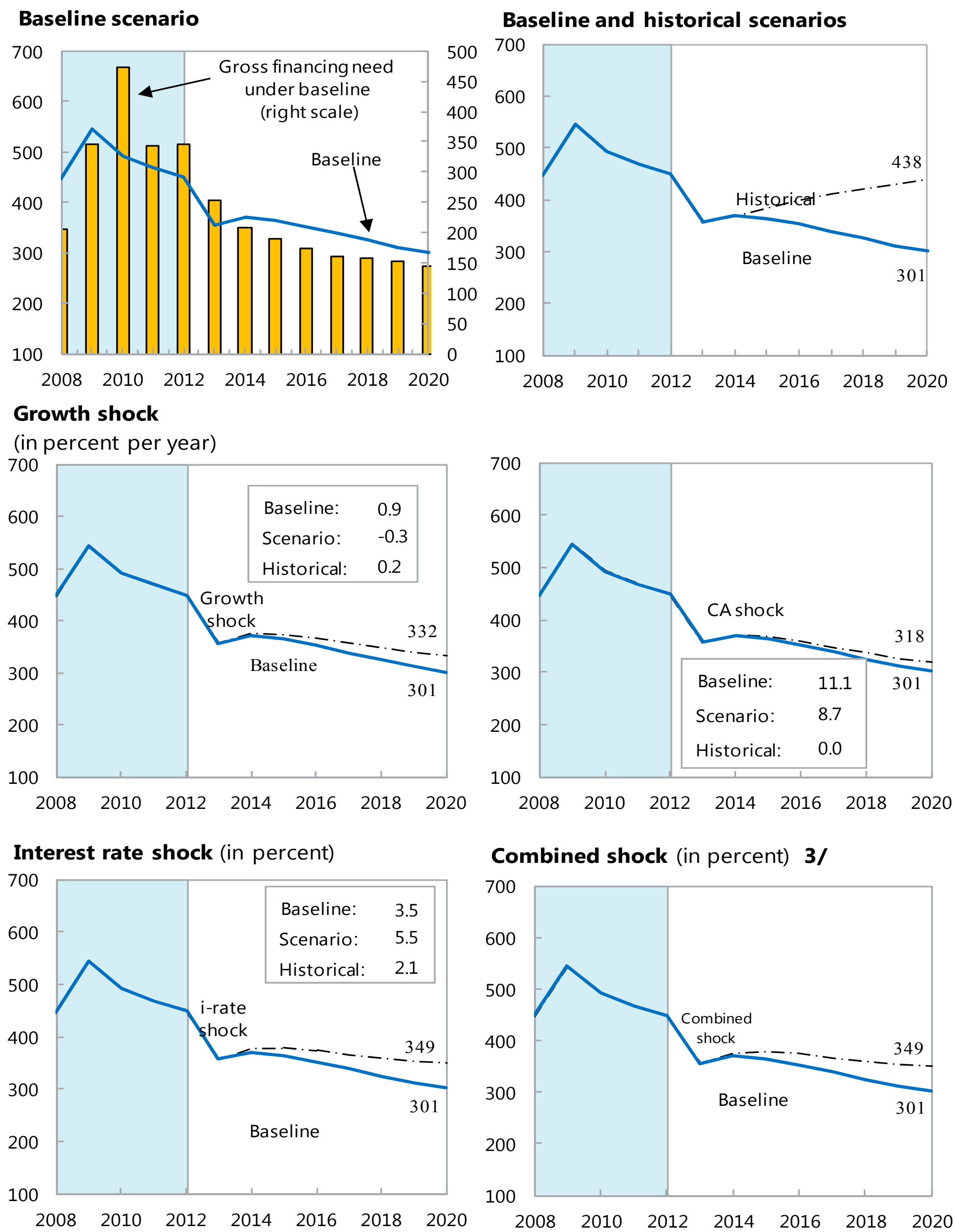
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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.

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

(External debt in percent of GDP)



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

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

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

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

Appendix 1. Cyprus—Letter of Intent

Nicosia, December 4, 2013

Ms. Christine Lagarde:
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

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

Our policy implementation under the program has remained on track:

- Fiscal performance through end-September continued to exceed expectations, while the decline in output has been somewhat less than anticipated. As a result, we have met all program performance criteria (PCs) with comfortable margins, due to revenue over-performance relative to projections and prudent budget execution.

- We are making substantial progress toward stabilizing our financial system. In particular:

    - Bank of Cyprus (BoC) has a new Board of Directors and Chief Executive Officer, and the Central Bank of Cyprus (CBC) has favorably assessed the bank's restructuring plan, in compliance with the program's structural benchmark.

    - The recapitalization of Hellenic Bank with private funds, including foreign investment, was completed ahead of schedule, thus satisfying two structural benchmarks for this and the next review.

    - A new Board of Directors has been elected at the Cooperative Central Bank (CCB) and, on the basis of a draft restructuring plan, we have started the consolidation of the sector by merging 38 cooperative credit institutions (CCIs) into 9 entities.

    - During August-October, we took additional steps to gradually ease payment restrictions in line with our published milestone-based roadmap, meeting the continuous performance criteria on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple currency practices.

- Finally, we have also met the end-September structural benchmark on revision of the anti-money laundering legal framework already in August and have met the requirements of the structural benchmark on the establishment of a central credit register on November 28.

We remain committed to preserve the sustainability of our public finances. To this end, for 2014 we target a somewhat more ambitious fiscal consolidation than assumed in our original program, on the basis of additional streamlining of public spending. The additional effort brings forward part of the adjustment envisaged for the coming years. As a prior action for this review, we will amend the 2014 budget in line with the program's revised targets. Fiscal policy will be complemented by reforms of revenue administration, public financial management, and the welfare system, the latter aiming to better protect vulnerable groups during the downturn.

We will continue to implement financial sector policies aiming to restore confidence in the banking sector. In particular, BoC and the cooperative credit sector will be restructured, while we will continue to strengthen the supervisory, regulatory, and private debt restructuring frameworks to address rising non-performing loans. Also as prior actions for completion of the second review: (i) the CBC will approve BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to above-mentioned targets; and (ii) we will finalize an agreement between the Ministry of Finance and the CCB on the terms of the relationship framework defining the responsibilities and governance boundaries between bank owners and the bank.

Financing of our program remains adequate. The €2.5 billion Russian loan originally set to mature in 2016 was restructured in September at more favorable terms, relieving medium-term government financing needs. We are making efforts to secure additional financing and to reduce our public debt, including through privatization, the allocation of central bank profits, and a debt-to-asset swap.

Based on the above, we request the following:

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

- Modification of the end-December PCs on: (i) the general government primary balance, (ii) the general government primary expenditure; (iii) the stock of general government debt; and (iv) the ceiling on the accumulation of general government guarantees, to reflect the stronger performance through end-September (Table 1).

- Establishment of new quantitative performance criteria for end-March 2014 (Table 1).

- Establishment of new structural benchmarks on the following (Table 3): (i) completion of an independent fair value assessment of the CCB's and CCI's assets aimed at quantifying the size of the government's stake in the sector and submission of the final restructuring plan of the CCI sector to the European Commission, by end-January 2014; (ii); transfer of voting rights of legacy Laiki's shares in BoC to an independent institution, by end-January 2014; (iii) establishment of an effective and adequately resourced AML/CFT supervisory unit by end-February 2014; (iv) completion by the CBC of an in-situ assessment of the degree of operational preparedness of the banks' loan workout units to implement their arrears management plans, by end-March 2014;and (v) approval by the Council of Ministers of the final design of the reformed social welfare system in line with the 2014 and medium term budget ceilings, by end-March 2014.

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

Sincerely,

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

Attachment 1. Cyprus—Memorandum of Economic and Financial Policies

A. Strategy, Recent Developments, and Outlook

1. **The economic situation remains difficult, but the outturn so far has been better than anticipated.** Economic activity has fallen significantly in the first half of the year, given the severe shock to our banking sector. Our businesses and consumers are seeing their disposable income declining, and unemployment is rising toward unprecedentedly high levels. Nevertheless, the recession has been somewhat less pronounced than expected, and recent indicators point to gradually improving confidence. Indeed, retail sales, tourism arrivals, and professional services have proven to be relatively resilient. New foreign direct investment in our banking sector is also a positive sign. Still, the uncertainty surrounding the outlook remains high.

2. **We have revised our macroeconomic framework to reflect a shallower but more protracted recession this year and next and a somewhat slower recovery thereafter.** In light of the outturn to date, real economic growth is projected at -7.7 percent in 2013, relative to an initial estimate of -8.7 percent. Looking forward, a significant though more gradual deleveraging process expected to take place through the banking sector, which together with the fiscal adjustment already underway, will pose a drag on growth. As a result, we expect growth of about -4.8 percent in 2014, and 0.9 percent in 2015. Other macroeconomic variables underlying our program remain broadly unchanged. As in the past, medium-term growth projections do not incorporate the potential upside from the exploitation of natural gas resources.

3. **We remain committed to full and timely implementation of our adjustment program, so as to pave the way for the resumption of sustainable economic growth.** Our program's main objectives are to restore the health of the financial sector and put public finances on a sustainable path through fiscal consolidation and structural reforms. Building on important steps taken so far, the second review focuses on specific measures to restructure and repair the banking sector, which are key to set the conditions for an eventual resumption of credit and a gradual lifting of capital controls. In the fiscal area, the review concentrates on ensuring that the 2014 budget remains in line with the program targets, and on defining next steps in our structural reform agenda aimed at improving economic efficiency through privatization of state-owned enterprises, modernizing our revenue administration, and strengthening the social welfare safety net so as to provide adequate protection to those most vulnerable given the downturn.

B. Financial sector Policies

4. **Stabilizing the financial sector remains our key priority.** To this end, we have made important strides since end July, when Bank of Cyprus (BoC) was fully recapitalized and exited the resolution process. First, after ensuring their fitness and probity, the Central Bank of Cyprus (CBC) cleared the appointment of BoC's new Board of Directors and its Chief Executive Officer. Second, the

CBC completed the assessment of BoC's restructuring plan. Third, the CBC also cleared the appointment of the Board of Directors of the Central Cooperative Bank (CCB), following a fit and proper test. Fourth, on the basis of the finalization of a draft restructuring plan for the sector, all credit cooperative institutions (CCIs) have agreed to voluntary mergers, and nine such mergers of 38 CCIs have already been completed. Fifth, Hellenic Bank has been successfully recapitalized from private sources. Sixth, the CBC completed the review of banks' practices regarding loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning against best practices. Looking forward, we will build on these steps to ensure that our credit institutions can effectively support the economic recovery. In this regard, we commit to preserve the free functioning of markets in the determination of lending rates to ensure prudent allocation of credit.

Recapitalizing and restructuring financial institutions

5. We will take steps to ensure that BoC will adequately implement its restructuring plan. The CBC has finalized the assessment of the plan, which aims at cleaning up the bank's balance sheet, returning the bank to profitability, maintaining adequate capitalization, and ensuring stable funding over the medium term. The plan is broadly consistent with the program assumptions and includes a strategy to deal with troubled borrowers through the creation of specialized units inside the bank. To enhance confidence, the CBC will instruct BoC to publish selected features of the restructuring plan before end-2013. On the basis of the plan, as a **prior action** for the review, the CBC will approve: (i) BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators; and (ii) the terms of a quarterly report on progress relative to above-mentioned targets. This report will be submitted to the CBC and its main conclusions made public starting with end-March 2014. A CBC team has been appointed to closely monitor BoC's compliance with the targets, assess any deviations, and define remedial actions if warranted. The team will prepare a quarterly report on its main activities to be discussed by the CBC Board, starting with end-2013.

6. We will also strengthen the management of legacy Laiki's equity stake in BoC. Legacy Laiki is the single largest shareholder in BoC, with a shareholding of 18 percent of total shares. It remains under resolution, pending the planned sale of its foreign subsidiaries. By end-January 2014, the Resolution Authority will present a detailed roadmap for the full disposal of legacy Laiki's assets, while maximizing value for creditors. Pending disposal of legacy Laiki's shares in BoC, to ensure their adequate management, the Resolution Authority will instruct the Special Administrator to entrust (by end-January 2014) the voting rights of these shares to a well-recognized and independent consulting or auditing firm(s) or international institution(s) **(structural benchmark)**.

7. Following the full recapitalization of Hellenic Bank (HB) with private funds, we will ensure that it prepares a business plan in line with the new economic conditions. On November 1, HB increased its share capital by the issuance of €100 million in shares to three private funds, including a foreign participant, which brought its capitalization level to 9.5 percent CT1. In addition, the bank secured the conversion of €255 million of junior bonds into CT1 eligible instruments, thus exceeding the capital requirements determined by the PIMCO due diligence exercise under the adverse scenario by about €60 million. To ensure that the bank can adapt to the new circumstances, the CBC will require HB to submit by end-March 2014 a business plan through end-2015, including capital, and funding plans.

8. We are taking steps to complete the restructuring and recapitalization of the cooperative credit sector, while strengthening its governance structure. The Ministry of Finance has set up a specialized unit to manage the state's future stake in the sector. Already, nine mergers of 38 CCIs have been completed, and a draft restructuring plan for the sector has been finalized. Looking forward:

- As a **prior action**, the Ministry of Finance will agree with the CCB on the terms of the relationship framework that will define, on the basis of international best practices, the responsibilities and governance boundaries between the state as majority owner and the board and senior management of the bank, to ensure that the bank operates on a commercial basis without undue political interference.
- As an initial step toward decisively restructuring the sector, the CBC has required the new board of CCB to publish, by end-November 2013, a roadmap agreed with the CBC specifying key interim actions for the next three months, including: (i) the appointment of the new CEO, (ii) measures to bolster the independence and qualification of the CCI Boards, (iii) actions to retain customers, (iv) measures to impede further asset deterioration, and (v) measures to prepare the transfer of NPLs to specialized units within the sector.
- By end-January 2014, we will: (i) complete an independent fair value assessment of the CCB and CCIs' assets aimed at quantifying the size of the government's stake in the sector; and (ii) submit the final restructuring plan to the European Commission, reflecting the views of the new Board and top management (**structural benchmark)**. The restructuring plan will contain quarterly financial and operational performance targets to be closely monitored by the new unit responsible for the supervision of the CCI sector at the CBC. Immediately following approval of the plan by the European Commission, we will inject €1.5 billion of state funds into the CCB. The CCB will recapitalize the CCIs as the 18 mergers are completed and their new Boards are appointed; the recapitalization process will be completed by end-March 2014 (existing **structural benchmark**). The 18 CCIs will be subject to independent external audits starting with 2013 accounts.

Private sector debt restructuring

9. We are making efforts to revamp the corporate and household debt restructuring framework to facilitate loan workouts and a cleanup of banks' balance sheets. We remain committed to support with adequate legislation the restructuring of troubled borrowers on the basis of international experience and best practices, so as to address the large private sector indebtedness and increasing non-performing loans. In this regard, we will strengthen our legal and institutional frameworks to facilitate voluntary workouts between banks and viable debtors in real need while minimizing incentives for non-cooperation and strategic loan defaults by borrowers. Our efforts are concentrated on four critical fronts:

- *Establishment of a framework to facilitate negotiations between borrowers and creditors.* The CBC has completed its first review of banks' compliance with the recently published Code of Conduct (CoC), which sets the framework for voluntary negotiations between banks and their borrowers. On this basis, the CBC provided recommendations for its full implementation by banks. By end-November, the CBC will publish supplementary information on the CoC to further enhance public awareness and facilitate its implementation. By end-May 2014 the CBC will complete a second round of inspections to verify banks' compliance with the CoC and impose sanctions as needed.

- *Adoption by banks of an effective arrears management strategy*. In late October 2013, the CBC completed its review and made recommendations for the banks' strategies to implement the new framework for arrears management providing for minimum standards and procedures to restructure problematic loans. By end-November 2013, the CBC will require banks to submit by end-January 2014 their revised strategies and a detailed implementation plan for arrears management approved by their boards (including pre-packaged programs, and general policies to deal with small and large troubled borrowers, respectively). Also by end-November 2013, the CBC will define the key performance indicators for progress on loan restructuring (e.g. number of loans restructured, cash collections, etc.) and instruct the banks to report quarterly on progress on these indicators beginning end-March 2014. Moreover, by end-March 2014, the CBC, with external technical support, will complete an *in-situ* assessment of the operational capacity of the banks' loan workout units to implement their plans (**structural benchmark**).

- *Review of corporate and personal insolvency framework*. With the help of technical assistance, by end-December 2013 we will carry out a review of the corporate and household debt-restructuring framework and prepare a report identifying impediments to implementation and measures to address them. As needed, by end-February 2014 we will submit legislation to parliament to implement these measures.

- *Creation of mediation services*. By end-January 2014, we will pass legislation to expand the role of the Financial Ombudsman to mediate debt-restructuring negotiations between banks and borrowers.

Ensuring adequate liquidity and normalizing financial flows

10. We remain committed to preserve sufficient banking system liquidity. The Central Bank of Cyprus will continue to monitor closely the liquidity situation of the banking system and stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. The government stands ready to consider the issuance of additional government funding guarantees up to € 2.9 billion - in line with state aid rules and in compliance with the provisions of our Public Debt Management Law - if there is a clear need to safeguard financial stability.

11. We remain fully committed to our published milestone-based roadmap aimed at gradually easing administrative measures and capital controls while safeguarding financial stability. Building on initial signs of improving confidence in the banking sector and concluding the first stage of the roadmap, during August-October 2013 we relaxed restrictions on wire transfers and opening of new accounts. Looking forward, to ensure that further relaxations remain consistent with financial stability, the Central Bank will fine-tune its technical impact assessment of relaxation measures on banks' liquidity and our methodologies to assess market confidence. On the latter, by end-December 2013, the Central Bank will appoint an independent specialized panel of experts to study current market conditions, including through well-targeted surveys and focus groups. The panel will be tasked with issuing a report (containing main recommendations, a communication strategy and an action plan) by end-January 2014, which will inform actions during the second stage of our roadmap.

Financial sector supervision and regulation

12. We are taking measures to strengthen banking supervision and regulation. To this end, following initial delays with finalizing legislation to establish a comprehensive credit register (end-September 2013 structural benchmark), legislation was passed by Parliament on November 28. Moreover, the CBC has issued guidelines on loan origination, requiring banks to base their loan decisions primarily on the borrowers' cash flow as a means of loan repayment as opposed to earlier asset-based lending practices. We will build on these actions as follows:

- By end-December 2013, we will issue guidelines on asset impairment and provisioning and the treatment of collateral in provisioning to bring our current accounting practices up to the most conservative international level. Also by then, the CBC will issue mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their loan portfolios and operations. Provisions on disclosure requirements will become effective for the publication of the 2013 financial statements. The CBC will require banks to submit by end-February 2014 an action plan to fully implement these guidelines in the preparation of their 2014 financial statements.
- By end-January 2014, the CBC will complete its annual supervisory program detailing its main objectives and activities for 2014, including a tentative timeframe to gradually resume regular on-site inspection of commercial and cooperative banks (which will also include review and implementation of provisioning requirements), staffing, cost and budget assigned to each activity, and main training programs. To ensure that the CBC can effectively carry out its supervisory tasks, we will clarify the allocation of tasks and responsibilities in the governance structure of the bank and will address staffing issues related to retention and recruitment. Also by end-January 2014, we will require banks to submit the 2014 work program of their internal audit departments to the CBC.
- We stand ready to submit to Parliament by end-June 2014 draft legislation to introduce early corrective measures to enhance supervisory powers to address capitalization issues. This will help the broader integration of our regulatory and supervisory measures with European initiatives, including the Single Supervisory Mechanism.

- By end-January 2014, we will also amend as necessary our resolution law and define procedures to ensure the effectiveness of the resolution authority.

13. We remain committed to strengthen the implementation of our AML/CFT framework. Having recently amended our legal AML/CFT framework (end-September structural benchmark), commissioned an external audit of the implementation of AML measures by banks, and articulated an action plan to strengthen implementation, our efforts are concentrated in two areas:

- *Exchange of information*: To monitor progress in this area, following the September 2013 revision of the AML law, the Financial Intelligence Unit (FIU) will compile on a quarterly basis, statistics on financial information exchanged with other FIUs, both upon request and spontaneously, with a breakdown by country. Starting from the forthcoming 2012 annual report (which will be posted on the web), the FIU statistics will also include information on spontaneous exchanges of information broken down by country, in addition to the information already provided on exchanges upon request.

- *Follow-up on the AML audit findings*: The CBC has made progress with the follow-up on the auditor's findings regarding possible breaches of compliance with AML requirements by banks and will complete this work by end-January 2014.

- *AML supervision by CBC*: To address capacity constraints, the CBC will adopt a plan for 2014 aimed at strengthening the effectiveness and adequacy of resources of the AML/CFT supervisory function for financial institutions (end-February 2014 **structural benchmark)**. Onsite supervision will be stepped-up over the program period to a level commensurate to the size, complexity, and risk profiles of the financial institutions operating in the system.

C. Fiscal Policy

14. We are committed to achieving our revised 2013 fiscal targets. We maintained a cumulative primary surplus of 0.7 percent of GDP by end-September 2013, due to better-than-expected revenue collections and prudent execution of discretionary spending. This allowed us to meet with ample margins our end-September primary balance and primary spending targets, which were exceeded by 3.2 and 1.7 percent of GDP, respectively. Of this, 0.9 percent of GDP was due to postponing from the third quarter to October the compensation of Laiki pension funds for resolution-related losses. In light of fiscal outturns to date, we have revised our end-year primary deficit target for the general government (cash terms) to 2.6 percent of GDP (relative to 3.3 percent of GDP at the time of the first review).

15. For 2014, we will target a primary deficit of 3.3 percent of GDP on a cash basis. This is better than envisaged under our original program by 1 percent of GDP, reflecting the net effect on revenues (0.7 percent of GDP) of a higher 2013 base which more than offsets the weaker growth in 2014, but also some limited additional measures (0.3 percent of GDP) which advance part of the consolidation we will need to carry out in the medium term. The measures include further rationalization of allowances and overtime of public employees, better targeting of the social pension by introducing income criteria, reducing exemptions on pension contributions of previously exempted groups, and increasing the taxation of lottery winnings. Amendment of the 2014 draft budget incorporating a revised macroeconomic framework and our revised targets is a **prior action** for the completion of the second review. The budgetary impact associated with the eventual exploitation of hydrocarbon resources will be consistent with our program's medium-term fiscal and public debt targets. We will refrain from introducing any tax amnesties during the program period.

16. We will support credit to SMEs through the provision of government guarantees. To this effect, in 2014 the government will guarantee up to €115 million to banks for borrowing from the EIB for SME on-lending, to provide trade credits to small and medium enterprises (SMEs), and other ongoing projects. The end-December 2013 ceiling will be adjusted downwards to reflect the reduced probability of disbursement of the loan to EAC related to the Vassilikos power plant and updated guarantees for other projects. However, an adjustor of up to €130 million will be included in case the loan to EAC is actually disbursed. The debt ceilings for end-December 2013 and end-March 2014 will also be adjusted to accommodate the proceeds of the direct loans included in the 2014 budget to be spent in the course of 2014.

D. Structural Fiscal Reforms

17. We are committed to implement a comprehensive social welfare reform to protect vulnerable groups during the downturn. The new system, centered on a new Guaranteed Minimum Income (GMI) scheme, will ensure adequate and equitable protection of vulnerable groups while preserving work incentives. To this end, by end-November 2013 we will define the level of basic needs in order to achieve a decent standard of living and the composition of a minimum consumption basket. On this basis, by end-December 2013, we will complete the costing of the GMI to determine the benefit level and eligibility criteria and refine the means-testing mechanism. The GMI will be complemented by other well-targeted benefits, such as child or education benefits. The final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium-term budget ceilings, will be approved by the Council of Ministers by end-March 2014 **(structural benchmark)** after consultation with social partners. The reform will be implemented by end-June 2014 (existing **structural benchmark**).

18. We are taking steps toward the integration of the Inland Revenue Department and VAT services into a new function-based tax administration. On October 30, the Council of Ministers empowered the Ministry of Finance to initiate the revenue administration reform and established a governance structure—including a High-Level Steering Committee and an Executive Technical Committee—to oversee its implementation. Both the project manager and head of the integration reform project team have been appointed, as well as other members of the team, have been appointed, and work is underway. The reform implementation plan—now being drafted—will be approved by the government by end-December 2013, as planned. Also by end-December 2013, we will adopt short-term measures to establish a work program of joint audits to target high-risk taxpayers and large traders. In addition, legislative amendments will be passed, which aim at increasing the collection enforcement powers of the revenue administration and establishing full self-assessments for all income taxpayers (existing **structural benchmark**). In this context, we will also take initial steps to identify compliance risks.

19. We are proceeding with reforms of public financial management. A Fiscal Responsibility and Budget Systems Law will be adopted by end-December 2013 (existing **structural benchmark**). Also by then, the amendment to the Public Debt Management Law will be approved, assigning responsibility for monitoring the stock of guarantees to the Public Debt Management Office. Finally, to improve fiscal monitoring and reporting, since September, the Treasury department has assumed responsibility for the monthly collection and reporting of key financial indicators for the general government, and a "Statement of state-owned enterprises (SOE) and semi-government entities" will be included as an appendix to the 2014 budget.

20. We remain committed to our privatization objectives. We are determined to make progress with the privatization process in order to reap the benefits of efficiency gains expected from private ownership and generate the targeted proceeds of €1.4 billion by end-2018. To this end, we are preparing a plan specifying the portfolio of state-owned assets eligible for privatization, an estimate of expected receipts, and the timetable for individual transactions, indicating required preparatory steps and the estimated duration of each stage. The plan will be adopted by the Council of Ministers in early December 2013. By end-January 2014, we will adopt the institutional and legal framework to govern the privatization process, providing, among others, for the establishment of a unit within the Ministry of Finance to implement the privatization plan.

E. Program Financing and Monitoring

21. In line with our program commitments, we continue to undertake measures to limit financing needs. We have restructured our bilateral loan with Russia providing for extended maturities and a lower interest rate. In addition, after finalizing its financial accounts by end-March 2014, the CBC Board will decide on the allocation of central bank profits of €0.4 billion (in line with CBC duties under the Treaties and the Statute) to be distributed to the government in 2014. Finally, an inventory of state assets has been completed, paving the way for a debt-to-asset swap to be decided by the CBC in accordance with its rules and the Treaty. This aims to reduce public debt by approximately €1 billion by end-June 2014.

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

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

Table 1. Cyprus: Quantitative Conditionality 1/

(Millions of euros)

	Performance criteria				Indicative targets	
	Sep-13		Dec-13	Mar-14	Jun-14	Sep-14
	Target	Actual				
Floor on the general government primary balance 2/	-402	110	-435	24	-224	-94
Ceiling on the general government primary expenditure 2/	5,065	4,784	7,205	1,530	3,204	4,804
Ceiling on the stock of general government debt	18,521	18,403	18,668	18,658	18,042	18,380
Ceiling on the accumulation of new general government guarantees 4/	145	-2.2	25	65	90	115
Ceiling on the accumulation of external arrears 3/ 4/	0	0	0	0	0	0
Ceiling on the accumulation of domestic arrears 4/	0	0	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 4/	10	-7	10	10	10	10

1/ As defined in the technical memorandum of understanding.

2/ Cumulative since January of the corresponding year.

3/ Continuous performance criterion.

4/ Cumulative since March 2013 for 2013 and since January 2014 for 2014.

Table 2. Cyprus: Conditionality for the Second Review

Measures	Timing	Status
Prior Actions		
Approval by the CBC of BoC's proposed set of quarterly targets for the next 12 months of key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to these targets	Before Board meeting	Met
Finalize an agreement between the Ministry of Finance and the CCB on the terms of the relationship framework defining, on the basis of international best practices, the responsibilities and governance boundaries between bank owners and the bank (MEFP ¶9)	Before Board meeting	Met
Submission to parliament of amendments to the 2014 budget in line with program's macroeconomic framework and revised targets	Before Board meeting	Met
Performance criterion		
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous	Met
Structural benchmarks		
Adopt the legal framework for a central credit register	End-September 2013	Completed on November 28
Revise the anti-money laundering legal framework	End-September 2013	Met
CBC to instruct Hellenic Bank to launch an offer for private participation in the bank's capital	End-September 2013	Met
CBC to prepare an assessment of BoC's restructuring, business, funding and capital plans	End-October 2013	Met
Recapitalize Hellenic Bank in line with the capital needs identified by the PIMCO exercise 1/	End-December 2013	Met

1/ Required for the third review but completed ahead of time.

Table 3. Cyprus: Existing and Proposed Conditionality

Measures	Timing
Proposed New Structural Benchmarks	
Resolution Authority to instruct the Special Administrator to entrust the voting rights of legacy Laiki equity stake in BoC to a well-recognized and independent consulting or auditing firm(s) or international institution(s)	End-January 2014
Completion of an independent fair value assessment of the CCB's and CCI's assets aimed at quantifying the size of the government's stake in the sector and submission of the final restructuring plan of the CCI sector to the European Commission	End-January 2014
Adoption by the CBC of a plan to strengthen the effectiveness and adequacy of resources allocated to the AML/CFT supervisory function (TMU¶18)	End-February 2014
Completion by the CBC of an in-situ assessment of the degree of operational capacity of the banks' loan workout units to implement their arrears management plans	End-March 2014
Approval by the Council of Ministers of the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI and any remaining benefits, consistent with the 2014 and medium term budget ceilings	End-March 2014
Existing Structural Benchmarks	
Adoption of a law on fiscal responsibility and budget systems (TMU ¶16)	End-December 2013
Adoption of measures to fight tax evasion (TMU ¶17)	End-December 2013
Merger of the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014
Implementation of a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs	End-June 2014

Attachment 2. Cyprus—Technical Memorandum of Understanding

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

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

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

A. Quantitative Performance Criteria and Indicative Targets

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

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

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

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

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

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

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

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

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

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

- The end-December 2013 target will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank up to €163 million. Should these payments be partially or totally deferred to 2014, the adjustor will be applied to the end-March 2014 target for the remainder payments, up to a cumulative amount of €163 million.

- The 2014 targets will be adjusted downwards by the dividends received from the CBC and the semi-government organizations.

Ceiling on the General Government Primary Expenditure (performance criterion)

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

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

8. The ceiling on the GGPCB of end-December 2013 will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank up to €163 million. Should these payments be partially or totally deferred to 2014, the adjustor will be applied to the end-March 2014 target for the remainder payments, up to a cumulative amount of €163 million.

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

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

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

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

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

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

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

- Upwards for the issuance of government guaranteed bonds to be used in monetary policy operations to boost BoC's liquidity up to €2.9 billion.

- Upwards for the issuance of government guarantees for the EAC Vassilikos Power Plant Phase IV loan up to €130 million.

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

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

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

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

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

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

B. Monitoring of Structural Benchmarks

16. Adopt 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.

17. Adopt measures to fight tax evasion (end-December 2013)

Specification. The adopted measures will include the following:

- Develop a work program for conducting targeted joint audits through end-December 2014;
- Amend relevant legislation to establish self-assessment for all income taxpayers;
- Pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act and assistance of to tax evasion into a criminal offense.

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

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

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

AML supervision's implementation:

- On a quarterly basis, in the context of the program review starting in the fourth quarter of 2013, the supervisory competent authorities will, on a confidential and anonymized basis grant Fund staff access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.
- With regard to the CBC, in line with the 2014 annual inspection program, onsite supervision missions will start in the first quarter and step-up during the year, as capacity builds and resources are expanded. The total number and quarterly profile of these inspections, as well as staffing objectives and levels will be subject to periodic review by the CBC and the Fund in light of experience.

Exchange of financial intelligence:

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

C. Reporting Requirements

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

Table 1. Cyprus: Reporting Requirements

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

Table 1. Cyprus: Reporting Requirements (Concluded)

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

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

Appendix 2. 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 and strengthening supervision;

- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and

- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

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 was 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 restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress since July

Work continued to address the challenges, in particular the downsizing and the restructuring of the banking sector, as well as the related regulatory reforms. First, BoC’s new Board of Directors was elected by the AGM that took place on 10 September 2013 and on 22 October the BoD appointed a new CEO. Second, the authorities have started implementing the strategy to restructure the cooperative credit institutions and first mergers have been completed according to the agreed timetable. Third, Hellenic Bank attracted significant private capital, including from foreign investors, and raised the required capital. Fourth, the gradual relaxation of the administrative restrictions and the capital controls continued in line with the milestones-based approach presented by the authorities on 8 August.

Considerable progress has also been achieved with respect to the supervisory and regulatory reforms. The working plan for the integration of the supervision of the cooperative credit institutions into the CBC was finalised. The CBC issued a Directive on arrears management and a Code of Conduct for dealing with troubled borrowers. The legislation for establishing a financial mediation service is being finalised. The review of banks' asset impairment, provisioning and accounting practices by the external consultant was finalised, and the Directive on the regulatory framework on loan origination was issued, though with a slight delay. The authorities have also finalised the legal framework for setting up a single credit register which has been submitted to the House of Representatives. Finally, an amendment to the Banking Law was passed on 5 September 2013, which limits and regulates bank lending to members of the Board of Directors. The amendments to anti-money laundering legislation have been enacted and the trust registers to improve the availability of information on beneficial ownership have been set up.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. The Cypriot authorities commit to continue implementing the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. This roadmap identifies a series of milestones for the gradual liberalisation of the restrictions also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. A number of restrictions have already been relaxed or lifted according to the roadmap. By **end-January 2014** the CBC will study current market conditions, including through well-targeted surveys and focus groups, in order to ensure that further relaxations during the second stage of the roadmap remain consistent with financial stability.

1.2. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the Cypriot authorities stand ready to consider to issue additional government guarantees in line with State aid rules, if and as needed to safeguard financial stability.

1.3. The authorities will request domestic banks relying on central bank funding or receiving State aid to submit medium-term funding and capital plans to the CBC at the end of each quarter. These plans will be transmitted to the ECB, the EC, the ESM and the IMF. The Cooperative Central Bank and the Bank of Cyprus will submit their first plans together with their final restructuring plans. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector and reduction of borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario are provided by the CBC, in coordination with the ECB.

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 requirements **by December 2014**, after consultation with the ECB, the EC and the IMF and informing the ESM.

Regulation and supervision of 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 technical assistance, the necessary legislative changes will be submitted to the House of Representatives **by end-February 2014** and implemented **by end-2014**, macroeconomic conditions permitting. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.

1.6. A new definition of non-performing loans has entered into force on 1 July 2013. The time series for non-performing loans will be published **by end-December 2013**, 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. Following the establishment of the legal framework for the credit register **by mid-December 2013**, the central credit register will be operational **by end-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 reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Taking into account the conclusions of this review, the CBC will introduce regulatory amendments, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will be finalised **by 31 December 2013** and will become effective for the publication of the 2013 financial statement concerning disclosure requirements. The CBC will require banks to submit **by end-February 2014** an action plan for the full implementation of these guidelines starting from their 2014 annual accounts.

1.9. The CBC will consider the need for introducing mandatory supervisory action based on capitalisation levels **by 30 June 2014**. The follow-up will take into account the related developments in the Single Supervisory Mechanism. If required, technical assistance will be requested by the CBC.

1.10. The CBC will issue **by end-November 2013** mandatory disclosure requirements to banks submitting restructuring plans. Starting with reference date **end-December 2013**, these banks will be required to publish quarterly reports describing the progress with the implementation of the restructuring plans. These reports will contain a set of key performance indicators to be developed by the CBC and communicated to the banks, in advance of the forthcoming quarterly report.

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

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

1.13. **By end-January 2014**, the CBC will complete its annual supervisory program detailing its main objectives and activities for 2014, including a tentative timeframe to gradually resume regular on-site inspection of commercial and cooperative banks (which will also include review and implementation of provisioning requirements), staffing, cost and budget assigned to each activity, and main training programs. The CBC will clarify the allocation of tasks and responsibilities in the governance structure of the CBC to effectively carry out the supervisory tasks of the central bank in line with SSM requirements. Also **by end-January 2014**, the CBC will require banks to submit the 2014 work program of their internal audit departments.

1.14. The accounts of cooperative credit institutions 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. The consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.

1.15. The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. Legal obstacles to the CBC's ability to retain and employ the necessary qualified staff should be removed, **prior to the granting of the third disbursement of financial assistance**.

1.16. The authorities will, in consultation with EC, ECB and IMF and informing the ESM, review the effectiveness of the Resolution Authority, including its composition and governance, with a view to adopting legislative and operational changes **by end-January 2014**.

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

1.17. 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. The first quarterly monitoring report has been received in the beginning of July 2013 and its scope and content will be further enhanced.

1.18. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of 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.

- In line with the framework for the management of arrears, and in accordance with the strategies they are required to develop, banks will submit to the CBC their revised strategies (including pre-packaged programs, and general policies to deal with small and large troubled borrowers, respectively) and plans for their internal implementation **by end-January 2014**. **By**

end-March 2014, the CBC, with external technical support, will complete an assessment of the operational capacity of the banks' loan workout units to implement their plans. Banks will also be required to report quarterly on restructuring progress and management of NPLs, beginning **end-March 2014**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which will be determined **by end-November 2013** by the CBC in consultation with EC, ECB and IMF and informing ESM.

- **By end-November 2013**, the CBC will publish supplementary information on the Code of Conduct (CoC) in order to further enhance public awareness and facilitate its implementation. **By end-May 2014** the CBC will complete a second round of inspections to verify banks' compliance with the CoC and impose sanctions as needed.

- Building on recent work to identify and address impediments for private debt restructuring, **by end-December 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed. On this basis, legislation will be passed to expand the role of the Financial Ombudsman **by end-January 2014** to achieve fair debt restructuring, while ensuring adequate resources for the service given the expected case load.

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

- The CBC will with assistance of an external expert review banks' arrears management policies and practices, taking into account international best practices. This review will be completed **by end-June 2014** and serve as a basis for further policy recommendations on the arrears management processes in credit institutions.

<u>Increasing financial transparency</u>

1.19. 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 April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

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

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

- The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).

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

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts related to money laundering and tax matters. **Prior to the granting of the third disbursement of financial assistance**, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are in line with relevant legislation and international standards**.** To this end, the authorities **by 20 November** provide an analysis of the adequacy of relevant CBC directives for review by the programme partners.

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

B. Recapitalisation and restructuring

<u>Restoring adequate capital buffers</u>

1.20. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by end-December 2013**. By the same date, the CBC will assess the impact of the entry into force of the Common Equity Tier 1 capital definition laid down in the CRDIV and CRR. On the basis of that assessment the CBC will define, by **end-February 2014** and in consultation with the EC, ECB, IMF and informing ESM, the minimum capital requirements taking into account the parameters of the balance sheet assessment and the stress test of the Single Supervisory Mechanism. In no circumstances will this revision lead to a decrease in the minimum amount of capital held by the banks. In the interim period until the revised requirements enter into force, the CBC will prohibit any release of capital by the banks which were found in the PIMCO exercise to face a capital shortfall.

<u>Management of legacy Laiki</u>

1.21. By **end-January 2014**, the Resolution Authority will present a detailed roadmap for the full disposal of legacy Laiki's assets, while maximizing the value for the creditors. Pending disposal of legacy Laiki's shares in BoC and to ensure their adequate management, the Resolution Authority will instruct the Special Administrator to entrust **by end-January 2014,** the voting rights of these shares to a well-recognised and independent consulting or auditing firm(s) or an international institution(s).

Restructuring of Bank of Cyprus

1.22. The CBC will instruct BoC to publish selected features of its restructuring plan before end-2013. On the basis of the plan, **prior to the granting of the third disbursement of financial assistance**, the CBC will approve BoC's proposed set of quarterly targets for the next 12 months for key financial and operational indicators in critical areas and the terms of a quarterly report on progress relative to above-mentioned targets. This report will be submitted to the CBC **by end-March 2014**. A CBC team has been appointed to closely monitor BoC's compliance with the above-mentioned targets, assess any deviations, and define remedial actions if warranted. The report of the team on its main activities will be submitted quarterly to the CBC Board, starting with **end-2013**.

Restructuring and recapitalisation of Hellenic Bank

1.23. Following the successful recapitalisation of Hellenic Bank with privately raised funds, the CBC will require Hellenic Bank to submit **by end-March 2014** a business plan covering the period up to end-2015.

Restructuring and recapitalisation of cooperative credit institutions

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

1.25. To this end the restructuring plan for the cooperative sector will be submitted to the EC **by end-January 2014**. The terms and remuneration of the public support will comply with the EU State aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee.

1.26. In line with the strategy for the restructuring and recapitalising of the sector that was published in July 2013, the individual cooperative credit institutions will be merged into a maximum of 18 entities **by end-March 2014**. These mergers are designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

1.27. Upon completion of each legal merger of affiliated credit cooperative institutions, the Cooperative Central Bank will inject sufficient capital into them to take a 99% stake and ensure compliance with the 4% individual core Tier 1 ratio. These operations will be finalised by end-March 2014, with the view to speed up the appointment of the Board of Directors of each institution and the implementation of the new governance guidelines. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9%.

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

1.29. With the view to decisively restructure the sector, the CBC has required the new board of the CCB to publish, **by end-November 2013**, a roadmap agreed with the CBC specifying key interim actions for the next three months, including: (i) the appointment of the new CEO, (ii) measures to bolster the independence and qualification of CCI Boards, (iii) actions to retain customers, (iv) measures to impede further asset deterioration, and (v) measures to prepare the transfer of NPLs to specialized units within the sector.

1.30. As part of the implementation of the restructuring plan, the Cooperative Central Bank will leverage on external expertise, in particular in the areas of arrears management and corporate restructuring. In addition, it will ensure that the recruitment of executive and senior management of the CCB and CCIs take place in line with international best practices. The selection criteria will be established by the Cooperative Central Bank and consulted by the Ministry of Finance with the EC, ECB, ESM and IMF. Compliance with the requirements of this paragraph will be assessed in the quarterly progress reports of the Cooperative Central Bank on the implementation of the restructuring plan.

2. FISCAL POLICY

<u>Key objectives</u>

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

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2013, listed in Annex 1 and below; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

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

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-20 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

In accordance with Regulation 472/2013, Cyprus shall provide all the information that the programme partners consider to be necessary for the monitoring of the implementation of the economic adjustment programme. The Cypriot authorities will consult ex-ante with the European Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a budgetary outcome in line with the Council Recommendation of 16 May 2013, with a view to bringing an end to the situation of an excessive government deficit, taking into account the Commission's assessment of effective action of 6 September 2013. To this end, the Cypriot authorities will rigorously implement the 2013 Budget Law (as amended) and the agreed consolidation measures, amounting to at least EUR 351 million.

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

Fiscal policy in 2014

Based on programme's current macroeconomic and fiscal projection and reflecting the draft 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of

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

EUR 483 million (3.1% of GDP) in 2014[2], respecting the EDP recommendation of a headline deficit of no more than 8.4% in 2014. To this end, Cyprus will fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014 (Annex 1). The total amount of fiscal policy measures to underpin the 2014 budgetary targets, will be included in the 2014 Budget Law.

Notably, the authorities will take the following permanent additional measures, amounting to approximately ⅓% of GDP, as proposed by the Government in the draft 2014 Budget Law, with a view to advance part of the future consolidation effort:

- ensure additional expenditure savings by a further reduction of public sector allowances and streamlining of overtime compensation, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees.;
- a further targeting of social pensions;
- an abolition of income tax exemption for certain pension schemes;
- a reduction in the tax-free threshold for lottery gains;
- an introduction of a contribution of 3% on salaries of casual employees servicing on a contract basis, who receive gratuity, including volunteers of 5 years services and police constables.

Prior to the granting of the third disbursement of financial assistance, the Cypriot authorities will submit to the House of Representatives the necessary amendments to the 2014 draft Budget Law in order to align it with the revised macroeconomic and budgetary projections of the economic adjustment programme. Any amendments to the budget that could have a material impact on the achievement of the programme's objectives will be assessed and agreed with the programme partners.

The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document (see also 5.6.3). 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 to the programme partners.

Fiscal policy in 2015-16

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

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

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

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document (see also 5.6.3). Any deviation from the budgetary objectives contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided to the programme partners. In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3% 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 acknowledging that the Cypriot authorities have recently introduced substantial reforms (as noted in Annex 1), which, according to the results of the actuarial study which were peer reviewed in the Ageing Working Group of the Economic Policy Committee in September 2013, have adequately addressed the issue of the high projected increase in pension spending and secured the long-term financial viability of the pension system through 2060, it remains important to monitor the long term financial sustainability of the system and consider further reform steps, if needed.

The Cypriot authorities have implemented/agreed to implement the following measures:

- **prior to the granting of the third disbursement of financial assistance**, pass legislation to ensure that total annual public pension benefits do not exceed 50% of the highest pensionable salary of the official's career for Members of the House of Representatives; and
- ensure that all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees **by Q4-2013**, to enter into force **on 1 January 2014.**

Health care reform

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

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed **by Q2-2014** with the programme partners and all co-payments for using public health care services;

b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aim at full implementation **by Q2-2015;**

c) taking into account the results of the updated actuarial study and after consultation with the programme partners, implement without further delay a National Health System (NHS), to be in place **by end-2015**, ensuring its financial sustainability while providing universal coverage and considering the possibility of implementation in stages **by end-2015**. To this end, the government will present its detailed plan by **January 2014**;

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

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

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

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

h) 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 Q4-2013**;

i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) achieving full coding of all inpatient cases in public hospitals **by January 2014**; and,

j) adjust back by half an hour the regular starting and ending working times in the Health Service (to 7:30/8:30 – 15:00/16:00) and further reduce overtime and related costs to the wage bill, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 to 19:00 under regular working time (see 3.10.).

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 3.10) **by Q1-2014**.

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

Budgetary framework and public financial management

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the high-level Fiscal Responsibility and Budget System Law (FRBSL), which will be adopted **by Q4-2013** (including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance);

- Enact a FRBSL applicable to the entire general government sector. The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts (on budget documentation and statistics) ensuring that adopted measures are fully effective **by Q4-2013**.

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

- Remove the risk of overspending by making sure that spending commitments, as these will be defined in the FRBSL, of the central government are subject to pre-commitment validation **by Q4-2013**, and of the general government **by Q1-2014**. All outstanding commitments should be timely and properly recorded and reported in the accounting system.

- Improve the monitoring of government guarantees through a risk assessment analysis. To this end, amend the Public Debt Management Law, **by end-December 2013**, in order to ensure a proper risk assessment of the outstanding stock of government guarantees and ensure appropriate human resources to that end.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- update the inventory of PPPs, including contingent liabilities, **as of 1 January 2014**, and include it both in the annual budget law and in the annual financial report;

- put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will enter into force **on 1 January 2014**; 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:

- **by Q4-2013**, the Council of Ministers will examine a list of SOEs to be restructured or liquidated;
- the Cypriot authorities will complete the full inventory of real estate and land assets **by Q4-2013,** specifying which ones are ready for privatisation; 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**. No additional SOEs will be created until the legal framework has been adopted.

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 will include the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (commercial activities of ports), as well as real estate/land assets and will be based on a prudent estimation of privatisation proceeds. 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 adopted by the Council of Ministers **prior to the granting of the third disbursement of financial assistance,** after consultation with programme partners, and will include asset-specific timelines and concrete intermediate steps;
- In parallel, the specific legal and institutional framework for the privatisation process will be implemented **by January 2014**, after consultation with 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 reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. The short-term programme will be implemented by Q4-2013 and include the following sets of measures:

Enact legislative changes to enhance tax collection and voluntary compliance by

- attributing personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and
- strengthening 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.

Improve efficiency and effectiveness of the administration by,

- ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- optimising the use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities and with other relevant authorities, taking into account legal provisions for data protection; and (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers);
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk;
- deciding on a joint audit programme for large taxpayers, to be conducted **in 2014;**
- developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and
- conduct an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

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

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin **in Q4-2013**.

- The full integration of the two tax departments will be completed in several phases and will be accompanied by a set of flanking reform measures, such as the development of a common tax procedure code. After having established the project management, which includes a high level steering committee, chaired by the Minister of Finance and an executive technical committee, chaired by the Permanent Secretary the authorities will,

  1. develop a reform plan that reflects the recommendations of the TA received in February 2013 and further recommendations derived from future TA. The reform plan will be agreed with program partners and approved by the government **by Q4-2013**; and
  2. reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the tax gap) **by Q2-2014**.

3.8. 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[3] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;

- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;

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

- 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

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

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

Immovable property tax reform

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.

3.9. In view of this, the Cypriot authorities have agreed to:

- implement a property price index that establishes the average market valuation in 2013 by square meter of habitable surface and land plot, taking into account recommendations derived from technical assistance. This index shall be operational to provide imputed market valuations for each cadastral plot **by Q2-2014**, in time for the immovable property tax collection in 2014. The index shall vary according to location and zoning as well as other tangible building- and plot-related characteristics. Moreover, the authorities will implement a methodology for annual updates of such imputed market valuations;

- implement the recurrent immovable property tax based on such imputed market valuations **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 authority **by Q3-2014**;

In addition, the recommendations of the following studies should be implemented at the latest **by 1 January 2015**:

- 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 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 revenues from transaction fees and taxes to recurrent taxation. The tender procedure and the assignment of the study to the successful bidder shall be concluded **by Q4-2013**.

Public administration reform

3.10. 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, **by December 2013,** adjust back by half an hour the regular starting and ending working times, to 7:30 - 8:30 and to 15:00 – 16:00 and 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 (see 3.2).

In addition, the Cypriot authorities are commissioning an independent external review of possible further reforms of the public administration. The review will include a horizontal and a sectoral element.

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

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

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

The sectoral element will cover:

- an examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- an examination of the possibility of abolishing or merging/consolidating non-profit organisations/companies and state-owned enterprises; and
- the re-organisation/re-structuring of local government,

and will comprise two batches:

- the first batch will be undertaken by the World Bank and the UK public administration and will cover the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies and Official Receiver. The results of the first batch will be presented **by Q1-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with programme partners, submit it to the House of Representatives for approval and implement it **by Q2-2014**.
- the second batch will cover all remaining Ministries (Labour and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defense, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Planning Bureau being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provision of 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented **by Q4-2015.** Based on the findings of this review, the Cypriot

authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q1-2016.**

Welfare system

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

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

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance.
- improving the targeting of benefits; and
- providing work incentives to avoid welfare dependency.

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

- on the basis of the level of the minimum consumption basket covering basic needs in order to achieve a decent standard of living, define the level, the composition and the eligibility criteria of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme and estimate its overall costing **(Q4-2013)**;
- refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria across different benefit schemes **(Q4-2013)**;
- adopt the final design of the reformed welfare system by the Council of Ministers **by Q1-2014** after consultation with social partners, followed by consultation and review by programme partners. The adopted reform would define all benefits, their respective level, and eligibility criteria, as well as the overall costing of the system;
- ensure that a comprehensive database and the necessary IT requirements are in place to support the administration of the reformed welfare system **(by May 2014)**; and
- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people), (see 3.10).

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

4. LABOUR MARKET

Key objectives

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

Cost of living adjustment (COLA) of wages and salaries

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

- 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 (Annex 1) of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

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

Activating the unemployed and combating youth unemployment

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

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

Therefore, the Cypriot authorities will prepare detailed policy proposals to address the identified shortcomings and weaknesses, to be submitted to the programme partners by end-2013 for review and consultation. These will include:

- the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes, thereby enabling the assessment of their performance and effectiveness;

- the development of the appropriate IT infrastructure so as to automatize better and more comprehensive collection (see 3.11), processing and exchange of data across the various schemes as well as with the administration of social welfare services;

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

- enhancing staff mobility to support the administrative capacity of the public employment services so as to enable them to better respond to the increased demand for their services; and

- reviewing and enhancing the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present by Q4-2013 a draft action plan for the implementation of measures envisaged for support under the Youth Employment Initiative, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.

5. Goods and services markets

Key objectives

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

Services directive: Sector-specific legislation

5.1. In accordance with EU law in general and Services Directive in particular, the Cypriot authorities will adopt the necessary amendments to the following sector-specific legislation: Construction services, Travel Agencies, Tourism services on beaches, Car rental services, **prior to the granting of the third disbursement of financial assistance.** The Cypriot authorities stand ready to adopt any further necessary amendments towards the full implementation of the Services Directive. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

Reform of regulated professions

5.2. The Cypriot authorities will:

- complete the comprehensive review of the requirements affecting access and exercise of all regulated professions by Q4-2013. Following completion of the review, the requirements that are not justified or proportional will be eliminated by Q1-2014; and
- eliminate any existing total bans on the use of a form of commercial communication (advertising) in the veterinarians profession, as required by the Services Directive by November 2013.

Competition and sectoral regulatory authorities

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

- guaranteeing sufficient and stable financial means and qualified personnel to ensure its effective and sustained operation **by Q4-2013;**
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by Q4-2013**; and
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q4-2013**;

The Cypriot authorities will increase competition by ensuring that powers and independence of the National Regulatory Authorities (NRAs) remain effective, by enabling them to have the necessary resources in line with their duties and in accordance with the EU Regulatory Framework. Any necessary legislative amendments will be adopted **by Q4-2013**.

Housing market and immovable property regulation

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

The Cypriot authorities will:

- implement guaranteed timeframes for the issuance of building certificates and title deeds **by Q1-2014**; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits); take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property **by Q4-2014**;

- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations, starting end-July 2013;

- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**. Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **prior to the granting of the third disbursement of financial assistance**;

- amend the procedure on the forced sale of mortgaged property (see 1.5) to allow for private auctions by amending the relevant legislation and rules in relation to the forced sales of mortgaged property either by adopting similar principles of the rules for immovable property recovery in bankruptcy regulations or by enacting new legislation **by Q4-2013**; and

- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016** and provide for specialized judges **by Q4-2013,** with instructions for the expeditious processing of cases under commercial and immovable property laws.

Tourism

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

- present a progress report on the implementation of the action plan twice per year (every March and September until the end of the programme), starting **in Q4-2013,** including an assessment of its implementation based on performance indicators.

- amend the current hotel and other relevant legislation (e.g. the immovable property law and town planning policies), in order to facilitate mixed-use developments, **by Q4-2013**;

- provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements **by Q4-2013**. This report will provide the basis for an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. This strategy accompanied with a concrete action plan will be launched **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

Energy

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented particularly during and after the transformation of the sector; and provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate their intended duration of the latter derogations;

- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy constitutes a living document to be developed under the full authority of the Cypriot

Government. It 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 technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; updated version **by Q4-2013.**

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

2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy sector and gas exports, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; and full unbundling of gas suppliers and customers, in particular electricity companies; by **Q4 2013,** with a view to a final outline **by Q2 2014**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. As a first step, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. These will be anchored in the FRBSL (see 3.3) which will be adopted **by Q4-2013**.

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

6. TECHNICAL ASSISTANCE

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-2013**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

Annex 1

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 4.1).

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

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

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

Revenue measures

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

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% 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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% 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".

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

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

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

Revenue measures

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

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

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

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

I.25 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.26 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

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

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

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

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

I.30 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.

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

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

Expenditure measures

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

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

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

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

Revenue measures

I.36 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.37 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.38 Increase the reduced VAT rate from 8% to 9%.

I.39 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.40 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

I.41 A reform of the tax system for motor vehicles with effect from budget year 2014, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

Annex 2

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

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Q4 - 2013
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Q4 - 2013 Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Q4 - 2013
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Q4 – 2013
1.3	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Q4-2013 Q2-2014

2	**Reliance/introduced business**		
	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Q4 – 2013
	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Compliant
3	**Suspicious Transaction Reporting**		
	Changes in the legal framework.	3.1 MOKAS to reiterate and clarify through further training the requirements to report STRs, including the new duty to report issues relating to tax crimes as of December 2012, in coordination with relevant supervisory authorities.	Q1 - 2014
4	**Transparency of beneficial ownership**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC).	Partially Compliant CBC Directive

	and best practice.	4.1.2. In the case of nominees, either a) require nominee directors[1] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	prior action Compliant
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners, and ensure the department of the registrar is appropriately resourced.	End 2013
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Compliant
5	**<u>Supervision of financial institutions</u>**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[2] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Q4 – 2013

[1] Under Cyprus law, there is no legal concept of "nominee director", but it is used with reference to professionals who provide director services.
[2] in accordance with BCP 2 and FATF 26-27

		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[3] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[4]	– 31 January 2014
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[5] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Q4 - 2013
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools;	Q2 – 2014

[3] FATF Immediate Outcome (IO) 3

[4] See BCP 2.6c

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

		- customer acceptance policies; - customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1 CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	– Partially Compliant 31 January 2014
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4- 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of the pilot reviews, and develop an onsite supervisory program for 2014. 5.5.3.2 Assign institutional ML/TF risk profiles to financial institutions reviewed under the pilot exercise. 5.5.3.3 Develop customised supervisory strategies for financial institutions reviewed under the pilot exercise. 5.5.3.4 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customised supervisory strategies to all financial institutions under its responsibility.	Q2 - 2014
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections.	Q2 - 2014

		5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	
6.	**<u>Supervision and monitoring of lawyers, accountants and TCSPs</u>**		
6.1	**Align resources with risks** **Establish an effective monitoring structure for AML/CFT matters**	6.1.1 Ensure adequate human resources and technical capacity to undertake effective AML/CFT monitoring. The level of resources should be commensurate with the size, complexity, and risk profiles of each business and professional. To meet this objective, if deemed necessary by the supervisory authorities, hire AML/CFT experts with the necessary professional skills and experience (e.g. professionals having performed monitoring or supervision of these professions abroad) – subject to necessary confidentiality restrictions.	Q4 - 2013
6.2	**Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to implementation**	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - risk profiles; - specific AML/CFT monitoring strategies (adapted to institutional risk profiles).	Q1-2014 (CBA and ICPAC) Q3-2014 (CySEC)
		6.2.2.1 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of business and professionals. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews. 6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise. 6.2.2.3 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customized supervisory strategies to all business and professions under monitoring.	Q2-2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program	Q2 – 2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.4	**Establish Formal**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training	Q2– 2014

	AML/CFT Training Program	courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR - recordkeeping - compliance function - risk assessment systems etc.	(CBA and ICPAC) Q4-2014 (CySEC)
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Q4 – 2013, ongoing
		Subsequent to the successful development of the tools stipulated under 6.2 and 6.3, the Supervisory authorities will undertake the following: 6.5.2 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews, and come-up with a supervisory program for 2014	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)
		6.5.3 Implement the new examination/verification procedures through pilot onsite inspections of a selected group of lawyers, accountants and TCSPs. Adjust/fine-tune the procedures using the results of the pilot inspections.	Q3 – 2014 (CBA and ICPAC) Q4-2014 (CySEC)

Annex 3

The Public Administration Review: Second Batch of Studies

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

Ministries and the Departments/Services falling under each Ministry

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

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

Constitutional Powers /Services

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

Independent Services/Authorities

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

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

i. Office for the Commissioner of State Aid Control [1]
ii. Authority for the Supervision of Cooperative Societies [2]
iii. Competition Protection Commission[3]

[1] It functions according to *acquis communautaire* prescriptions and it employs only a limited number of people (4 persons).

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

[3] CPC is currently under review by PAPD and should be finalised by Q4 2013, as part of MoU paragraph 5.3. Once the review is finalised, programme partners will assess whether an independent review for the CPC will be needed.

Press Release No. 13/538
FOR IMMEDIATE RELEASE

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review Under Extended Fund Facility Arrangement for Cyprus and Approves €83.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Cyprus's performance under an economic program supported by a three-year, SDR 891 million (about €1 billion, or US$1.4 billion) Extended Fund Facility (EFF) arrangement. The completion of this review enables the disbursement of SDR 74.2 million (about €83.5 million, or US$114 million), which would bring total disbursements under the arrangement to SDR 222.7 million (about €250.4 million, or US$341.9 million). The Executive Board also approved the authorities' request for modification of performance criteria on end-December 2013 fiscal targets.

The EFF arrangement, approved on May 15, 2013 (see Press Release No. 13/175), 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 discussion, Ms. Christine Lagarde, Managing Director and Chair, said:

"The Cypriot authorities have established a record of strong policy implementation, meeting fiscal targets with comfortable margins, making strides in restructuring and recapitalizing the financial system, and advancing structural fiscal reforms. While macroeconomic outcomes have been somewhat better than expected, the economic situation and outlook remain difficult and subject to significant risks. Full and timely implementation of the adjustment program, as well as broad public support, is therefore crucial to restore confidence and growth.

"Considerable progress has been made in stabilizing the financial sector. Cyprus's largest bank put in place a restructuring plan, the second largest bank was fully recapitalized with private—including foreign—funds, and initial steps were taken to consolidate the cooperative credit sector. Building on these efforts, banks will need to implement their restructuring plans, and the recapitalization and consolidation of cooperative credit institutions should be completed rapidly. These will help pave the way for a further gradual relaxation of payment restrictions in line with the authorities' roadmap, while safeguarding financial stability.

"The resumption of credit flows and output growth will depend on progress in addressing banks' problem loans. This requires an effective framework for private sector debt restructuring with appropriate incentives. At the same time, efforts should continue to strengthen bank supervision and regulation and the implementation of the anti-money laundering framework.

"The 2014 budget is appropriately conservative, given the uncertain outlook. Continued prudence in budget execution is necessary, complemented by structural reforms to ensure adequate protection of vulnerable groups, improve revenue administration, and strengthen public financial management. The authorities also need to accelerate efforts to jump-start the privatization process," Ms. Lagarde said.

Statement by Mr. Menno Snel, Executive Director for Cyprus, and Mr. Ektoras Kanaris, Advisor to the Executive Director
December 20, 2013

We thank staff for their comprehensive second review of the Extended Arrangement for Cyprus. The report clearly indicates that programme implementation remains strong, with all quantitative targets met and all structural benchmarks achieved. We agree with the thrust of the staff report which recognizes the Cypriot authorities' achievements despite the difficult environment in which they operate in, while setting out in detail the remaining risks and vulnerabilities.

The authorities' performance so far clearly demonstrates their resolve and determination to fully deliver on programme conditionality and beyond. In fact, despite an over performance in the fiscal targets, the 2014 budget, which was submitted to the parliament on December 12, goes beyond programme requirements reinforcing Cyprus's commitment to an ambitious fiscal programme. The budget will bring the total fiscal adjustment for 2013-14 to 9.4 percent of GDP. Furthermore, significant progress has been achieved on the politically sensitive issue of privatizations. The decision by the Council of Ministers is a milestone that enables Cyprus to move forward and decisively with the process. Finally, the Cypriot authorities remain committed to undertaking the structural reforms necessary to return to sustainable growth, while at the same time seeking to maintain social cohesion.

Commitment, however, rarely translates into quick results. Indeed, the economy remains in deep recession while unemployment stands at historical peaks of around 17%. Nevertheless, there are encouraging signals from the first nine months of the program. First, we take positive note of the economy's stronger resilience than was initially assumed and that important growth levers, while negatively impacted, have not lost their momentum. The successful implementation of the programme has been reflected in improved market perceptions of Cyprus's financial position. Ratings agencies have also taken notice, with Standard & Poor's recently upgrading its long-term sovereign debt rating on Cyprus, the first ratings upgrade following a series of steep downgrades in the last three years. In the financial sector, there was a strong vote of confidence arising from the oversubscribed share capital increase of Hellenic Bank, including through foreign direct investment. Although the road ahead remains long and challenging, these developments are promising.

Macroeconomic developments

The economic situation remains difficult, but the outturn so far has been somewhat better than anticipated. Real economic growth has been revised to -7.7 percent in 2013, as compared with an initial estimate of -8.7 percent. A more favourable outcome for the year should be expected as the annualized growth for the first three quarters was -5.5 percent. Indeed, a number of indicators such as retail sales, tourism receipts, and professional services have proven to be relatively resilient, while recent sentiment indicators point to a gradually

improving confidence. Specifically, the Economic Sentiment Indicator (ESI) for November 2013 increased further, registering its seventh consecutive monthly increase.
Though much uncertainty underlies any growth forecast at present, looking forward, a significant deleveraging process is expected to take place through the banking sector, which together with the fiscal adjustment already underway will entail a drag on growth. At the same time, sparse liquidity in the system, in addition to the low level of confidence and ongoing capital controls, has rendered the banks apprehensive to the provision of credit. As a result, growth is expected to be about -4.8 percent in 2014, and 0.9 percent in 2015. As in the past, medium-term growth projections do not incorporate the potential upside from the exploitation of natural gas resources, including related forthcoming infrastructure investments.

Although the most recent figures in November show that the labour market is showing some signs of stabilization, unemployment remains unacceptably high at around 17 percent. Wages in both the public and private sectors have been reduced considerably and are contributing towards improving competitiveness. Nonetheless, the rapid increase in youth and long-term unemployment remains very worrying.

The significant adjustment of Cyprus's current account, which has moved to a surplus of 7.4 percent of GDP in the second quarter compared with a deficit of 4 percent of GDP a year ago, indicates the economy's ability to adjust. While most of the current account adjustment has emanated from lower imports, the modest recovery in the eurozone has contributed to increased trade, evidencing Cyprus's highly open economy.

Public Finances

The authorities remain determined to restore Cyprus's public finances to a sustainable footing, continuing their strong record of compliance with fiscal targets. Good progress has been made in that regard enabling the general government primary balance to reach a surplus of €110 million during the period under review (January –September 2013), comparing favourably with the forecast of a deficit of €402 million. As a percentage of GDP, the primary balance recorded a 0.7 percent surplus compared with a forecast deficit of 2.4 percent, an over performance of 3.1 percent. This was due to a better-than-expected revenue collection and prudent execution of discretionary spending. In light of the fiscal outturn to date, the end-year primary deficit target for the general government has been revised to 2.6 percent of GDP from 3.3 percent, locking in some of the over-performance during the first nine months of this year.

For 2014, the authorities are targeting a primary deficit of 3.3 percent. This is 1 percent of GDP less than envisaged under the original programme, reflecting the net effect on revenues (0.7 percent of GDP) of a higher 2013 base. This more than offsets the weaker growth in 2014, but also provides some additional high quality permanent measures beyond the program requirements (0.3 percent of GDP).

Financial Sector

Even though significant efforts have been made towards restoring confidence in the sector and progress has indeed been made, the state of affairs remains fragile. Confidence in the system is still low although there has been a distinct deceleration in deposit outflows since end-September 2013.

Stabilizing the financial sector remains the authorities' key priority. To this end, important strides have been made since end July, when Bank of Cyprus was fully recapitalized and exited the resolution process. In particular, a new Board of Directors for Bank of Cyprus was elected in September, soon followed by the appointment of a new Chief Executive Officer. Subsequently, the bank's restructuring plan was assessed favourably, in compliance with the programme's structural benchmark. The plan aims at cleaning up the bank's balance sheet including, most importantly, managing effectively non performing loans, returning the bank to profitability, maintaining adequate capitalization, and ensuring stable funding over the medium term. The plan is broadly consistent with the programme assumptions and includes a strategy to deal with troubled borrowers through the creation of specialized units inside the bank.

On November 1, Hellenic Bank increased its share capital from private sources, including foreign participants, thus satisfying two structural benchmarks for this and the next review. In addition, the bank secured the conversion of €255 million of junior bonds into CT1 eligible instruments, thus exceeding the capital requirements determined by the PIMCO due diligence exercise under the adverse scenario by around 20 percent.

At the Cooperative Central Bank (CCB), a new Board of Directors has been elected and, on the basis of a draft restructuring plan, the authorities have started consolidating the sector by merging 38 cooperative credit institutions into 9 entities. As a prior action, the Ministry of Finance has agreed on the terms governing the relationship framework with the CCB, on the basis of international best practices, to ensure that the bank operates on a commercial basis. Furthermore, supervision and regulation of the cooperative credit institutions have been transferred to the Central Bank of Cyprus (CBC).

Finally, the CBC completed the review of banks' practices regarding loan origination processes, asset impairment and provisioning and the treatment of collateral in provisioning. At the same time, the authorities are resolutely reforming the framework to facilitate the all important area of private debt restructuring in the following manner. First, the Central Bank has already finalized an Arrears Management Framework and a Code of Conduct for borrowers and creditors in line with international best practice. Second, banks are establishing specialized units to deal with NPLs, and third, a review aimed at strengthening the insolvency framework is underway, already enriched with technical assistance by the Fund.

Looking forward, the authorities will build on these steps to ensure that credit institutions can effectively support the economic recovery. At the same time the CBC remains committed to taking appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

Building on initial signs of improving confidence in the banking sector and concluding the first stage of the roadmap on capital controls, during August-October 2013 the authorities further relaxed restrictions on wire transfers and the opening of new accounts. Following the submission of the cooperative sector's final restructuring plan, the second phase of relaxations can begin, including the abolition of remaining restrictions requiring the automatic renewal of fixed-term deposits and the elimination of limits for the free transfer of deposits within the domestic banking system. To ensure that further relaxations do not jeopardize financial stability, the CBC will fine-tune its technical impact assessment of relaxation measures on banks' liquidity. Furthermore, to assess market confidence in order to proceed with relaxations in the context of financial stability, the CBC will study current market conditions, including through well-targeted surveys and focus groups, by end January 2014. At present experts from the Austrian National Bank are in Cyprus assisting the CBC in the design of a banking survey.

Structural reforms

The authorities continue to advance their ambitious structural reform agenda. As outlined in the report, the government is steadfastly moving forward with a comprehensive social welfare reform aimed at protecting vulnerable groups during the downturn. The scheme, which introduces a general minimum income for vulnerable groups, will be financed by consolidating and better targeting other social benefits to remain within the 2014 envisaged envelope.

Substantial progress is also being made in the area of revenue administration, aimed at supporting the consolidation efforts. More specifically, steps are being taken toward the integration of the Inland Revenue Department and VAT services into a new function-based tax administration while, as a more short-term response, a work programme of targeted joint audits is being prepared to be undertaken by the Internal Revenue Department and VAT Services. In the area of public financial management the authorities completed the drafting of the Fiscal Responsibility and Budget Systems Law which provides the legal basis for the efficient management of public investment projects, the establishment of a Fiscal Council, and establishes transparent management of natural resource revenues through the budget.

Finally, despite its political sensitivity, the Cyprus Privatization Plan was unanimously approved by the Council of Ministers on December 5. This has been a landmark decision which enables the authorities to embark on the privatization process. Following from this decision, the Government intends to further detail the asset-specific timelines and intermediate steps for all state-owned enterprises envisaged for privatization. In parallel, the legal and institutional framework for the privatization process will be finalized. The plan will be adjusted at regular intervals to reflect market developments with a view to maximizing revenues in line with the envisaged timelines as well as potentially attracting foreign direct investment.

Overall, the government places great emphasis in the area of structural reforms and has already embarked on an overhaul, inter alia, of public administration, the health system and tax administration. In conjunction with an ambitious privatization program, these reforms will create the conditions for Cyprus to regain its competitiveness and generate the foundation for a sustainable economic model.

Conclusion

In summary, Cyprus has taken decisive action to address its economic difficulties and restore stability, meeting its commitments under the program in terms of policy reforms as well as quantitative targets. As noted earlier, steadfast implementation has produced tangible results with indications that the process of recovery is taking place. These developments give some room for cautious optimism. Nevertheless, the authorities have no room for complacency and are aware that there are major challenges to be overcome. The adjustment remains painful in the face of a deep recession, high unemployment and an impaired banking system that is reluctant to provide any credit. To this end, it is encouraging to see that European institutions are not passive observers of these exceptional circumstances under which the Cypriot economy is operating, as recently evidenced by the EIB's approval of new financing instruments for Cyprus, for an amount of up to EUR 150 million. In this context the authorities would like to express their appreciation for efforts like this one which provide the impetus for continued commitment and execution as the programme unfolds. At the same time, the authorities look forward to continuing discussions on how the sustainability of Cyprus's well performing programme can be improved.

In conclusion, it should be noted that Cyprus's strong implementation record so far is equally attributed to staff's good programme design, by way of carefully balancing ambitious conditionality with the institutional capacity limitations that small economies face. While staff's overall guidance throughout this process has been instrumental in helping the authorities keep up, continued vigilance on this sensitive exercise will be crucial for continued success. Finally, credit must be handed to Fund management, the relevant area departments, and the EU's "Support Group for Cyprus" for generously offering, structuring and making possible the extensive technical assistance that Cyprus has received and will continue to receive across a vast number of areas.