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CYPRUS

July 2014

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

In the context of the fourth 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** prepared by a staff team of the IMF for the Executive Board's consideration on June 30, 2014, following discussions that ended on May 17, 2014, with the officials of Cyprus on economic developments and policies underpinning the IMF Extended Arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on June 17, 2014
- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Statement by the Executive Director** for Cyprus.

The following documents 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*
Memorandum of Understanding on Specific Economic Policy Conditionality by the European Commission*

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

CYPRUS

June 17, 2014

FOURTH 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). Four purchases of amounts equivalent to SDR 74.25 million (about €84 million) each have been made so far, and another purchase of the same amount is proposed to be released upon completion of the fourth review. The European Stability Mechanism has released €4.75 billion (of €9 billion committed), and an additional €600 million is expected to be disbursed in early July.

Recent Economic Developments: While still deep, the recession continued to moderate in the first quarter. Unemployment remains high, and mild deflation persists. Conditions in the banking sector are normalizing, although non-performing loans remain very high, constraining the ability of banks to provide credit to the economy. The outlook remains challenging, although with a somewhat milder output contraction expected this year, followed by a more gradual recovery. Overall, the economy remains weighed down by large private sector deleveraging needs.

Policy Implementation: The program remains on track. Fiscal targets for the first quarter were met with considerable margins, domestic payment restrictions were fully lifted, and the coop sector was consolidated. The authorities intensified efforts to overcome delays in the implementation of structural measures. Looking forward, there are three key policy challenges: (i) addressing the high level of non-performing loans; (ii) maintaining fiscal sustainability; and (iii) strengthening institutions to support fiscal consolidation efforts and long-run growth. Risks to the program remain significant, in particular those related to still strong macro-financial linkages.

Approved By
Philip Gerson and Mark Flanagan

Discussions were held in Nicosia during May 6–17. The mission met with the Minister of Finance, the Governor of the Central Bank of Cyprus, other Cabinet Ministers, members of Parliament, leaders of the main political parties, union representatives, and other representatives of the private sector. Staff worked in conjunction with representatives from the European Commission and the European Central Bank. The IMF team comprised Delia Velculescu (head), Ruchir Agarwal, Luis Cortavarría, Chady El Khouri, Alejandro Hajdenberg, Yinqiu Lu, Jeta Menkulasi, Nadia Rendak, Preya Sharma, Alejandro Simone, and Oliver Wuensch. Vincenzo Guzzo and Maria Heracleous (Resident Representative office) assisted the mission and Cristina Cheptea, Sarika Chinta, and Amara Myaing provided research and editorial support. Mr. Kanaris (OED) attended some of the meetings.

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BACKGROUND

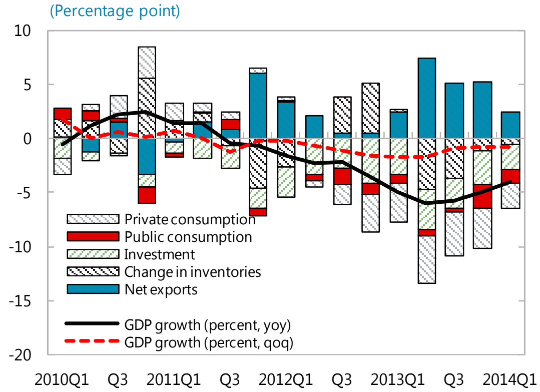
1. **The program remains on track**. All end-March and continuous performance criteria (PCs) were met. Compliance with structural benchmarks (SB) was mixed, although the authorities intensified efforts to overcome delays. In the financial sector, two SBs related to the cooperative credit sector were met. The requirements of two bank supervision SBs were fulfilled one partially and one with delay, while those of the SB related to legacy Laiki are expected to be achieved partially with a delay. In the fiscal structural area, the SB requirement on revenue administration was fulfilled with a slight delay, while that related to the welfare reform is yet to be achieved.

2. **External developments remain broadly supportive of Cyprus's situation**. The EU Parliamentary elections broadly reaffirmed the political support for Cyprus's ruling party and the program. The ECB's latest interest rate cut and measures to stimulate lending are welcome, given mild deflation and contracting credit in Cyprus. The recent political agreement on the pan-European single supervisory and resolution mechanisms (SSM, SRM) can help improve confidence in Cyprus's banking sector over the long run, as supervision will be harmonized and strengthened. However, in the short run, the transition to the SSM and preparations for the comprehensive assessment of the banking system are straining capacity.

RECENT ECONOMIC DEVELOPMENTS

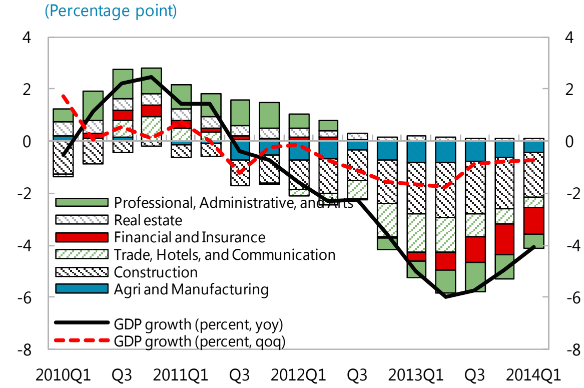
3. **The recession continues to moderate**. Output contracted by 4.1 percent year-on-year (y-o-y) and 0.7 percent quarter-on-quarter (q-o-q) in the first quarter of 2014, continuing the trends observed in the second half of last year. This performance is somewhat better than expected under the program. On the demand side, the decline in private consumption and investment moderated relative to a year ago. Exports were flat, while the contraction in imports declined relative to last year. On the supply side, construction and financial services contributed most to the contraction. Economic sentiment improved in May, reaching levels last observed in 2010 (Figure 1). The rate of deflation slowed to 0.1 percent in May, and core inflation edged up to 0.2 percent (Figure 2). The unemployment rate fell slightly to 16.4 percent in April from a revised 16.7 percent at end-2013, with youth unemployment at 42.3 percent in March.

Contributions to GDP Growth
(Percentage point)



Sources: Cystat; Eurostat; and IMF staff estimates.

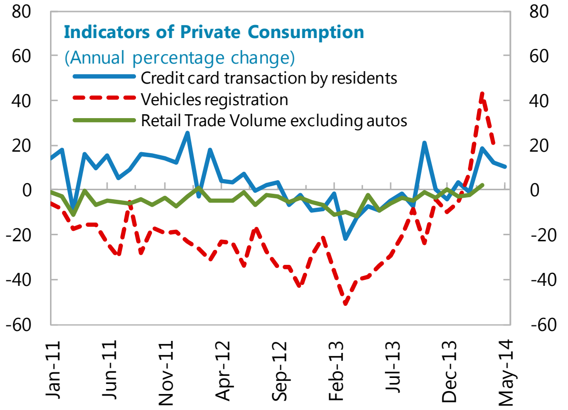
Contributions to GDP Growth
(Percentage point)



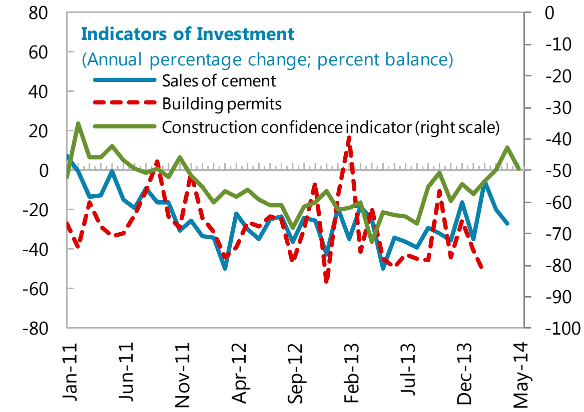
Sources: Cystat; and IMF staff estimates.

Figure 1. Cyprus: High Frequency Indicators

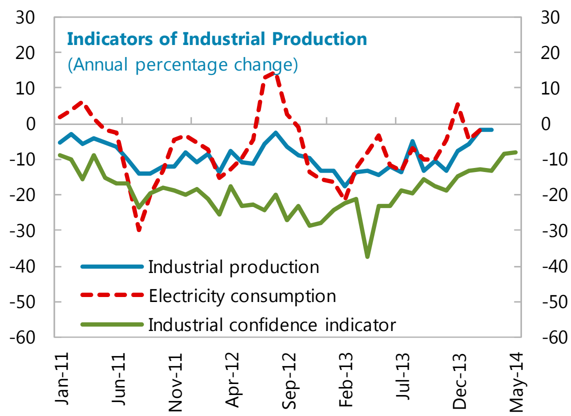
Vehicle registration, credit card transactions, retail trade increased relative to a year ago, in part reflecting the low base.



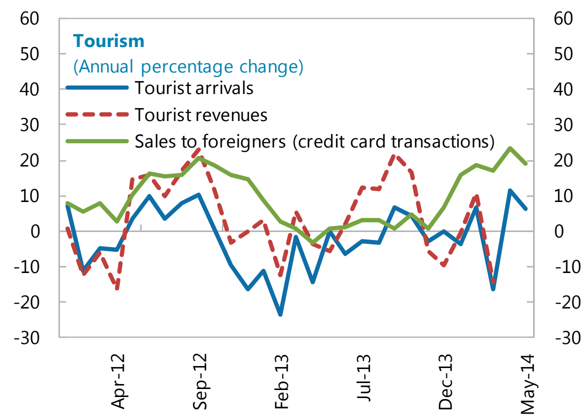
Construction activity remained weak.



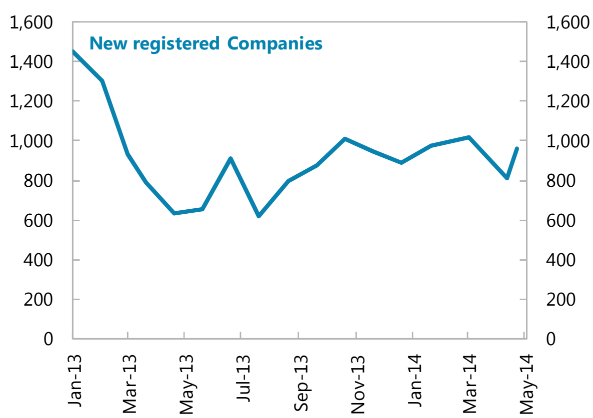
The pace of contraction of industrial production has decelerated.



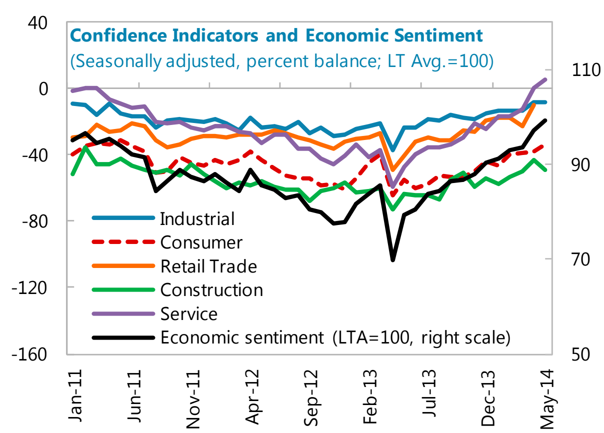
Tourism receipts and arrivals declined in March, given the timing of Easter, but arrivals have subsequently recovered.



The number of new company registrations has been broadly stable in recent months.

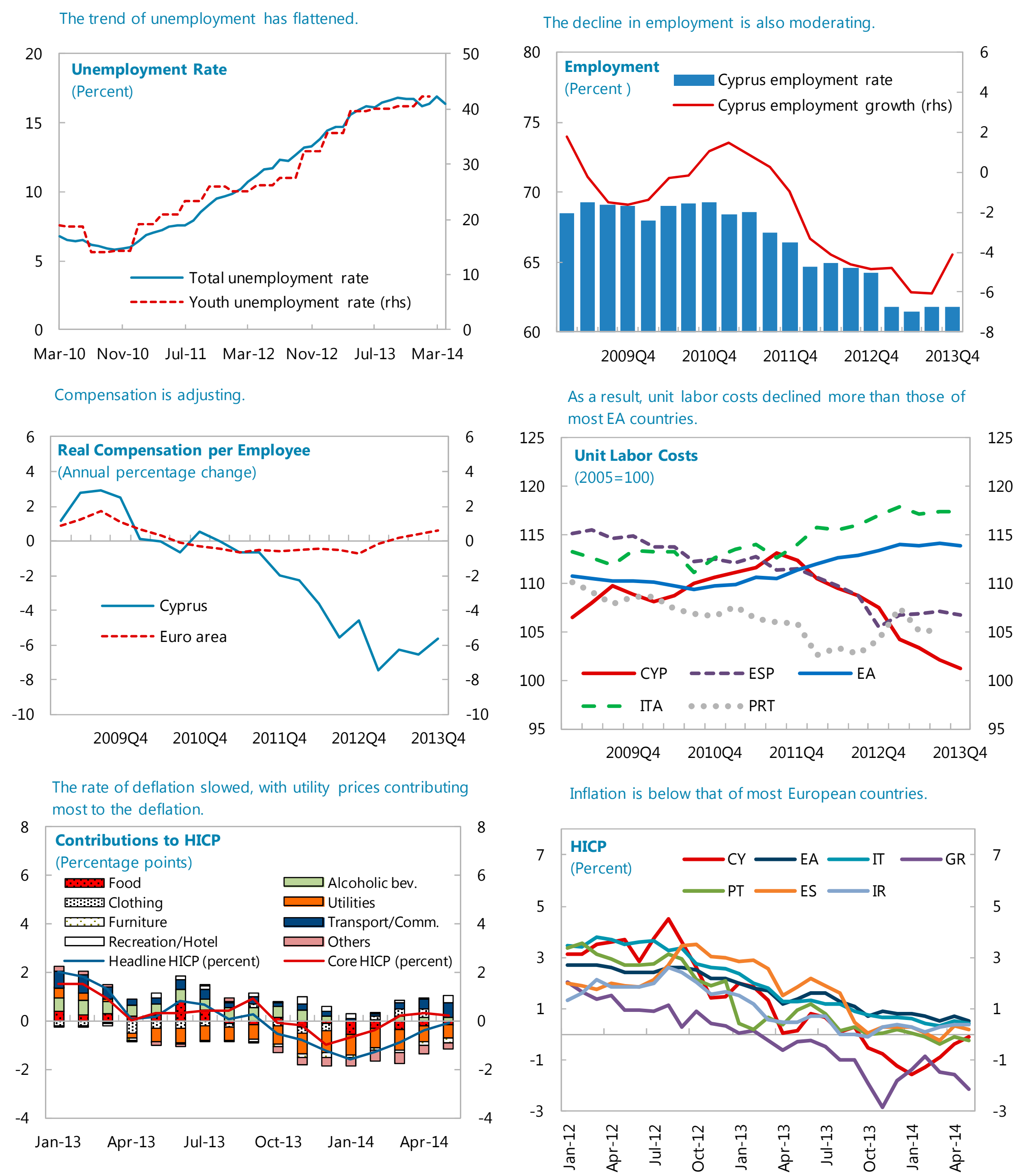


Confidence indicators and economic sentiment continue to improve.



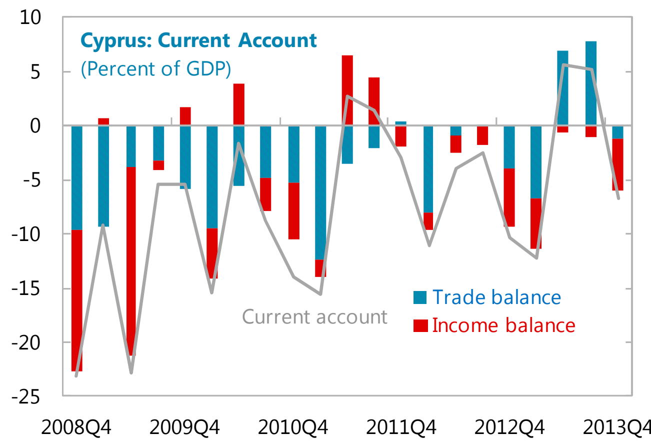
Sources: CYSTAT; Eurostat; MoF; and IMF staff estimates.

Figure 2. Cyprus: Employment and Inflation Developments



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

4. **The current account deficit narrowed to 1.9 percent of GDP at end-2013**. This compares to a deficit of 6.9 percent of GDP in 2012 (Figure 3). The adjustment was largely due to a turnaround in the trade balance, which recorded a surplus of 1.9 percent of GDP, larger than expected under the program, due to a steep decline in imports. The income balance, however, remained negative, with both foreign assets and liabilities falling. Competitiveness improved, with the real effective exchange rate (unit labor cost based) having declined by about 9 percent since its peak in mid-2011. Tourism receipts for the first quarter were down by 5.3 percent relative to a year ago, in part due to the different timing of Easter; tourist arrivals recovered in April and May.



Sources: Cystat; and Eurostat.

5. **The end-March cumulative primary fiscal surplus reached 0.6 percent of GDP, better than the target by 0.7 percent of GDP**. This performance was largely due to higher-than-expected tax revenues (by 0.3 percent of GDP) and also some one-off factors. Primary spending was slightly lower than the target (by 0.2 percent of GDP), with lower compensation of employees and under-execution of intermediate consumption and capital expenditure more than offsetting slightly higher social transfers and other current expenditures. In April, the cumulative primary surplus reached 1.5 percent of GDP, on account of CBC dividends transferred to the state (1.1 percent of GDP) and a continuation of the positive tax revenue trends observed in the first quarter (Figure 4).

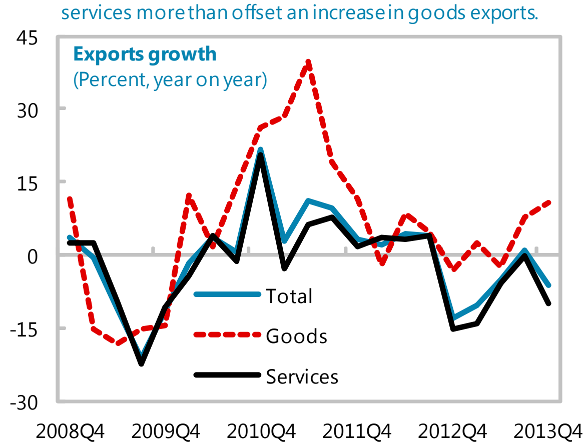
General Government, January-March 2014 1/

	(Millions of Euros)		(Percent of GDP)	
	Program 2/	Prelim.	Program 2/	Prelim.
Revenue	1,482	1,566	9.4	9.9
Taxes on production and imports	532	556	3.4	3.5
Current taxes on income and wealth, etc	412	446	2.6	2.8
Social contributions	395	380	2.5	2.4
Other revenue	143	184	0.9	1.2
Expenditure	1,625	1,611	10.3	10.2
Current expenditure	1,545	1,561	9.8	9.9
Intermediate consumption	168	142	1.1	0.9
Compensation of employees	548	532	3.5	3.4
Social transfers	581	606	3.7	3.8
Interest	120	135	0.8	0.9
Subsidies and other current expenditure	128	146	0.8	0.9
Capital Expenditure	80	50	0.5	0.3
General Government balance	-143	-46	-0.9	-0.3
General Government primary balance	-23	90	-0.1	0.6
General Government primary spending	1,505	1,476	9.5	9.3

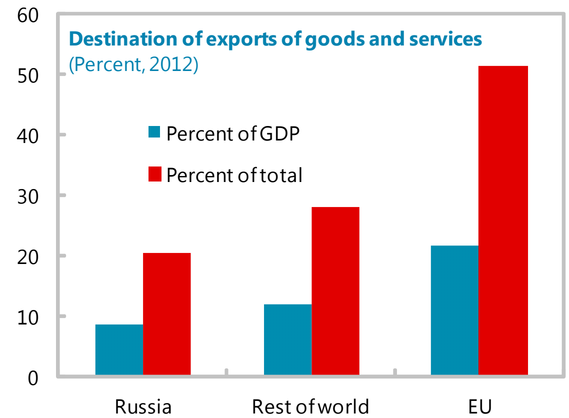
Sources: Ministry of Finance; and IMF staff estimates.
1/ ESA95 classification, cash data.
2/ Adjusted third review program projections. The primary spending and deficit targets were adjusted upwards and downwards by 0.6 million, respectively, reflecting additional compensation payments to pension funds (other current expenditure) as per the TMU.

Figure 3. Cyprus: External Indicators

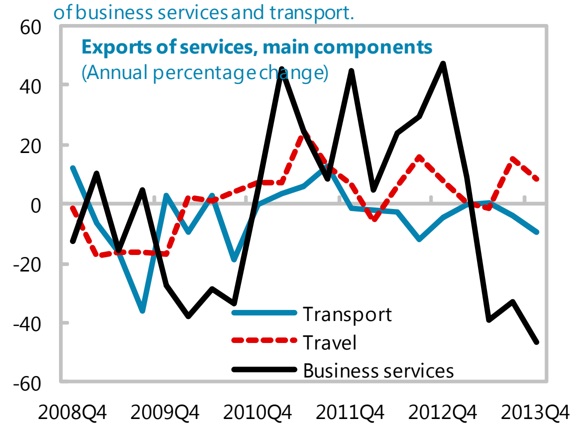
Exports declined in the final quarter of 2013 as the fall in services more than offset an increase in goods exports.



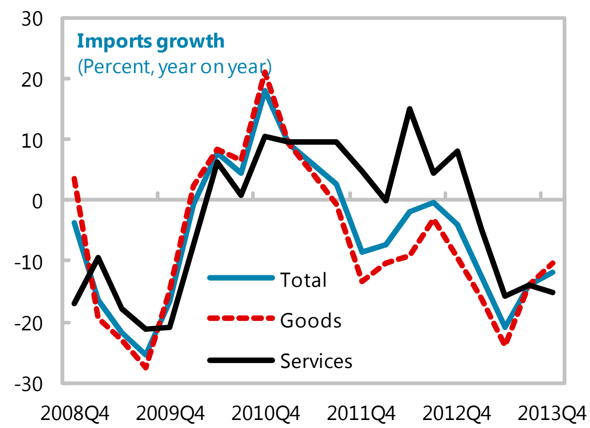
Russia and the EU are key export markets for Cyprus.



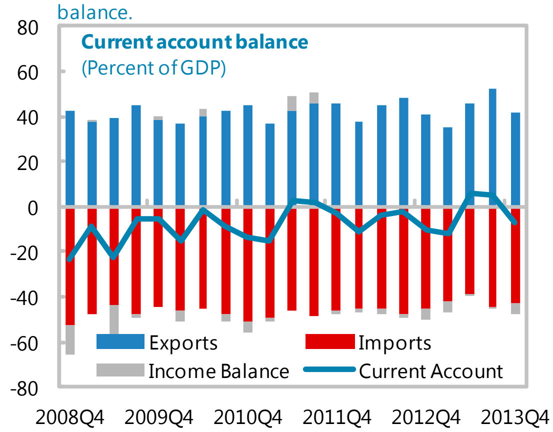
Growth in tourism has helped offset the decline in exports of business services and transport.



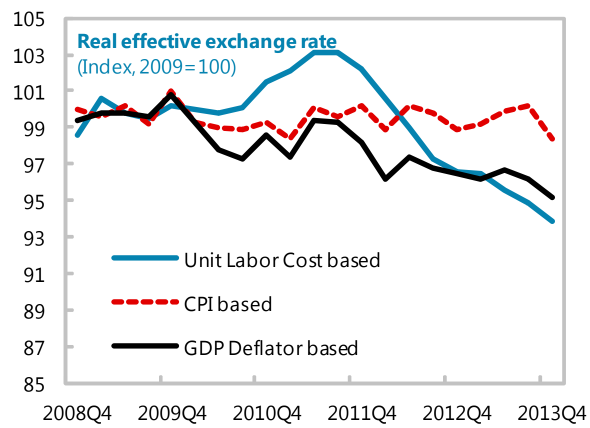
The pace of import contraction has moderated.



The current account returned to a deficit in the final quarter due to weaker exports and a negative income balance.



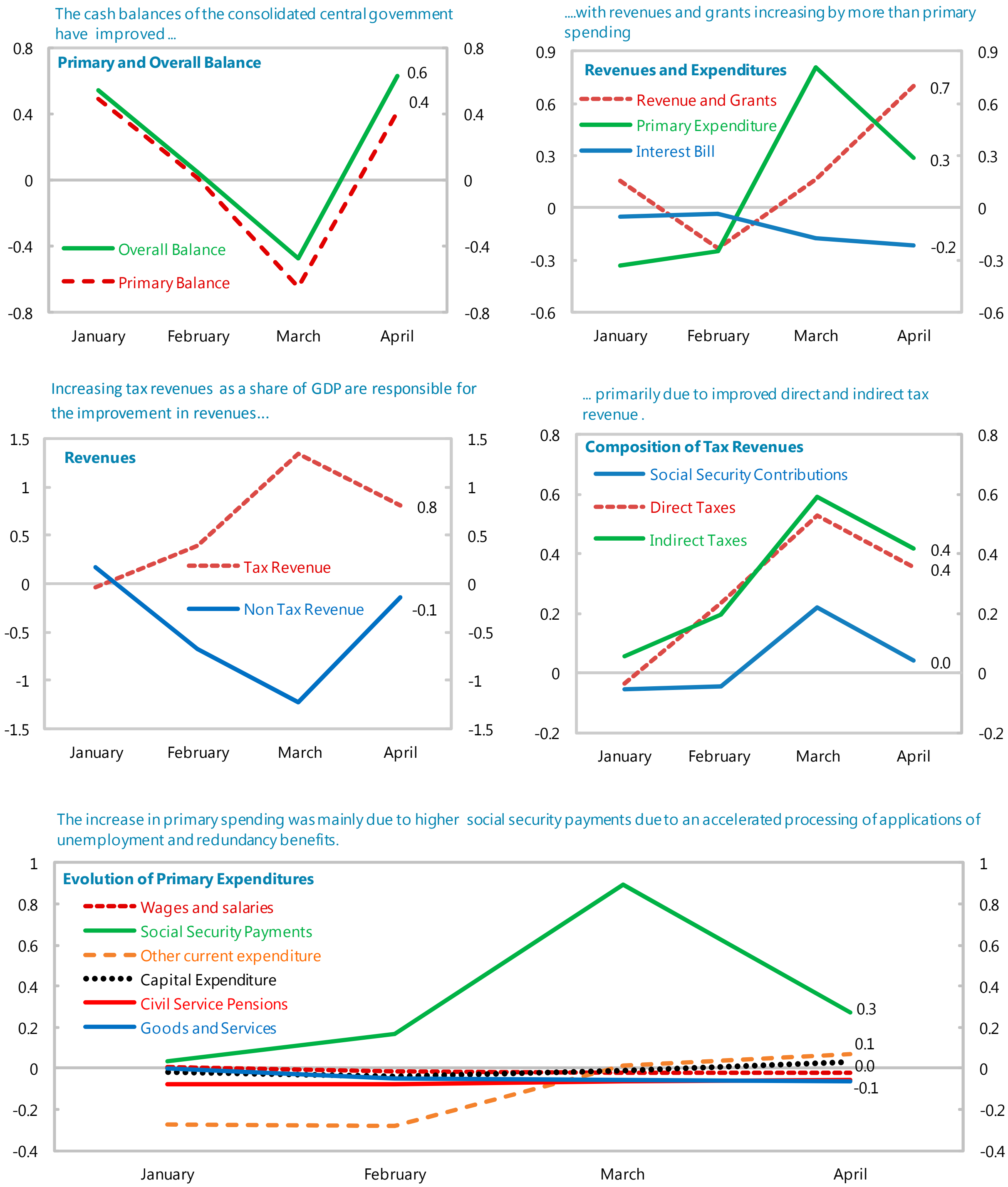
The real effective exchange rate continued to depreciate through 2013.



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

Figure 4. Cyprus: Recent Fiscal Developments 1/

(Cumulative percent of GDP difference relative to previous year)



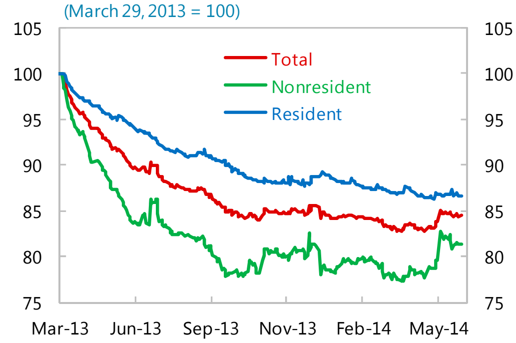
Sources: Ministry of Finance; and IMF staff estimates.

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

6. **Conditions in the financial sector are gradually normalizing, although vulnerabilities remain:**

- ***System-wide deposits have remained broadly stable, even as all domestic payment restrictions were recently abolished***. In the first five months of 2014, aggregate deposits declined by about 2 percent, compared to a 20 percent fall during end March–December, 2013 (excluding bailed-in amounts). During April and May, the system experienced net inflows for the first time since 2012, reflecting inflows of non-resident deposits into foreign banks, which more than offset mild outflows from domestic banks. The freeing of domestic payment flows (Table 10), together with the release of €1.3 billion of Bank of Cyprus' (BoC) frozen deposits in February–April, led to a shortening of the maturity profiles (deposits maturing in less than 3 months now represent about half of total deposits). BoC will release another €0.6 billion in equal tranches in July and September and decide on the release or extension of the last €1 billion in frozen deposits at end-July.

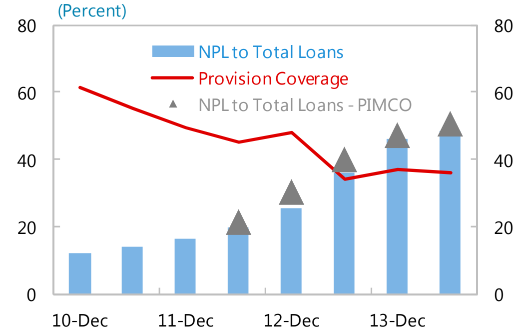
Total Deposits in Banking System
(March 29, 2013 = 100)



Sources: CBC; and IMF staff calculations.

- ***Nonperforming loans (NPLs) have stabilized, but remain very high***. NPLs of the core domestic banking sector represented 52 percent of gross loans (close to 140 percent of GDP) at end-March, only marginally higher than their end-2013 level, and broadly in line with PIMCO's projections. Corporate NPLs stood at 55 percent and are highly concentrated (the largest 30 exposures represent a fifth of corporate NPLs), while NPLs for owner-occupied housing loans are around 36 percent. Banks booked new provisions of about €5 billion in 2013, helping to stabilize provision coverage of NPLs at about 36 percent at end-February, in line with restructuring plans, albeit lower than the European average of 50 percent.

Nonperforming Loans and Provisions
(Percent)

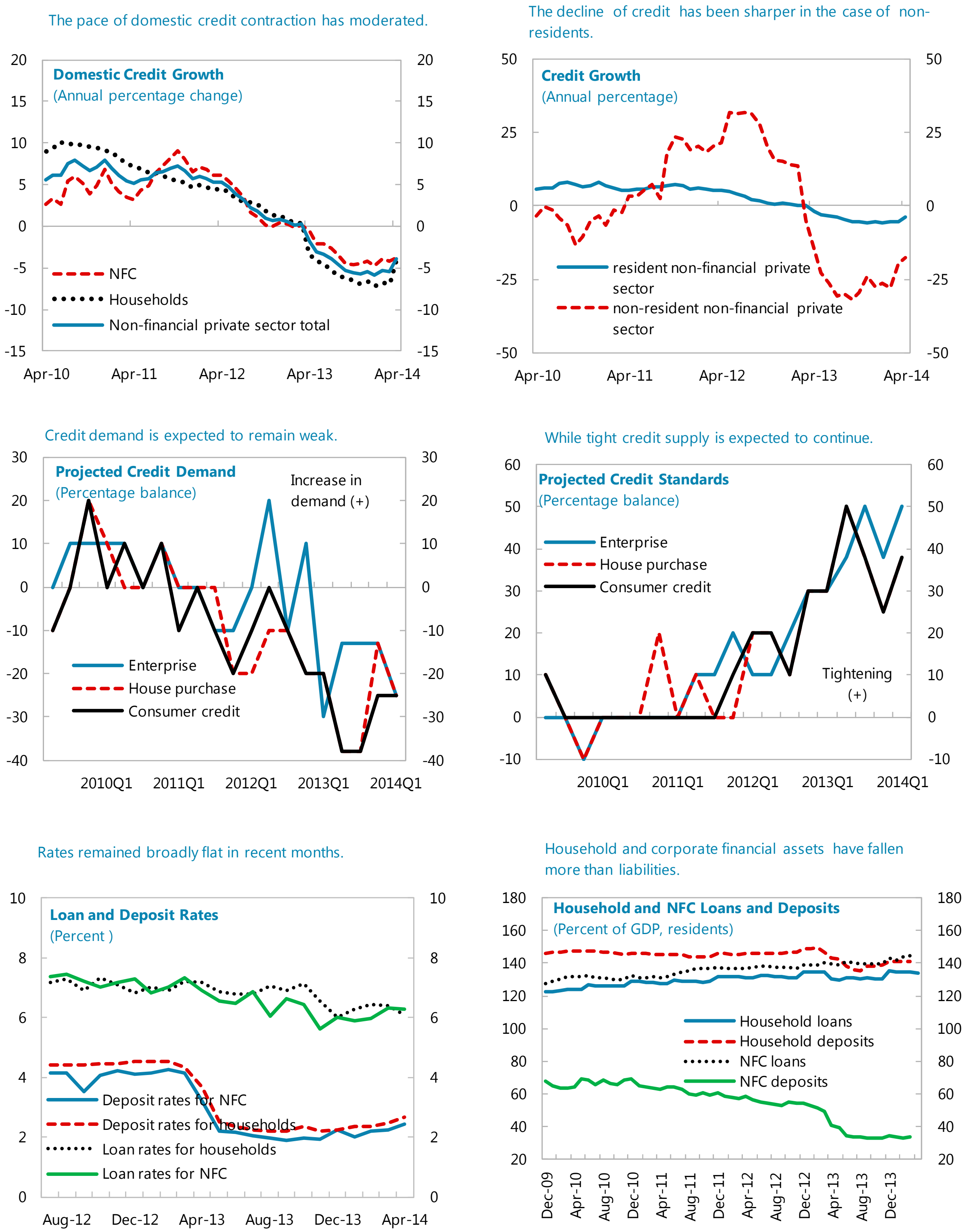


Sources: CBC ; and IMF staff calculations.

- ***The pace of credit contraction has slightly moderated*** (Figure 5). Non-financial private sector credit fell 8.4 percent y-o-y in the first four months of the year (5.2 percent for residents) compared to 10 percent at end-2013. Both corporate and household credit continued to decline. The lending survey indicates that credit demand remains weak and supply conditions are tightening, which is also reflected in relatively high lending rates.

- ***Financial institutions have made progress relative to restructuring plans***. Following its recapitalization at an aggregate level in March, the cooperative credit sector was consolidated into 18 institutions (meeting the end-March structural benchmark), which in turn were recapitalized to meet regulatory minima. BoC successfully divested its operations in Ukraine, Romania, and Serbia ahead of schedule, reducing its risk exposure and boosting its liquidity

Figure 5. Cyprus: Financial Sector Developments



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

position, while Hellenic Bank sold its Russian subsidiary in early June. CET1 capital of the core domestic sector stands at close to 11 percent and remains in line with the program.

MACROECONOMIC OUTLOOK

7. **The macroeconomic framework was modified in line with recent developments**.

- ***The 2014 growth projection was revised up to -4.2 percent, more than ½ percentage point better than at the time of the third review***. This reflects the better-than-expected outturn in 2013 and developments in the first few months of 2014. Specifically, both private consumption and investment growth in 2014 were revised up relative to the third review, while taking into account the still large indebtedness of the private sector, which is expected to weigh on domestic demand. Export growth projections incorporate an expected slowdown in demand from Russia, which is one of Cyprus's main trading partners.

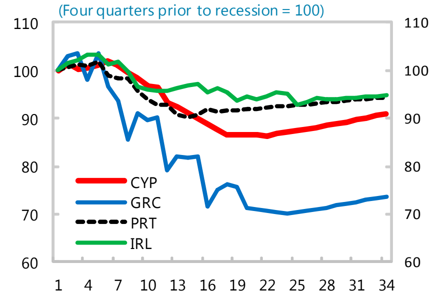
Selected Economic Indicators

	2014		2015	
	3rd Review	Revised Proj.	3rd Review	Revised Proj.
	(Percent change, unless otherwise indicated)			
Real GDP	-4.8	-4.2	0.9	0.4
Consumption	-5.3	-4.5	-0.1	-0.7
Private consumption	-6.3	-5.1	0.7	-0.2
Public consumption	-1.5	-2.7	-2.7	-2.4
Fixed investment	-18.1	-17.0	1.3	1.3
Inventory accumulation 1/	0.0	0.0	0.0	0.0
Foreign balance 1/	1.9	1.9	0.8	0.9
HICP (period average)	0.4	0.2	1.4	1.1
Unemployment rate EU stand. (percent)	19.2	18.6	18.4	18.0
Current account balance (percent of GDP)	0.1	-0.1	0.3	0.2

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

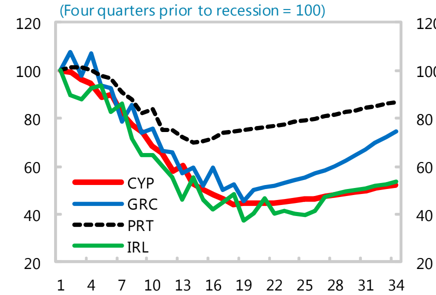
- ***The medium-term recovery is expected to be more gradual***. Growth in 2015 is expected to reach 0.4 percent, half the rate projected during the last review. Output dynamics are expected to remain somewhat more subdued in the following years as well. Staff analysis suggests a slower turnaround of private consumption than previously projected, as households deleverage and adjust to a lower net wealth (Box 1).[1] Investment is projected to rebound gradually, driven by sectors with free cash flow and less dependence on credit.[2] By 2020, private consumption and investment are

Private Consumption
(Four quarters prior to recession = 100)



Sources: Haver; WEO; and IMF staff estimates.

Fixed Capital Formation
(Four quarters prior to recession = 100)



Sources: Haver; WEO; and IMF staff estimates.

[1] Also see Country Report No. 13/374 for an analysis of private sector balance sheet deleveraging on growth.

[2] Also see Country Report No. 14/92 for a sectoral analysis of the expected credit-less recovery in Cyprus.

Box 1. The Household Saving Rate in Cyprus

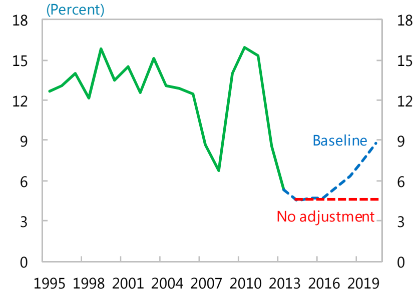
According to the literature, a number of factors affect the saving rate: (i) as populations age, savings are depleted; (ii) government dis-saving can be associated with higher household savings, as individuals may anticipate future increases in taxes (so called Ricardian equivalence) or future macroeconomic uncertainty (precautionary saving effects); (iii) a higher real interest rate encourages savings through a higher opportunity cost of consumption (substitution effect), while it also generates higher income on the stock of wealth (income effect); (iv) an anticipated increase in unemployment could boost precautionary saving; however, when unemployed, individuals make use of savings to smooth consumption; and (v) according to the permanent income hypothesis (PIH), permanently lower net wealth depresses consumption and leads to higher savings.

Variables	Coefficients	Std. Error	Probability
Fiscal Balance (change, lagged)	-0.68	0.12	0.00
Real Deposit Rate (change, lagged)	0.45	0.17	0.01
Unemployment (change, lagged)	-2.23	0.27	0.00
Net financial assets (change, lagged)	-0.10	0.02	0.00
Housing price (percent change, lagged)	-0.15	0.06	0.02
Constant	2.59	0.59	0.00
Adjusted R-squared	0.82		

Regression results suggest that the past behavior of the Cypriot household saving rate can be largely explained by the factors above. The coefficient of government fiscal balance is negative, indicating the possibility of Ricardian or precautionary savings effects. The negative coefficient of unemployment suggests consumption smoothing. The positive coefficient attached to real deposit rate suggests that the substitution effect is dominant, encouraging saving. The negative coefficients for net financial assets and housing wealth indicate that a decrease in wealth leads to lower consumption and an increase the household saving rate, in line with the PIHs.

A decomposition analysis reveals their relative importance in recent saving and dis-saving episodes. First, the decline in the saving rate over the boom period can be largely explained by increasing net financial assets and housing prices, and to some extent, by the improvement in the fiscal position. Second, the increase in the saving rate after the global crisis appears to be mainly driven by the worsening of fiscal position and lower net financial wealth. Third, in the current recession, the role of unemployment and fiscal consolidation appear dominant.

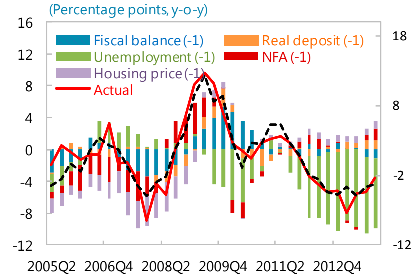
Cyprus: Household Gross Saving Rate
(Percent)



Sources: Cystat; and IMF staff estimates

Looking forward, an increase in the saving rate could be expected. Given their high indebtedness (140 percent of GDP) and interest burden relative to disposable income (around 13 percent), households are expected to boost savings as they gradually deleverage toward more sustainable levels (deleveraging needs are estimated at around 50–90 percent of GDP, although the positive net asset position provides a cushion). A further expected decline in house prices (estimated at 6–20 percent) to achieve equilibrium in the housing market is also expected to affect non-financial wealth, which would lead to a decline in consumption and an increase in savings. Unemployment is likely to continue to rise in the short run, further depressing saving as households smooth consumption, while it is expected to fall in the longer run, facilitating an increase in savings. On the other hand, substantial fiscal consolidation to strengthen public debt sustainability and reduced macroeconomic uncertainty could reduce the need for saving.

Cyprus: Household Saving Rate (Change)
(Percentage points, y-o-y)



Sources: Haver; CBC; Cystat; and IMF staff estimates.

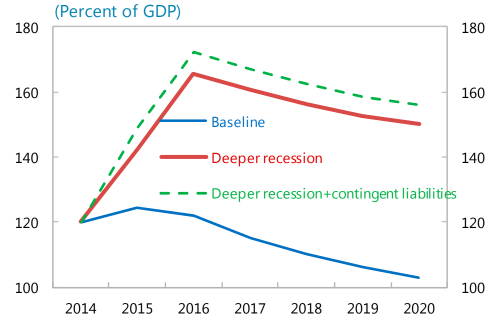
projected to remain some 10 and 45 percent below their 2008 peaks, respectively. Long-run growth is expected to be driven by tourism and non-financial service sectors where Cyprus retains a comparative advantage.

- ***Unemployment and inflation projections were revised down modestly***. Unemployment is expected to peak at 18.6 percent in 2014, ½ percentage point less than previously projected, reflecting the upward revision to the 2014 growth forecast. The inflation forecast was slightly lowered in 2014 and 2015, reflecting the permanent cuts in electricity prices in early 2014 and the more gradual recovery path.

8. **Risks to the outlook remain tilted to the downside**. External risks related to a potential re-intensification of geopolitical tensions in the CIS region could affect Cyprus negatively. While the impact has been limited so far, a sharper economic slowdown in Russia and a further depreciation of the ruble could affect Cyprus's service exports (a fifth of which go to Russia), in particular tourism; repatriation of Russian companies may reduce demand for Cyprus's service sector and affect fiscal revenues, which benefit from double-taxation treaties. A weaker recovery in the Euro area could also damage external demand prospects for Cyprus. On the domestic front, delays in addressing the high level of NPLs could lead to a more extended deleveraging process and continued tightening of liquidity conditions, which may prolong the recession. The risk of a deflationary spiral remains, which could further weigh on already stressed private sector balance sheets, even as it would boost competitiveness. On the upside, a continuation of positive trends seen since mid-2013 could lead to higher growth prospects.

9. **Public debt remains high and vulnerable to shocks** (Figures 7–11). Projected public debt was revised down slightly due to a slightly higher nominal GDP, and a somewhat lower expected cost of official financing. Still, it remains high; sizeable contingent liabilities associated with government guarantees (20 percent of GDP) and large implicit liabilities associated with the banking sector (including ELA exposure of close to 60 percent of GDP) increase its vulnerability to shocks. In particular, a severe shock to growth or a shock combining a deeper recession with higher banking sector contingent liabilities could push debt up to very high levels, which would likely require additional financing measures and commitments from European partners to protect Cyprus's debt sustainability.[3]

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



Source: IMF staff estimates.

10. **External debt also remains a source of vulnerability** (Figure 6). External debt fell to just under 350 percent of GDP at end-2013 from 450 percent of GDP a year ago, reflecting the decline in banking sector deposits. This is slightly higher than the program projections, due to a higher rollover of non-financial sector liabilities. The forward looking trajectory is broadly unchanged and remains

[3] Details underlying the combined shock assumptions are provided in Annex I of the staff report for the Second Review (IMF Country Report No. 13/ 374).

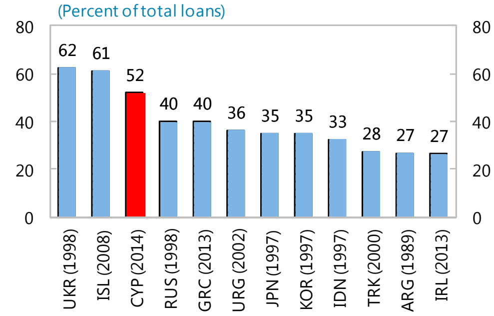
vulnerable to shocks, in particular to growth, the current account, and interest rates. Despite a small improvement in nominal terms in 2013, the net international investment position (IIP) deteriorated slightly relative to GDP to -86 percent compared with -82 percent in 2012. Regarding the composition, the IIP of the private sector improved, while the IIP of the public and financial sector deteriorated, the latter due to a decline in assets as a result of banks' sales of foreign operations, which more than compensated the fall in deposit liabilities.

POLICY DISCUSSIONS

A. Financial Sector Policy: Tackling NPLs and Safeguarding Stability

11. **Addressing the high level of NPLs is critical to restoring credit and growth**. At just above half of total loans, NPLs in Cyprus are the highest in Europe, and among the highest following any recent banking crisis. While rising unemployment and bankruptcies are taking a toll on borrowers' ability to repay their loans, strategic defaults are also reportedly on the rise, given weak capacity and poor incentives to restructure and repay loans. The large and positive aggregate net financial asset position of households (close to 140 percent of GDP at end-2013)—notwithstanding distributional considerations—suggests that there may be room to address at least some NPLs of households, which now amount to 46 percent of total loans and 70 percent of GDP. The high level of NPLs is preventing the resumption of credit to the economy, which in turn weakens economic activity and leads to a further deterioration of repayment capacity. Staff and the authorities agreed that reversing this cycle by lowering NPLs will be essential to support the recovery (Box 2).

Peak NPLs
(Percent of total loans)



Sources: IMF: Laeven and Valencia (2013)
Note: For Greece NPLs include restructured loans. For Ireland NPLs exclude loans transferred to NAMA.

12. **Discussions stressed the need to enhance supervisory monitoring to ensure that banks were taking effective action to reduce NPLs (MEFP ¶3)**. Efforts are focused on several fronts:

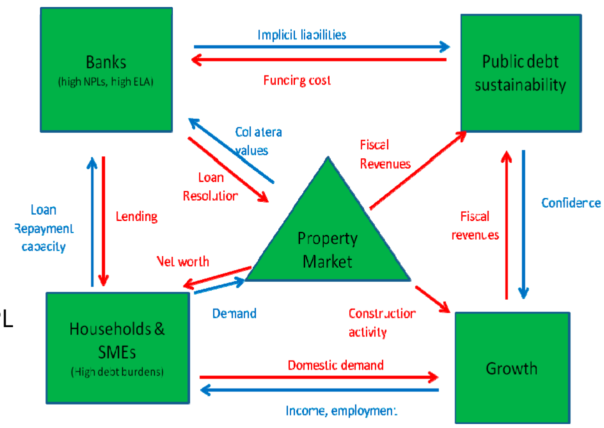
- ***Enhancing banks' operational capacity*:** Banks need to build operational capacity to manage their high NPLs, including by reassigning and training staff and putting in place supportive processes and IT systems. BoC shifted 500 staff to its specialized NPL unit, while the coop sector has 173 dedicated staff. External audit assessments of BoC's and the coops' operational capacity were completed in May, meeting one SB and the requirement of another SB with a delay. The audits identified the need to: (i) further enhance staff training; (ii) establish a clear separation between front-line, restructuring, and recovery functions within banks; (iii) improve IT systems to cope with the large caseload of NPLs; and (iv) strengthen monitoring of restructurings. The CBC has required BoC and the coops to submit action plans to address these shortcomings.

- ***Strengthening implementation of the arrears management framework*:** The CBC is reviewing banks' and coops' compliance with the existing framework to ensure that necessary steps are

Box 2. Challenges in Dealing with NPLs

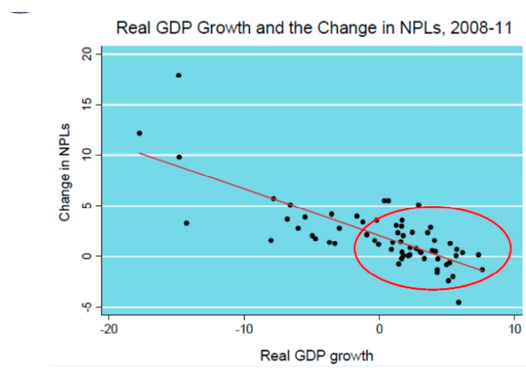
Bank-sovereign-real sector feedback loops in Cyprus weigh on economic prospects. At about 470 percent of GDP, the banking sector (of which domestic banks account for about 300 percent of GDP) remains large relative to the size of the economy, affecting, and in turn being affected by it:

- Although they have been recently recapitalized, domestic banks remain vulnerable, given a very large burden of non-performing loans (NPLs), now close to 140 percent of GDP. High NPLs constrain the ability of banks to lend, which, combined with a very high indebtedness of households and SMEs (close to 300 percent of GDP) contributes to weakness in consumption and domestic demand.[1] This impairs the ability of the state to generate fiscal revenues, putting strains on public debt sustainability, which, in turn, affects banks' ability to acquire long-term funding at reasonable cost. Indeed, funding costs for Cypriot banks are relatively high (also due to high deposit rates). Moreover, reliance on central bank emergency liquidity support is the largest in the Eurozone, at over 30 percent of total deposits (close to 60 percent of GDP).



- Feedback loops also work in reverse. The large NPL and ELA burden also pose an implicit liability onto the sovereign and debt sustainability. This weakens confidence, which in turn leads to tight supply side conditions and weak employment prospects, making it difficult for households and SMEs to service their loans. Loan resolution affects property prices, which feed back into lower collateral values for the banks, lower net worth for households, depressed contruction activity, and lower fiscal revenues for the state, amplifying the negative loops.

Reversing these feedback loops is key to supporting growth. Indeed, the literature finds a positive link between NPLs reduction and growth.[2] To help set in motion such virtuous cycles, some countries (e.g. the United States, Hungary, and Iceland) supported troubled borrowers directly through accross-the-board debt relief financed by the state. Others established asset management companies (AMCs) (e.g., Ireland, Spain, Portugal, Slovenia) funded either with direct fiscal support or with the use of government guarantees. Guarantees where also employed to shield banks from risks associated with NPLs (Belgium, Germany, Ireland, Netherlands, UK). While such direct or indirect fiscal support can help to strengthen banks' balance sheets, risks are effectively transferred to the sovereign balance sheet. Unless the latter can absorb them, feedback loops may not be effectively curtailed.



Source: Klein (2013)
Sample includes 16 CEESE countries

In the case of Cyprus, options to deal with NPLs are limited. Given the amount of NPLs, the constrained funding environment, tight capital buffers, and acute lack of fiscal space, the strategy focuses on dealing with NPLs through developing capacity and targeted policies within bank internal units. In addition, the authorities are embarking on a reform of the legal framework for foreclosure and in and out of court debt restructuring (as was done in Ireland, Portugal, Iceland, Latvia, Slovenia). Still, even with well designed frameworks in place, cross-country experience suggests that it takes time for progress to materialize.

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[1] Leigh et al., 2012, "Dealing with Household Debt," in *IMF World Economic Outlook* (October).
[2] Klein, 2013, "*Nonperforming Loans in CESEE: Determinants and Impact on Macroeconomic Performance*," IMF WP 13/72.

taken to restructure the loans of viable borrowers fairly. However, due to the high workload associated with the ongoing ECB comprehensive assessment, the completion of the CBC review has been extended to end-July. On this basis, banks will be required to develop action plans to address potential shortcomings. The CBC will reassess the implementation of these plans, along with the plans on operational capacity noted above, and will issue recommendations, including on updating the arrears management framework as needed, by **end-November** (**new SB**).

- ***Monitoring progress toward restructuring targets:*** In April and May, BoC and the coops submitted first progress reports on restructuring performance against targets (e.g. NPLs, number of restructured loans, collection rates, re-defaults, and early arrears). Preliminary findings indicate that banks find it difficult to deal with the high inflow of NPLs, which leads to an increasing backlog of restructuring and recovery cases. The CBC supervisory units presented their assessment and recommendations for BoC to the CBC board at end-May, partially meeting their SB; they are expected to so do with a delay for the coops (**modified end-July SB**).

- ***Auditing past lending and restructuring decisions*:** Unduly favorable past treatment of former or current managers and major shareholders may have exacerbated losses for banks and consequently led to tighter credit conditions for other borrowers. Discussions focused on the need to conduct a special internal audit of such lending and restructuring decisions, which will be evaluated by the CBC by **end-January 2015** (**new SB**). Where applicable, banks will be required to take civil action to recover damages.

13. **Reforming the debt-restructuring legal framework is another key policy action needed to lower NPLs (MEFP ¶4)**. Even if banks succeed in having a well managed in-house system to deal with NPLs, progress with NPL resolution critically depends on putting in place an adequate insolvency and foreclosure framework with balanced incentives to promote voluntary debt renegotiations. The authorities have agreed to reform the existing framework but indicated that they needed additional time to finalize the overall strategy, given the complexity of the reform and the need to address specific domestic issues, such as the pervasive use of personal guarantees and title deeds and the need to design specific procedures for restructuring SMEs.[4] They will finalize the reform strategy, to be approved by the government by **end-July** (**new SB**), after having completed an impact assessment of debt restructuring options. In the meantime, to deter strategic behavior and facilitate collections, they will amend the foreclosure law by end-June to facilitate private auctions without government interference. However, to address social concerns, the new foreclosure legislation for primary residences will enter into effect at end-2014, together with the adoption (rather than submission) of the new insolvency framework (**end-December modified SBs**).

14. **While domestic payment flows have been fully liberalized, external controls remain in place to preserve financial stability (MEFP ¶5, 6)**. Discussions focused on the last step of

[4] Also see Country Report No. 13/374 and 14/92 including a discussion of the debt restructuring strategy, cross country experiences with debt restructuring and an assessment of the current legal framework in Cyprus.

relaxations of domestic restrictions related to opening of new accounts, which the authorities subsequently completed at end May. was agreed that further progress under the program and with respect to banks' restructuring and funding plans will be needed before considering removing restrictions on external capital account transactions. In the meantime, monitoring of the effectiveness of external restrictions will need to be enhanced.

15. **Staff continued to call for adequate provision of liquidity by the Eurosystem**. The liquidity situation remains challenging, especially for Bank of Cyprus, given its large ELA exposure (amounting to close to 60 percent of GDP) and limited collateral buffers. In this context, staff reiterated its call for a relaxation of collateral rules to facilitate longer-term ECB refinancing rather than short-term provision of ELA. The authorities indicated that approved but unused government guarantees would remain available for BoC to obtain additional liquidity if necessary to safeguard financial stability.

16. **Bank supervision and regulation are being strengthened ahead of entry into effect of the SSM (MEFP ¶7)**. The CBC has taken steps to increase its supervisory resources, and enhanced supervisory monitoring of banks and coops. Discussions focused on three areas:

- ***Capital requirements*:** To achieve consistency with pan-European requirements and the capital benchmark of the comprehensive assessment, it was agreed to set the regulatory minimum of CET1 capital at 8 percent (the average CET1 ratio for the core domestic sector stands close to 11 percent). However, as risks remain, a higher capital ratio would be desirable. In this context, staff called on the CBC to request banks to maintain conservative capital buffers and, to the extent possible, proactively strengthen their capital bases—given currently favorable market conditions—in anticipation of the completion of the comprehensive assessment later this year. The program buffer (10 percent of GDP) provides a cushion against shortfalls if any were to be identified at the completion of the comprehensive assessment later this year.

- ***Bank resolution*:** Staff stressed the importance of finalizing the resolution process for Laiki, which has taken more than a year. While the authorities have initiated the process of selecting a firm to manage the asset disposal and voting rights in BoC, interest has been limited. An advisor is expected to be appointed for the disposal process by end-June, which would achieve partly and with delay the SB requirement in this area. The timeframe related to entrusting the voting rights in BoC was extended to **end-September**, to allow for concluding negotiations on this matter with the EBRD (**modified SB**). Separately, the authorities submitted to parliament the amendments of the resolution law to ensure the independence of the Resolution Authority.

- ***Credit register*:** Work on operationalizing a country-wide credit register is ongoing and expected to be completed by end-September. The availability of more comprehensive information on borrowers will allow banks to make better informed lending decisions. It will also help to improve banking supervision by facilitating the monitoring of credit quality (i.e. loan origination practices and credit risk).

17. **The authorities are strengthening the implementation of the AML/CFT framework** (**MEFP ¶8**). This is expected to further bolster the credibility of the financial sector and foster sustainable growth of the business service sector. Discussions focused on three key areas:

- ***Supervision of financial institutions*****:** The CBC has resumed the inspections of banks to ensure that the AML/CFT legal framework is adequately implemented. One bank has already been inspected, and the CBC plans to complete an additional ten inspections by end-year. The risk-based supervisory tools now being tested should improve the effectiveness of supervision once they are rolled out. As regards the CBC's follow up on the findings of Deloitte's audit, three letters requesting corrective actions have been issued. While no sanctions have been applied yet, the CBC is considering the adoption of appropriate supervisory measures.

- ***Supervision of professions*****:** To reduce risks of misuse of some professions (i.e., lawyers, accountants, and administrative services providers), including in the context of company formation and management, supervisors are making progress with developing risk-based tools to improve monitoring of these professions in line with the overall AML/CFT framework.

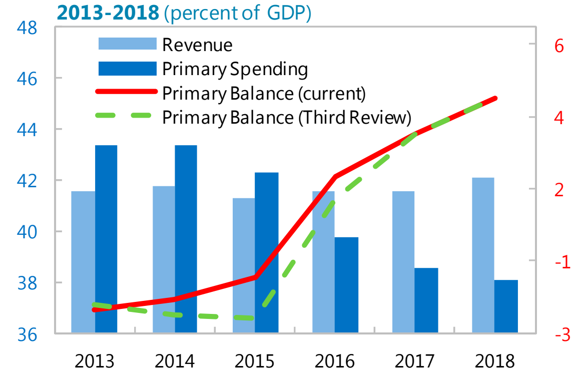
- ***Company transparency*****:** The Council of Ministers recently adopted an action plan to address recommendations of a third-party assessment of the Registrar of Companies and remedy weaknesses identified by the Global Forum Report related to corporate transparency and exchange of information for tax purposes. As part of the plan, the authorities will amend legislation to streamline procedures for company registration and de-registration, strengthen enforcement powers of the Registrar, and update corporate information to allow competent authorities timely access to accurate and current beneficial ownership information.

B. Fiscal Policy: Maintaining Sustainability

18. **The 2014 primary deficit target was tightened to 1.6 percent of GDP (MEFP ¶9)**. The 0.4 percent of GDP revision largely reflects the impact of higher growth. In nominal terms, the primary balance will improve modestly, as higher nominal tax revenues are expected to more than offset a small increase in nominal spending (about 0.2 percent of GDP on a cash basis) due to the restructuring of about 1.5 percent of GDP of called government guarantees that will be repaid over several years. Staff and the authorities agreed that continued prudent budget execution is warranted, in light of risks associated with the large stock of government guarantees and potential additional costs related to the upcoming implementation of the welfare reform (¶19, 21). Should macroeconomic conditions deteriorate beyond expectations, staff called for allowing automatic stabilizers to operate.

19. **Over the medium term, the primary balance is projected to strengthen gradually toward the target of 4 percent of GDP in 2018**. The medium-term primary balance targets were revised to include

Revenue, Primary Spending, and Primary Balance, 2013-2018 (percent of GDP)



Sources: Eurostat; and IMF staff projections.

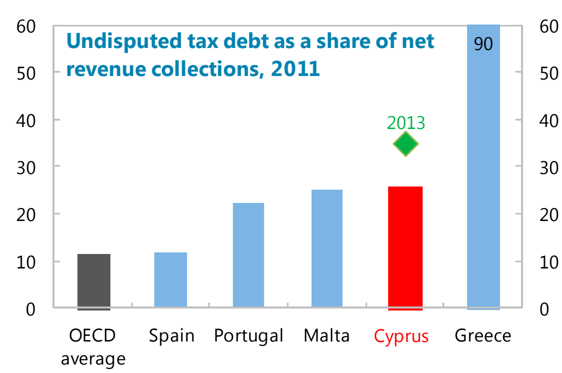
CBC dividends of about 0.6 percent of GDP per year in 2015–16, expected to be distributed in line with Eurosystem Treaties and the Statute. At the same time, the fiscal adjustment path was modified to better balance the need to reach the long-run primary surplus target required to put public debt on a firmly downward path with the objective to minimize the negative fiscal impulse during the initial stages of the recovery. The primary balance is expected to turn positive in 2016, reflecting, in part, the pickup in growth. The authorities set medium-term budget ceilings consistent with the revised path, which have been included in their fiscal strategy statement. It was agreed that the implementation details of the revised path will be finalized in the context of the 2015 budget.

C. Fiscal Structural Reforms: Strengthening Institutions

20. **The authorities remain committed to implementing the reform of the social safety net in July (MEFP ¶10)**. In line with practice in other EU countries, the reform introduces a guaranteed minimum income scheme (GMI) covering all vulnerable groups, which is expected to increase coverage and reduce poverty, while maintaining budget neutrality (Box 3). Financing included in the 2014 budget is expected to be sufficient to cover reform costs in the second half of the year (about 0.2 percent of GDP). The authorities expect to achieve with a delay the SB requirement for government approval of the budget-neutral reform, once the social dialogue is completed in mid-June. Passage of the new law and the start of the reform implementation are expected shortly thereafter (**end-June existing SB**). However, to prepare for potential additional costs, should applications exceed expectations, and ensure that the reform remains consistent with medium-term fiscal targets, staff called for identifying additional non-GMI benefits that could be further streamlined and preparing other contingency measures. Staff also urged setting up a monitoring unit to assess GMI outcomes (i.e. number of applications and costs, targeting accuracy, coverage, impact on poverty) to allow refining reform parameters as needed.

21. **They are also taking steps to strengthen tax collections and reform the revenue administration (MEFP ¶10):**

- ***Short-term measures to increase collections*:** To help recover the large and growing tax debt and tackle the tax evasion associated with Cyprus's large informal economy (26 percent of GDP compared to 18 percent for EU27), the authorities committed to adopt as a **prior action** for this review the legislative amendments submitted to parliament prior to the completion of the third review. These amendments will establish self-assessment and increase the collection enforcement powers of the tax authority by allowing it to go after debtors' assets. Separately, the authorities have started joint audits of large and high-risk taxpayers, with four audits already completed and another six planned by end-June (MEFP Table 2).

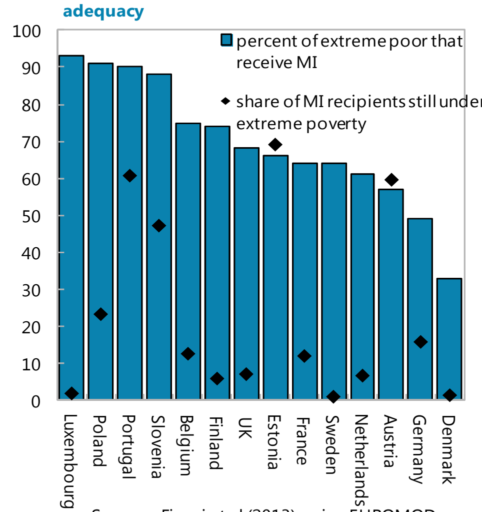


Source: OECD 2013 Tax Admnistration comparative series.
Note: Data for Cyprus from Inland Revenue Department and VAT Services. Data for Greece refers to 2010.

Box 3. Cyprus's Social Welfare Reform

Guaranteed minimum income (GMI) schemes play an important role in addressing poverty in Europe. Twenty-four EU countries have put in place such schemes. While the design features differ across countries, all are means-tested and guarantee a minimum standard of living. For 14 select EU countries, such schemes cover, on average, around 70 percent of the 'extremely poor' (individuals below the poverty line of 40 percent of median disposable income), with Luxembourg, Poland and Portugal achieving 90 percent or more coverage.[1] Still, even with good coverage, some countries do not manage to fully eradicate extreme poverty (i.e Portugal, Estonia, Austria), likely on account of the level of benefits. On the other hand, Luxembourg, Sweden, and Denmark stand out by having eliminated extreme poverty through inclusive and generous welfare systems.

Minimum Income (MI) Schemes - coverage and adequacy



Sources: Figari et al (2013) using EUROMOD

The Cypriot authorities have embarked on a welfare reform aimed at increasing coverage and reducing poverty. The design parameters—including the level of the basic needs and eligibility criteria—were determined on the basis of a household survey and poverty impact assessment, while being mindful of the need to remain within existing budget constraints, given limited fiscal space. The reform is expected to improve targeting and broaden coverage by 20 percent relative to the current public assistance scheme (status quo) by allowing access to minimum income for the working poor and the young unemployed, which were previously excluded. As a result, relative poverty (defined relative to 60 percent of median income) is expected to decline by 17 percent. Absolute poverty (based on the value of the minimum consumption basket) could be reduced by as much as 70 percent following the reform.

	Status quo	GMI
Number of beneficiaries	71,130	84,659
Total spending (millions of euro)	212	285
Change in spending (from status quo,millions of euro)		73
Poverty gap reduction (from status quo)		17%
Absolute poverty reduction (from status quo)		71%

Source: Ministry of Labor and Social Insurance.

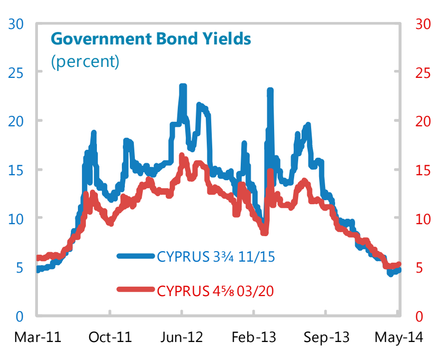
The GMI will be financed in a budget-neutral manner. On an annual basis, the GMI scheme is estimated to cost an additional 0.5 percent of GDP due to the expanded coverage. This will be covered by streamlining and better targeting other non-GMI benefits (i.e. family benefits, education grants, housing and disability benefits, as well as other cash benefits). The integration of benefits under a single administrative framework is also expected to help to achieve efficiency gains and improve the scrutiny of applications to reduce abuse.

[1] Figari et al, 2013, "Are European social safety nets tight enough? Coverage and adequacy of Minimum Income schemes in 14 EU countries", *International Journal of Social Welfare* 22: pp. 3–14.

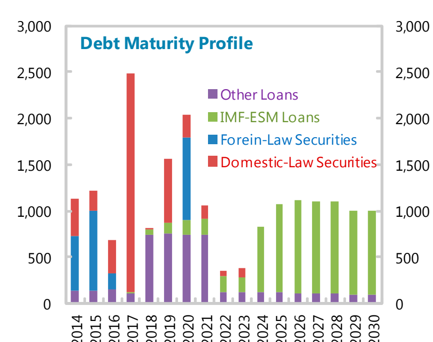
- ***Long-term revenue administration reform*:** In early May, the authorities submitted to parliament the enabling law consolidating the existing two tax authorities, meeting with a slight delay the related SB requirement. The law was adopted in early June. As a next step, a management team will need to be appointed to lead the new transitional structure. Staff stressed the importance of a transparent recruitment process and the need to ensure impartial and independent leadership. The operational integration will start with the implementation of an integrated unit for large taxpayers (**end-December 2014 existing SB**). To minimize disruptions to revenue collections during the transition, staff called for addressing promptly data reconciliation issues and intensifying monitoring of monthly performance indicators (i.e. registration, filing, payment, auditing, and debt collection).

22. **Budget and fiscal risk management needs to be further strengthened (MEFP ¶12)**. Following the adoption of the fiscal responsibility and budget system law (FRBSL) earlier this year, the authorities are now focusing on its implementation, with priority on medium-term budget formulation ahead of preparations for next year's budget. They also plan to finalize and update a database of government guarantees (see ¶9) and an associated risk assessment report. Discussions focused on the need to improve the management of such guarantees, including by clarifying ministerial responsibilities and developing common procedures for their issuance and monitoring as well as for managing the restructuring and recovery process.

23. **A medium-term debt strategy is needed to pave the way for a sustainable return to capital markets (MEFP ¶13)**. Significant maturities are coming due after the program period (37 percent of GDP in 2017–20, of which 14 percent of GDP in 2017 alone). Discussions focused on the need for a comprehensive approach to debt management, with a view to preparing to re-access markets on a sustainable basis in due time. The authorities committed to developing a strategy aiming at minimizing risks, including by diversifying the structure of the debt, improving the functioning of the domestic T-bill market, and strengthening the management of government guarantees (**end-October new SB**). In the meantime, they considered that there could be scope to probe markets early, given the marked decline in yields and generally favorable market conditions. Such an operation could help to partly address post-program refinancing concerns and be used to reduce the outstanding Laiki recapitalization bond now held by BoC, thus boosting the bank's liquidity. Staff stressed that any such operation would need to safeguard the overall objective of minimizing risks by securing adequate terms.



Source: Bloomberg.



24. **The authorities are taking steps to prepare state-owned enterprises for privatization (MEFP ¶14)**. There was agreement that privatization remains critical not only to reduce public debt (by about 8 percent of GDP by 2018), but also to increase economic efficiency. Discussions focused on the next steps. The head of the new privatization unit has been appointed, and the unit is expected to be fully operational by end-June. Efforts are focused on preparing for privatization the commercial activities of the ports authority (CPA) and the state-owned telecom (Cyta), which are expected to be privatized during the program period. To this end, the authorities plan to update the port regulatory framework and to pass legislation to convert Cyta into a limited liability company by end-year. In the meantime, Cyta embarked on a restructuring process and agreements were recently reached to reduce staff by ¼ through a voluntary retirement scheme.

PROGRAM MODALITIES AND FINANCING

25. **All of the program's end-March and continuous quantitative performance criteria (PCs) have been met, but compliance with structural conditionality has been mixed**. Out of seven SBs for this review, two were met, the requirements of three were achieved one partially and two with a delay, and requirements for another two SBs are expected to be achieved in full or in part in June (Table 13). In this context, one prior action for completion of this review and new conditionality for upcoming reviews have been established (MEFP Table 1):

- ***Prior action*:** The authorities will adopt legislation to fight non-compliance and tax evasion (submission of legislation was a prior action for the third review).

- ***Quantitative PCs*:** Modifications of three end-June PCs are proposed: (i) the floor on the primary balance will be raised given the over-performance through March and the improved growth outlook for 2014; (ii) the ceiling on primary expenditure will be raised to reflect the restructuring of called government guarantees (expected cash payments of about 0.3 percent of GDP have been booked under other capital transfers); and (iii) the ceiling on government debt will be increased to account for the effect of the called guarantees to entities outside the general government (about 0.5 percent of GDP) and accommodate a slight delay of the asset swap with the CBC to the third quarter. End-September PCs are being established.

- ***Structural benchmarks*:** Seven new or modified SBs are proposed (MEFP, Table 3): (i) government approval of the debt-restructuring reform strategy (new SB, end-July); (ii) CBC assessment of coops' performance against operational and financial targets (modified SB, end-July); (iii) appointment of a third party to manage Laiki's voting rights in BoC (modified SB, end-September); (iv) government approval of a debt management strategy (new SB, end-October 2014); (v) CBC assessment of banks' and coops' implementation of action plans to address arrears management deficiencies (new SB, end-November 2014); (vi) adoption of legislation to modernize personal and corporate insolvency procedures and regulate insolvency practitioners (modified SB, end-December 2014); and (vii) CBC assessment of preferential bank lending practices (new SB, end-January 2015).

26. **Risks to program implementation remain significant, but there are mitigating factors:**

- ***Risks:*** The large and still vulnerable banking sector continues to pose a large implicit liability on the sovereign and remains intrinsically linked with the economy. Inability to make progress with reducing NPLs—including due to opposition to the foreclosure and insolvency reforms from vested interests—could reignite negative bank-sovereign-real sector feedback loops. Uncertainty regarding the implications of the comprehensive assessment for bank capital needs may dent confidence. Shocks to confidence could also lead to a renewal of liquidity pressures. Finally, reform fatigue could compromise the authorities' ambitious structural reform agenda.

- ***Mitigating factors:*** The program's enhanced bank supervisory measures and the authorities' decision to accelerate the passage of the new insolvency framework are expected to help with facilitating the workout of NPLs. Recent successful capital-raising initiatives by other European banks and indications of investor interest in the Cypriot banking system (already evidenced by the early investment in Hellenic Bank last year) may help to boost bank capital buffers; the sizeable program buffer also provides a cushion. Stabilizing deposit trends, continued prudence with respect to capital controls, and the availability of government guarantees help to guard financial stability. The authorities have stepped up efforts to overcome delays and increased and reorganized resources, which, together with their public commitment to structural reforms and renewed support following the European parliamentary elections, provide reassurance about program implementation going forward.

27. **Financing assurances for the program remain in place**. The program is expected to be fully financed over the next 12 months. Available government deposits of about €1.3 billion in early May (including €0.2 billion of CBC profits transferred to the government), expected proceeds of €0.1 billion from the transfer of the coinage function from the CBC to the Treasury in June, and planned cash disbursements from the ESM/IMF of €2.3 billion more than cover projected financing needs of €2.6 billion over the next year. Adequate financing for the remainder of the program remains in place. This includes remaining ESM/IMF disbursements, the expected transfer of €0.2 billion central bank dividends in 2015–16, and expected privatization proceeds. Moreover, the program buffer (about 10 percent of GDP) could help provide a cushion against contingent risks, such as those related to government guarantees or potential additional capital needs in the banking sector.

28. **Capacity to repay the Fund remains adequate** (Table 7). The medium-term macroeconomic and debt outlook are slightly better than at the time of the third review. Peak exposure to the Fund occurs in 2016 at 563 percent of quota or 6 percent of GDP. Debt service to the Fund, assessed relative to GDP and exports, remains manageable. Still, risks remain, given large post-program financing needs and still high macroeconomic uncertainty. External and public debt sustainability and the capacity to repay the Fund are dependent on the recovery taking hold next year, a continued external and fiscal adjustment, and full and timely program implementation.

STAFF APPRAISAL

29. **In its first year of implementation, the program has made notable progress toward its objectives**. Growth has been better than projected under the program's macroeconomic framework. The authorities have made substantial progress in resolving problems in the banking sector by taking upfront decisions to address the root of the problems. Fiscal targets have been consistently met, and important fiscal structural reforms have been set in motion.

30. **Still, important challenges remain**. Economic conditions continue to be difficult. The recession is expected to continue this year, to be followed by a very modest and gradual recovery. Implementation of structural conditionality is also becoming more challenging, as efforts are shifting from crisis management to restructuring and from reform legislation to implementation and follow up.

31. **The stabilization of the financial sector is a major achievement**. Domestic banks and coops have been recapitalized. The coop sector was significantly consolidated. All financial institutions made progress in setting up restructuring units, cutting costs, and deleveraging operations abroad. Importantly, one year after the crisis, the authorities have fully normalized payment flows within the country.

32. **NPLs, however, remain very high, requiring resolute policy action**. Reducing NPLs is essential to facilitate the provision of credit that is needed to support employment and growth. Implementation as soon as possible of the insolvency and foreclosure reform is needed to give incentives to borrowers and lenders to restructure NPLs. The authorities also need to intensify the supervisory monitoring of banks' effective action to collect and restructure debt.

33. **External controls are still needed to safeguard financial stability**. Bank liquidity and funding conditions have not fully normalized. In this context, restrictions on the capital account need to be maintained until further progress is made under the program and with respect to banks' restructuring and funding plans. Careful monitoring of the effectiveness of the restrictions and adequate provision of liquidity by the Eurosystem remain key.

34. **Financial supervision and regulation need to be further strengthened, as does the implementation of the AML/CFT framework**. Ahead of the completion of the pan-European comprehensive assessment, the supervisory authorities need to ensure that banks maintain conservative capital buffers and, if possible, strengthen their capital base. Governance arrangements for legacy Laiki should be completed to facilitate its orderly wind-down. The authorities will need to further enhance the AML supervision of banks and professions and company transparency.

35. **The authorities met fiscal targets with comfortable margins**. Implementation of ambitious fiscal measures and additional discretionary tightening allowed for a larger-than expected reduction in the budget deficit, despite the sharp output contraction. The authorities have locked in the permanent savings achieved so far.

36. **Looking forward, fiscal policy needs to remain prudent**. Careful budget execution is called for, given still high uncertainty. Automatic stabilizers should be allowed to operate if downside risks materialize. Over the medium term, the authorities need to target a smooth fiscal adjustment balancing the long-run need to reduce public debt with short-run cyclical considerations.

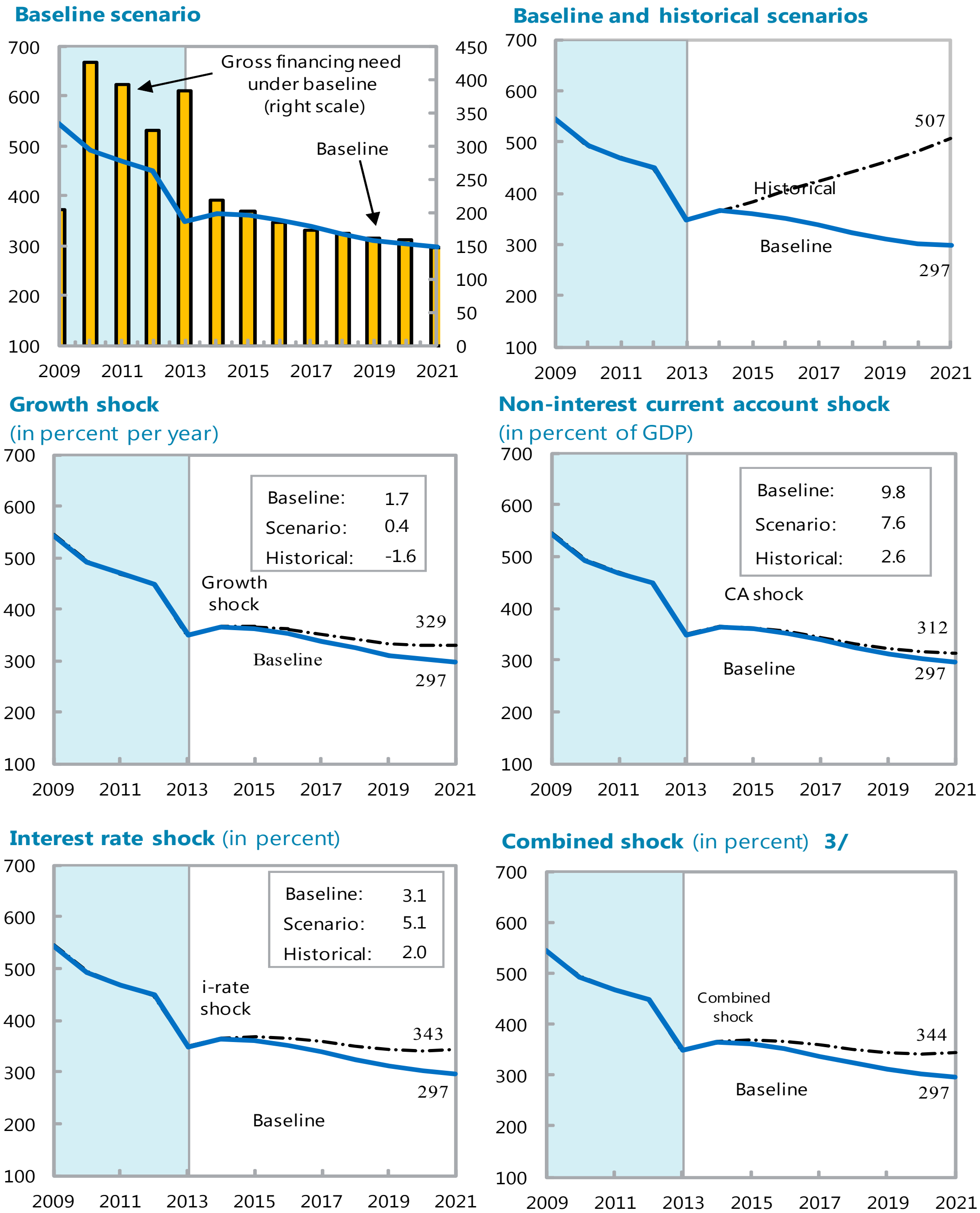
37. **As the program enters its second year, greater emphasis is needed on structural reforms**. To ensure adequate protection of vulnerable groups during the downturn, the authorities need to implement the reform of the social safety net without delay, while safeguarding fiscal targets. Further progress is required to fight tax evasion, reform the revenue administration, improve budget processes, and strengthen the management of fiscal risks. A debt management strategy and privatization of state assets will help ensure a sustainable exit from official financing in due course.

38. **Given still significant risks, full and timely policy implementation remains essential to the program's success.** Strong links between the banking sector and the macro-economy highlight the criticality of measures to deal with NPLs and protect financial stability. And the still high and vulnerable public debt points to the importance of continued fiscal prudence and complementary fiscal structural reforms. The authorities will need to maintain the reform momentum and overcome resistance and fatigue to implement identified policies to pave the way for sustainable growth and an eventual exit from official financing.

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

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

(Percent of GDP)



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

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

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

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

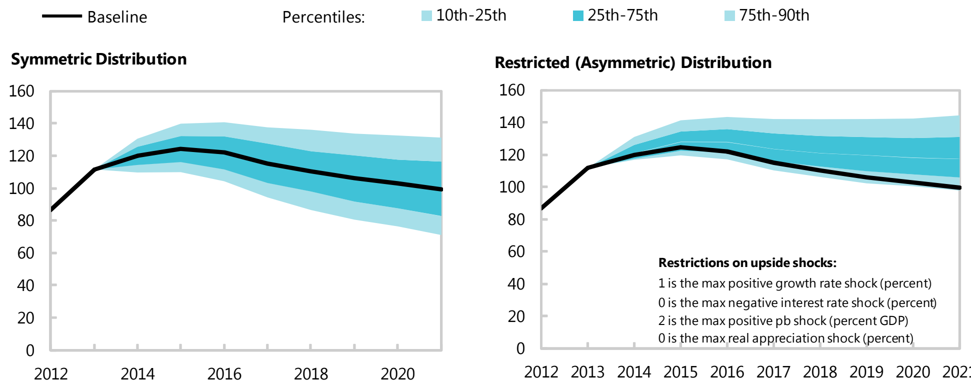
Figure 7. Cyprus: Public Debt Sustainability Analysis - Risk Assessment */

Heat Map

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

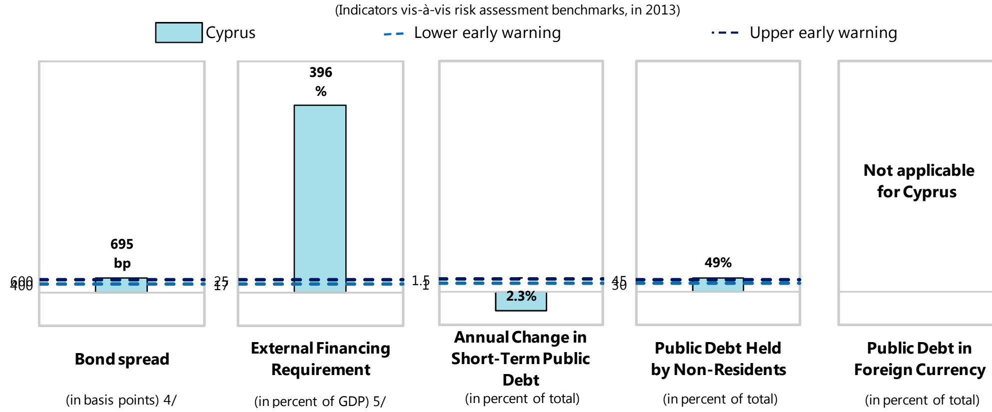
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

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

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. The baseline debt path and the analysis based on it assume the full utilization of program buffers.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. Gross financing needs have been reduced below the 20% threshold in the baseline scenario leading to an improved risk assessment with respect to the Third Review. This reflects a reduction in expected ESM interest costs and a planned repayment of 2014 interest (previously assumed as capitalized) on the Laiki recapitalization bond as well as a small principal repayment of the bond.

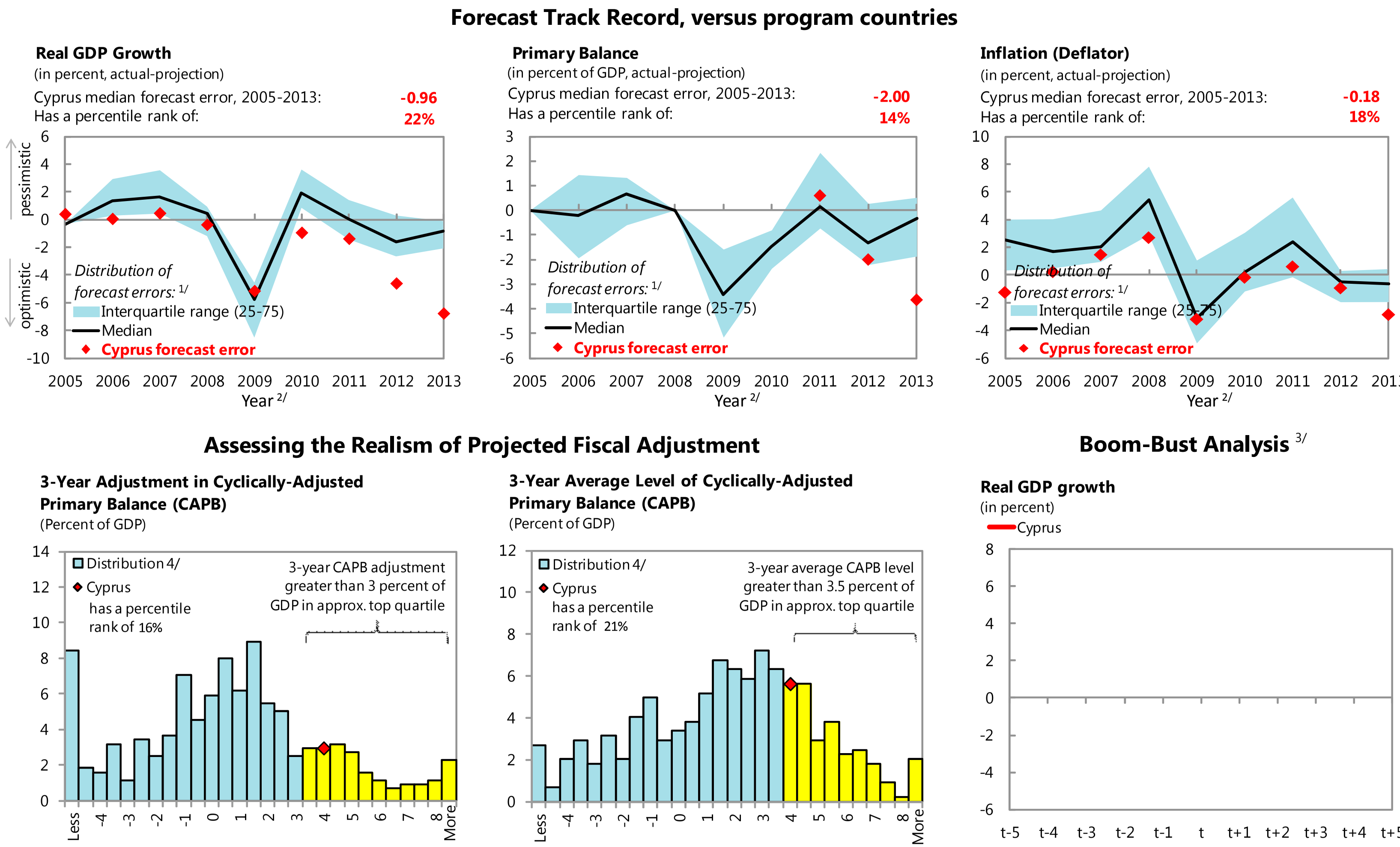
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 04-Mar-14 through 02-Jun-14.

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

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



Source : IMF Staff.

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

2/ Projections made in the spring WEO vintage of the preceding year. The 2012 spring WEO forecast did not factor in extreme tail risks which materialized in March 2013.

3/ Not applicable for Cyprus.

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

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

(In percent of GDP unless otherwise indicated)

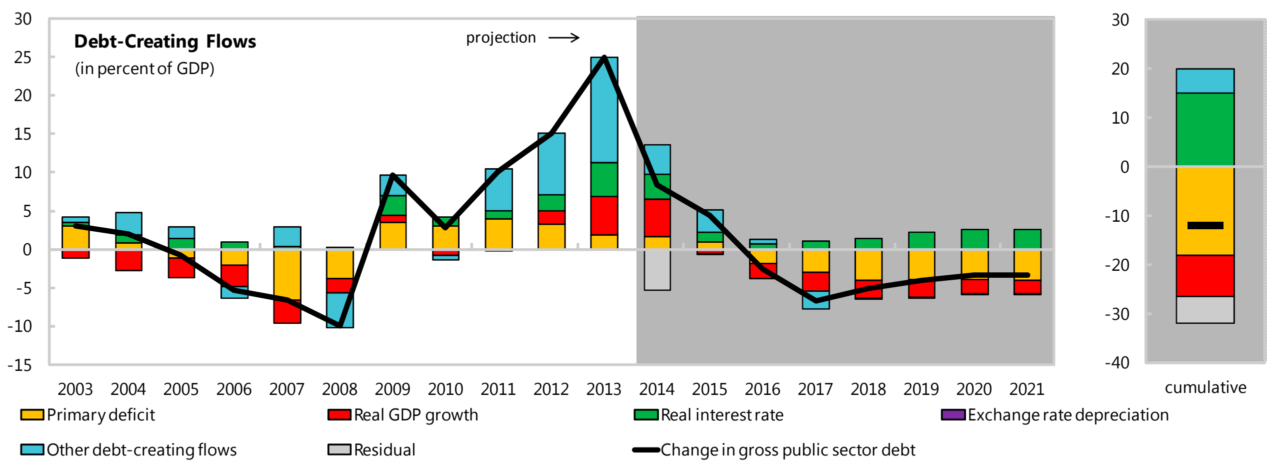
Debt, Economic and Market Indicators [1/]

	Actual			Projections							
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	64.0	86.6	111.5	119.9	124.4	121.9	115.2	110.2	106.1	102.8	99.5
Public gross financing needs	14.0	18.9	19.2	17.0	16.0	9.7	19.2	8.5	12.6	14.9	9.4
Real GDP growth (in percent)	2.5	-2.4	-5.4	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation (GDP deflator, in percent)	3.1	1.6	-1.5	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Nominal GDP growth (in percent)	5.7	-0.9	-6.9	-4.0	1.8	3.4	4.2	4.4	4.2	3.9	3.9
Effective interest rate (in percent) [4/]	5.0	4.4	3.3	3.0	2.4	2.4	3.1	3.5	4.1	4.6	4.7

As of June 02, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		363
5Y CDS (bp)		381
Ratings	Foreign	Local
Moody's	Caa3	Caa3
S&Ps	B	B
Fitch	B-	B-

Contribution to Changes in Public Debt

	Actual			Projections									
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.5	15.1	24.9	8.4	4.5	-2.5	-6.7	-5.0	-4.1	-3.3	-3.3	-5.4	
Identified debt-creating flows	0.5	15.1	24.9	13.6	4.6	-2.5	-6.7	-5.0	-4.1	-3.3	-3.3	0.0	
Primary deficit	0.1	3.2	1.9	1.6	1.0	-1.8	-3.0	-4.0	-4.0	-4.0	-4.0	-10.2	0.7
Primary (noninterest) revenue and gra	41.0	39.4	41.5	41.7	41.3	41.6	41.5	42.1	42.2	42.3	42.4	250.4	
Primary (noninterest) expenditure	41.1	42.6	43.4	43.3	42.3	39.8	38.5	38.1	38.2	38.3	38.4	240.2	
Automatic debt dynamics [5/]	-0.5	3.8	9.4	8.2	0.7	-1.2	-1.3	-1.0	-0.1	0.7	0.7	5.3	
Interest rate/growth differential [6/]	-0.5	3.8	9.4	8.2	0.7	-1.2	-1.3	-1.0	-0.1	0.7	0.7	5.3	
Of which: real interest rate	1.0	2.1	4.4	3.3	1.2	0.8	1.1	1.4	2.2	2.5	2.5	10.0	
Of which: real GDP growth	-1.6	1.7	5.0	4.9	-0.5	-2.0	-2.4	-2.4	-2.3	-1.8	-1.8	-4.7	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.0	8.1	13.6	3.8	2.9	0.5	-2.4	-0.1	0.0	0.0	0.0	4.9	
Net privatization/asset sales proceed	0.0	0.0	0.0	-0.6	-3.1	-3.0	-2.3	0.0	0.0	0.0	0.0	-9.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	1.0	8.1	13.6	4.5	6.0	3.5	-0.1	-0.1	0.0	0.0	0.0	13.9	
Residual, including asset changes [8/]	0.0	0.0	0.0	-5.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-5.4	



Source: IMF staff estimates.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

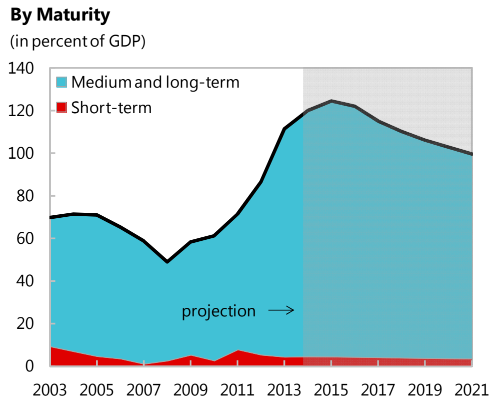
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

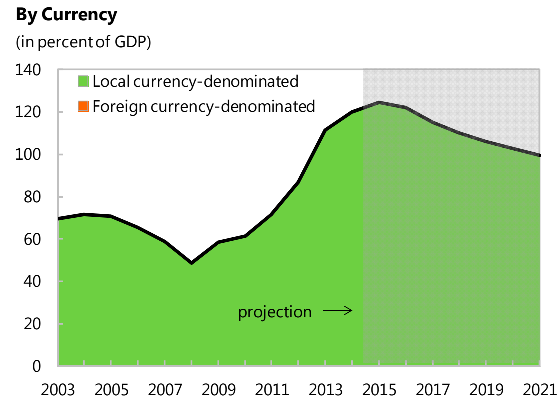
8/ For projections, includes exchange rate changes during the projection period. In 2014, the residual is the Euro 1 billion asset swap.

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

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

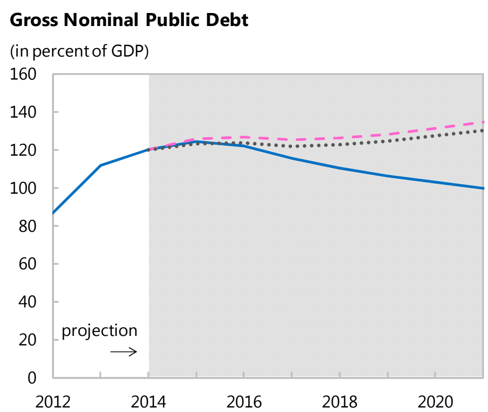
Composition of Public Debt

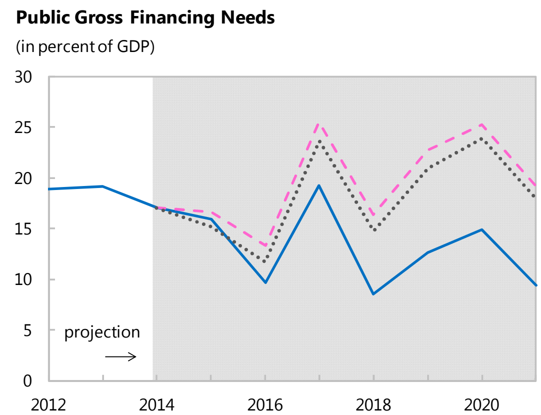




Alternative Scenarios

Baseline   Historical   Constant Primary Balance





Underlying Assumptions

(Percent)

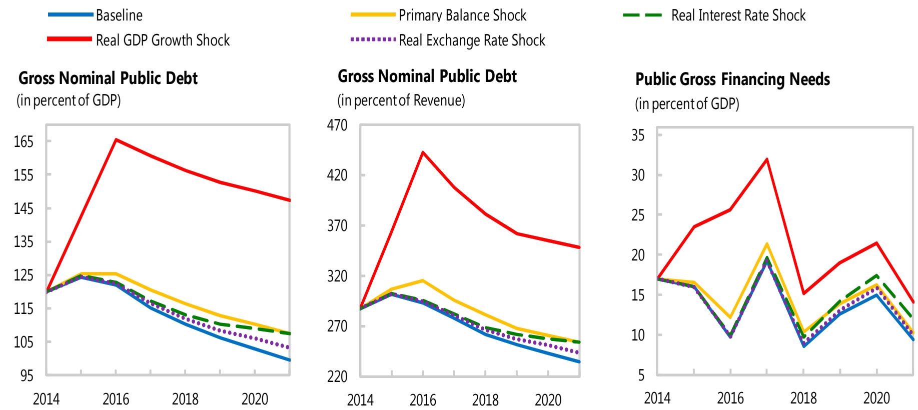
Baseline Scenario	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary Balance	-1.6	-1.0	1.8	3.0	4.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.4	3.1	3.5	4.1	4.6	4.7
Constant Primary Balance Scenario								
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary Balance	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6
Effective interest rate	3.0	2.4	2.5	3.1	3.5	4.1	4.6	4.7

Historical Scenario	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth	-4.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary Balance	-1.6	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	3.0	2.4	2.5	3.2	3.7	4.3	4.8	5.0

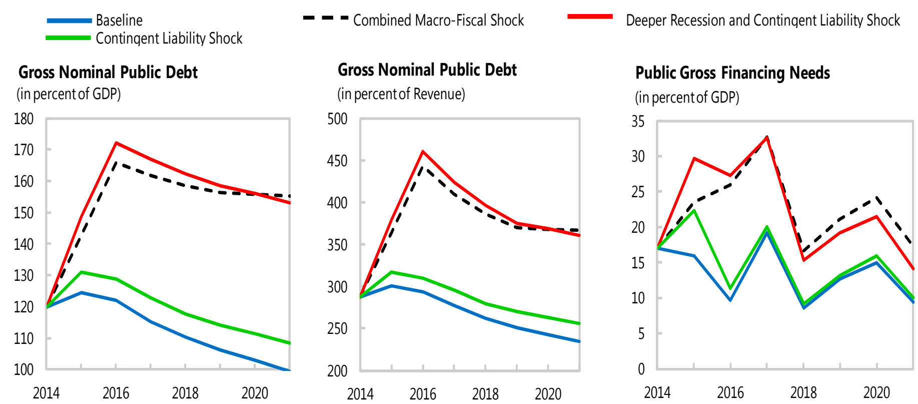
Source: IMF staff estimates.
1/ Inflation in the tables refer to GDP deflator growth.

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

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(Percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-1.5	-0.4	2.0	3.2	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.5	3.1	3.5	4.1	4.5	4.6
Real Interest Rate Shock								
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-1.0	1.8	3.0	4.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.6	3.3	4.1	4.8	5.6	6.0
Combined Shock								
Real GDP growth	-4.2	-6.6	-5.4	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	-0.4	0.0	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-7.1	-10.2	0.7	2.8	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.6	3.2	4.1	4.7	5.5	5.9
Contingent Liability Shock								
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.3	1.7	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-7.3	1.8	3.0	4.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.4	3.0	3.4	3.9	4.4	4.4

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth	-4.2	-6.6	-5.4	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	-0.4	0.0	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-7.1	-10.2	0.9	3.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.4	2.9	3.4	3.9	4.3	4.4
Real Exchange Rate Shock								
Real GDP growth	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	1.6	1.7	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-1.0	1.8	3.0	4.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.4	3.1	3.5	4.1	4.5	4.6
Deeper Recession and Contingent Liability Shock								
Real GDP growth	-4.2	-6.6	-5.4	2.0	2.2	2.1	1.8	1.8
Inflation	0.2	-0.4	0.0	2.1	2.2	2.0	2.1	2.1
Primary balance	-1.6	-13.3	-10.2	0.9	3.0	4.0	4.0	4.0
Effective interest rate	3.0	2.4	2.3	2.8	3.3	3.8	4.2	4.2

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	-5.4	-4.2	0.4	1.6	2.0	2.2	2.1	1.8
Domestic demand	8.0	-7.0	1.9	-1.5	-3.8	-10.1	-6.1	-0.5	0.9	1.7	2.2	2.1	1.7
Consumption	7.4	-4.6	1.4	1.0	-2.4	-5.6	-4.5	-0.7	0.5	1.2	1.7	1.6	1.2
Private consumption	7.8	-7.5	1.5	1.3	-2.0	-5.7	-5.1	-0.2	1.5	1.7	2.0	1.7	1.2
Public consumption	6.1	6.8	1.0	-0.3	-3.8	-5.0	-2.7	-2.4	-3.2	-0.6	0.4	1.0	1.0
Fixed investment	6.0	-9.7	-4.9	-8.7	-18.3	-21.6	-17.0	1.3	3.9	5.8	5.9	5.8	5.6
Inventory accumulation 1/	0.9	-1.5	1.8	-0.7	1.3	-2.4	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	1.6	5.0	1.9	0.9	0.8	0.4	0.1	0.1	0.2
Exports of goods and services	-0.5	-10.7	3.8	4.4	-2.5	-4.2	-2.7	1.9	2.9	3.6	3.6	3.6	3.6
Imports of goods and services	8.5	-18.6	4.8	-0.2	-5.4	-14.1	-6.9	-0.1	1.3	3.1	3.9	3.8	3.7
Potential GDP growth	2.4	1.7	1.6	1.7	-1.5	-5.4	-4.1	-0.2	0.6	1.1	1.6	1.9	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.3	-3.4	-2.8	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	0.4	0.2	1.1	1.7	1.9	2.0	1.9	1.9
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	-1.3	0.2	1.1	1.7	1.9	2.0	1.9	1.9
Unemployment rate EU stand. (percent)	3.6	5.4	6.3	7.9	11.9	15.9	18.6	18.0	16.8	15.2	13.8	12.2	10.9
Employment growth (percent)	2.0	-0.4	-0.2	0.4	-4.2	-5.2	-4.0	0.4	1.5	2.3	2.1	2.1	1.7
Public Finance	(Percent of GDP)												
General government balance	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-5.1	-3.8	-1.1	-0.6	0.1	-0.4	-0.7
Revenue	43.1	40.1	40.9	39.9	39.4	41.5	41.7	41.3	41.6	41.5	42.1	42.2	42.3
Expenditure	42.1	46.2	46.2	46.3	45.8	46.4	46.9	45.1	42.6	42.1	42.0	42.6	43.0
Primary Fiscal Balance	3.8	-3.6	-3.0	-4.0	-3.2	-1.9	-1.6	-1.0	1.8	3.0	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.5	86.6	111.5	119.9	124.4	121.9	115.2	110.2	106.1	102.8
Balance of Payments	(Percent of GDP)												
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-0.1	0.2	0.6	0.4	-0.1	-0.3	-0.4
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.9	4.0	4.9	5.6	5.8	5.7	5.7	5.7
Exports of goods and services	45.0	40.2	41.3	42.9	42.9	43.9	45.0	45.7	46.1	46.6	47.0	47.5	48.0
Imports of goods and services	56.4	45.7	47.5	47.2	46.0	42.0	41.0	40.8	40.6	40.8	41.3	41.8	42.4
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.8	-15.7	-15.3	-15.0	-15.0	-15.2	-15.4	-15.6
Services balance	21.0	19.9	20.6	20.1	18.7	19.7	19.7	20.1	20.5	20.8	20.9	21.1	21.3
Income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.7	-3.1	-3.6	-3.9	-4.4	-4.8	-5.0	-5.1
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.4	4.8	-26.3	-14.8	-14.0	-4.3	-0.5	0.2	0.7	1.0
Direct investment	-5.2	13.2	0.4	0.7	6.8	1.0	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment	-74.2	-101.1	-11.1	32.2	30.1	71.1	3.2	-5.1	-1.5	-2.1	1.6	1.8	2.7
Other investment	93.8	98.2	19.0	-28.8	-32.4	-98.6	-18.5	-13.2	-7.4	-1.5	-4.4	-5.1	-5.6
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	0.0	0.0	29.3	14.7	13.5	3.5	0.0	-0.3	-0.6	-0.8
European Union	0.0	0.0	0.0	0.0	0.0	27.8	12.6	11.5	3.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	1.5	2.1	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	-2.7	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	8.3	8.6	9.0	9.6	10.3	10.6	10.7	11.0	11.5
Government	4.9	-0.6	-0.1	-1.8	-2.6	-1.9	-2.0	-0.7	2.0	2.5	3.2	2.7	2.3
Non-government	2.8	9.2	10.0	15.0	10.9	10.5	11.1	10.2	8.3	8.2	7.5	8.3	9.1
Gross capital formation	23.3	19.4	19.8	16.6	15.2	10.5	9.1	9.3	9.7	10.2	10.8	11.3	11.9
Government	5.0	5.1	5.0	5.0	5.3	6.1	5.0	4.9	4.5	4.1	4.0	4.2	4.3
Private	18.3	14.3	14.8	11.6	9.9	4.4	4.1	4.5	5.2	6.1	6.8	7.1	7.6
Foreign saving	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-0.1	0.2	0.6	0.4	-0.1	-0.3	-0.4
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	17.9	17.7	16.5	15.8	16.1	16.7	17.4	18.1	18.9	19.6

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

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

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
							Projections						
Revenue	43.1	40.1	40.9	39.9	39.4	41.5	41.7	41.3	41.6	41.5	42.1	42.2	42.3
Current revenue	43.0	40.0	40.8	39.9	39.3	41.5	41.7	41.3	41.6	41.5	42.1	42.2	42.3
Tax revenue	30.6	26.4	26.5	26.4	25.9	26.2	26.3	26.4	26.6	26.8	27.0	27.0	27.0
Indirect taxes	17.7	15.2	15.4	14.6	14.9	14.5	14.9	15.1	15.2	15.3	15.5	15.4	15.4
Direct taxes	12.9	11.2	11.1	11.7	11.1	11.6	11.4	11.3	11.4	11.5	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	8.5	9.0	9.4	9.4	9.3	9.4	9.5	9.6	9.6
Other current revenue	4.6	4.9	5.4	4.8	4.8	6.3	6.1	5.6	5.6	5.3	5.6	5.7	5.7
Sales	2.9	2.4	2.6	2.4	2.7	2.7	2.8	2.8	2.7	2.8	2.9	3.0	3.0
Other	1.8	2.5	2.8	2.3	2.2	3.6	3.3	2.8	2.9	2.5	2.7	2.7	2.7
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.1	46.2	46.2	46.3	45.8	46.4	46.9	45.1	42.6	42.1	42.0	42.6	43.0
Current expenditure	38.2	40.7	40.9	41.7	42.0	43.4	43.8	42.0	39.6	39.1	38.9	39.5	40.0
Wages and salaries	14.6	16.2	15.8	16.1	15.9	15.6	15.1	14.6	14.0	13.8	13.7	13.6	13.5
Goods and services	5.0	5.4	5.6	5.3	4.9	4.7	4.9	4.7	4.4	4.2	4.1	4.2	4.1
Social Transfers	12.2	13.5	14.4	14.7	14.7	15.7	17.1	16.8	15.6	15.1	14.9	15.0	15.1
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Interest payments 2/	2.8	2.6	2.2	2.4	3.2	3.0	3.5	2.8	2.9	3.6	3.9	4.3	4.7
Other current expenditure	3.1	2.9	2.5	2.8	2.7	3.8	2.6	2.5	2.1	1.7	1.7	1.9	2.0
Capital expenditure	4.0	5.5	5.2	4.5	3.8	2.9	3.1	3.1	3.1	3.1	3.1	3.0	3.1
Overall balance 3/	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-5.1	-3.8	-1.1	-0.6	0.1	-0.4	-0.7
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-5.1	-3.8	-1.1	-0.6	0.1	-0.4	-0.7
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-5.1	-3.8	-1.1	-0.6	0.1	-0.4	-0.7
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.7	13.6	-1.8	2.3	0.0	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.6	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares 4/	0.0	0.0	0.0	0.0	0.0	9.1	-9.5	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.1	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.5	0.4	13.9	2.3	0.0	-2.3	0.0	0.0	0.0
Other assets	0.2	0.3	0.0	-0.4	0.0	0.1	-6.3	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	18.5	3.3	6.1	1.1	-1.7	-0.1	0.4	0.7
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	1.8	-10.3	-5.0	-6.7	1.4	1.2	0.7	1.5	2.0
Loans	3.0	-0.3	0.0	4.0	12.7	28.8	8.3	12.8	-0.3	-2.9	-0.8	-1.2	-1.3
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance 5/	3.8	-3.6	-3.0	-4.0	-3.2	-1.9	-1.6	-1.0	1.8	3.0	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.5	86.6	111.5	119.9	124.4	121.9	115.2	110.2	106.1	102.8

Sources: Eurostat; and IMF staff estimates.

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

2/ In 2014 and from 2017 onwards, part of the interest bill previously capitalized is projected to be paid annually.

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

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

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

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

(Millions of euros)

	2013 May-December	2014	2015	2016	2017
Gross financing requirement including a buffer	**5,839.7**	**3,383.1**	**3,433.1**	**1,987.4**	**3,344.0**
Government	3,406.0	2,729.0	2,577.7	1,611.6	3,344.0
Fiscal deficit ("+" = financing need)	833.7	847.4	610.6	179.5	108.0
Debt maturities	2,572.3	1,881.6	1,967.1	1,432.2	3,236.0
Medium- and long-term	1,596.2	1,131.3	1,216.7	681.8	2,485.6
Domestic 1/	138.3	500.8	307.4	457.9	2,422.3
Foreign	1,457.9	630.5	909.4	223.9	63.3
Short-term	976.0	750.3	750.3	750.3	750.3
Domestic	976.0	750.3	750.3	750.3	750.3
Foreign	0.0	0.0	0.0	0.0	0.0
Banks recapitalization/support	1,500.0	0.0	0.0	0.0	0.0
Market financing	**776.2**	**950.3**	**750.3**	**904.2**	**2,944.0**
Government	776.2	950.3	750.3	904.2	2,944.0
Fiscal deficit	0.0	0.0	0.0	0.0	0.0
Debt maturities	776.2	950.3	750.3	904.2	2,944.0
Medium- and long-term	25.9	200.0	0.0	153.8	2,193.7
Short-term	750.3	750.3	750.3	750.3	750.3
Net financing requirement	**5,063.6**	**2,432.7**	**2,682.7**	**1,083.2**	**400.0**
Government	2,629.8	1,778.7	1,827.3	707.5	400.0
Fiscal deficit	833.7	847.4	610.6	179.5	108.0
Debt maturities	1,796.1	931.3	1,216.7	528.0	292.0
Medium- and long-term	1,570.4	931.3	1,216.7	528.0	292.0
Short-term	225.7	0.0	0.0	0.0	0.0
Official Financing Sources and Financial Buffers	**5,063.6**	**2,432.7**	**2,682.7**	**1,083.2**	**400.0**
Domestic Financing Sources	225.7	100.0	500.0	500.0	400.0
Official financing sources	4,837.8	2,332.7	2,182.7	583.2	0.0
IMF	252.8	332.7	332.7	83.2	0.0
ESM	4,585.0	2,000.0	1,850.0	500.0	0.0

Source: IMF staff estimates.

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

2/ Medium and long term financing in market financing in 2013 refers to EIB financing. In 2014, it includes EIB financing and the € 100 million issued in May 2014.

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	-310	-10	40	102	66	-12	-52	-73
Trade balance (Goods and Services)	-1,954	-929	-1,084	-763	-546	313	635	785	926	1,010	1,037	1,074	1,118
Goods balance	-5,556	-4,291	-4,665	-4,349	-3,856	-2,941	-2,486	-2,461	-2,494	-2,605	-2,757	-2,912	-3,073
Exports	1,190	1,002	1,137	1,411	1,440	1,501	1,548	1,625	1,710	1,800	1,895	1,994	2,098
Imports	-6,746	-5,293	-5,802	-5,760	-5,296	-4,442	-4,034	-4,087	-4,204	-4,405	-4,652	-4,906	-5,171
Services Balance	3,602	3,362	3,581	3,585	3,310	3,253	3,121	3,246	3,421	3,615	3,795	3,987	4,191
Exports	6,538	5,779	6,049	6,262	6,167	5,750	5,579	5,736	5,983	6,299	6,629	6,976	7,341
Imports	-2,936	-2,417	-2,468	-2,676	-2,857	-2,497	-2,458	-2,490	-2,562	-2,684	-2,834	-2,989	-3,150
Current income, net	-662	-685	-379	357	-456	-452	-489	-589	-657	-772	-875	-945	-996
Current transfers, net	-63	-193	-116	-196	-215	-171	-155	-157	-168	-172	-175	-181	-196
Private	23	-107	-56	-101	-155	-127	-180	-178	-183	-186	-196	-204	-212
Public	-86	-86	-60	-94	-60	-44	25	22	15	14	21	24	16
Capital account, net	6	50	36	46	23	244	27	27	27	27	27	27	27
Financial account, net	2,765	1,835	1,647	781	847	-4,333	-2,350	-2,250	-713	-86	40	135	205
Direct investment	-890	2,224	65	132	1,197	169	79	702	783	539	544	756	786
Portfolio investment	-12,722	-17,039	-1,934	5,753	5,340	11,734	505	-818	-255	-365	297	344	523
Other investment	16,085	16,558	3,313	-5,146	-5,748	-16,266	-2,934	-2,134	-1,241	-260	-801	-965	-1,104
Reserves (- inflow; + outflow)	291	93	200	43	57	30	0	0	0	0	0	0	0
Program financing	…	…	…	…	0	4,838	2,333	2,183	583	-7	-55	-111	-159
European Union	…	…	…	…	0	4,585	2,000	1,850	500	0	0	0	0
IMF	…	…	…	…	0	253	333	333	83	-7	-55	-111	-159
Errors and omissions	-92	-78	31	-225	346	-439	0	0	0	0	0	0	0
						(Percent of GDP)							
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-0.1	0.2	0.6	0.4	-0.1	-0.3	-0.4
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.9	4.0	4.9	5.6	5.8	5.7	5.7	5.7
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.8	-15.7	-15.3	-15.0	-15.0	-15.2	-15.4	-15.6
Exports	6.9	5.9	6.5	7.9	8.1	9.1	9.8	10.1	10.3	10.4	10.4	10.5	10.7
Imports	-39.3	-31.4	-33.3	-32.2	-29.9	-26.9	-25.5	-25.3	-25.2	-25.3	-25.6	-26.0	-26.3
Services balance	21.0	19.9	20.6	20.1	18.7	19.7	19.7	20.1	20.5	20.8	20.9	21.1	21.3
Exports	38.1	34.3	34.8	35.0	34.8	34.8	35.2	35.6	35.9	36.2	36.5	36.9	37.4
Imports	-17.1	-14.3	-14.2	-15.0	-16.1	-15.1	-15.5	-15.4	-15.4	-15.4	-15.6	-15.8	-16.0
Current income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.7	-3.1	-3.6	-3.9	-4.4	-4.8	-5.0	-5.1
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Private	0.1	-0.6	-0.3	-0.6	-0.9	-0.8	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.4	4.8	-26.3	-14.8	-14.0	-4.3	-0.5	0.2	0.7	1.0
Direct investment	-5.2	13.2	0.4	0.7	6.8	1.0	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.2	-101.1	-11.1	32.2	30.1	71.1	3.2	-5.1	-1.5	-2.1	1.6	1.8	2.7
Other investment 2/	93.8	98.2	19.0	-28.8	-32.4	-98.6	-18.5	-13.2	-7.4	-1.5	-4.4	-5.1	-5.6
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	…	…	…	…	0.0	29.3	14.7	13.5	3.5	0.0	-0.3	-0.6	-0.8
European Union	…	…	…	…	0.0	27.8	12.6	11.5	3.0	0.0	0.0	0.0	0.0
IMF	…	0.0	0.0	0.0	0.0	1.5	2.1	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	-2.7	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 transactions 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
					Projections				
GROSS FINANCING REQUIREMENTS	**60,086**	**61,881**	**34,862**	**32,595**	**30,551**	**29,416**	**29,734**	**29,388**	**29,477**
Current account deficit ("-" = CA surplus)	1,217	310	9	-40	-101	-65	18	61	88
Medium- and long-term debt amortization	5,800	12,589	3,515	3,375	3,132	2,917	3,638	3,749	4,541
Public sector	593	1,458	615	514	276	63	743	809	1,539
Banks	4,380	10,056	1,362	1,337	1,332	1,330	1,341	1,355	1,369
Other private	827	1,075	1,539	1,523	1,523	1,523	1,554	1,585	1,633
Short-term debt amortization	53,069	48,982	31,337	29,261	27,520	26,557	26,022	25,466	24,689
Public sector	8,290	7,494	7,363	6,807	5,918	4,998	4,071	3,051	1,661
Central Bank	7,992	7,494	7,363	6,807	5,918	4,998	4,071	3,051	1,661
General government and SOEs	298	0	0	0	0	0	0	0	0
Banks	43,727	40,414	21,891	20,474	19,622	19,580	19,774	20,020	20,273
Other private	1,053	1,075	2,083	1,979	1,979	1,979	2,177	2,395	2,754
EU and IMF	0	0	0	0	0	7	55	111	159
SOURCES OF FINANCING	**60,086**	**57,043**	**32,529**	**30,412**	**29,968**	**29,416**	**29,734**	**29,388**	**29,477**
Capital account (net)	23	244	27	27	27	27	27	27	27
Foreign direct investment (net)	1,197	169	79	702	783	539	544	756	786
CYP investment abroad	219	-232	-158	-161	-334	-521	-544	-567	-589
Foreign investment in CYP	979	402	238	863	1,117	1,061	1,089	1,323	1,375
New borrowing and debt rollover	54,254	35,782	32,177	30,356	29,677	29,133	29,314	28,731	29,579
Medium and long-term borrowing	5,271	4,444	2,916	2,836	3,120	3,111	3,848	4,042	5,049
General Government	2,120	26	200	0	276	63	743	809	1,746
Banks	1,084	4,334	1,255	1,312	1,320	1,372	1,395	1,410	1,426
Other private	2,067	85	1,462	1,523	1,523	1,676	1,709	1,823	1,877
Short-term borrowing	48,982	31,337	29,261	27,520	26,557	26,022	25,466	24,689	24,530
Public sector	7,494	7,363	6,807	5,918	4,998	4,071	3,051	1,661	831
Central Bank	7,494	7,363	6,807	5,918	4,998	4,071	3,051	1,661	831
General government	0	0	0	0	0	0	0	0	0
Banks	40,414	21,891	20,474	19,622	19,580	19,774	20,020	20,273	20,532
Other private	1,075	2,083	1,979	1,979	1,979	2,177	2,395	2,754	3,167
Other	4,612	20,848	246	-672	-520	-283	-152	-126	-915
Of which: Net errors and omissions	346	-439	0	0	0	0	0	0	0
FINANCING GAP	**0**	**4,838**	**2,333**	**2,183**	**583**	**0**	**0**	**0**	**0**
ESM	0	4,585	2,000	1,850	500	0	0	0	0
IMF	0	253	333	333	83	0	0	0	0
ROLLOVER RATES									
General government 1/	238%	0%	16%	0%	100%	100%	100%	100%	113%
Central bank	94%	98%	92%	87%	84%	81%	75%	54%	50%
Private	89%	54%	94%	97%	100%	102%	103%	104%	104%
Banks	86%	52%	93%	96%	100%	101%	101%	101%	101%
Non-financial corporates	167%	101%	95%	100%	100%	110%	110%	115%	115%

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.
1/ Rollover rate does not include EIB loan

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)													
Assets	118.1	139.4	135.0	131.4	128.1	90.2	89.7	88.3	87.7	88.0	88.8	89.9	91.2
Claims on Central Bank of Cyprus	1.3	3.1	2.3	2.9	3.9	2.7	2.6	2.6	2.6	2.7	2.7	2.8	2.9
Claims on Cypriot resident other MFIs	3.3	5.4	5.6	5.0	4.6	3.3	3.2	3.3	3.4	3.5	3.7	3.8	4.0
Claims on Cypriot resident non MFIs	47.2	50.3	54.0	58.2	60.6	55.0	53.4	52.1	51.1	50.6	50.5	50.6	51.1
General government	3.7	4.6	4.5	5.3	6.5	5.4	5.8	6.0	6.1	6.0	6.0	6.0	6.1
Private sector excluding brass plates 1/	39.4	42.7	46.5	48.6	49.3	46.5	44.6	43.0	41.9	41.5	41.3	41.5	41.8
Households	19.1	20.6	22.5	23.5	23.9	22.2	21.5	21.0	20.5	20.2	20.0	20.1	20.2
Non-financial corporations	19.7	21.5	23.3	24.1	24.4	23.5	22.3	21.3	20.7	20.6	20.6	20.7	20.9
Non-bank financial intermediaries	0.6	0.6	0.7	1.0	1.0	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Brass plates 2/	4.1	3.0	3.0	4.4	4.8	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1
Claims on non-residents	63.4	76.9	69.3	61.3	55.9	25.4	25.2	25.1	25.4	25.9	26.6	27.4	28.0
Other assets	2.9	3.8	3.8	3.9	3.2	3.8	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Liabilities	118.1	139.4	135.0	131.6	128.1	90.2	89.7	88.3	87.7	88.0	88.8	89.9	91.2
Liabilities to the Central Bank of Cyprus and Eurosystem	4.7	7.6	5.5	5.5	9.8	11.2	10.5	9.8	9.0	8.2	7.7	7.4	7.2
Liabilities to Cypriot resident other MFI	3.3	5.3	5.5	4.9	4.5	3.1	3.0	3.1	3.2	3.3	3.4	3.6	3.7
Deposits of Cypriot resident non MFIs	39.5	41.0	45.4	43.7	43.3	33.0	32.1	31.9	32.0	32.6	33.4	34.4	35.3
General government	0.3	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Private sector excluding brass plates	33.4	34.5	36.8	37.4	37.5	29.9	29.0	28.9	28.9	29.6	30.4	31.3	32.3
Households	23.4	24.6	25.4	26.0	26.4	23.3	22.6	22.4	22.5	23.0	23.6	24.4	25.1
Non-financial corporations	6.3	6.1	6.7	6.7	5.7	3.9	3.8	3.8	3.8	3.9	4.0	4.1	4.2
Non-bank financial intermediaries	3.6	3.9	4.7	4.6	5.4	2.7	2.7	2.6	2.7	2.7	2.8	2.9	3.0
Brass plates	5.7	6.1	8.1	5.8	5.3	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Deposits of non-residents	51.7	66.6	60.6	56.5	51.3	24.7	22.7	22.0	22.0	22.4	22.7	23.0	23.4
Debt securities	5.6	4.8	2.4	2.6	1.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital and reserves	10.0	10.8	12.8	11.3	15.1	16.2	19.5	19.5	19.5	19.5	19.5	19.5	19.5
Other liabilities	3.4	3.3	2.8	7.1	2.4	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Money and Credit													
General government sector credit, net	4.5	5.3	5.2	5.3	7.2	5.5	5.3	5.6	5.7	5.6	5.6	5.6	5.7
Private sector credit excluding brass plates	39.5	42.7	46.5	48.6	49.3	46.5	44.6	43.0	41.9	41.5	41.3	41.5	41.8
Brass plates credit	4.1	3.0	3.0	4.4	4.8	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1
Cypriot resident broad money (M2)	40.6	42.2	46.6	45.0	44.6	34.5	33.5	33.4	33.5	34.2	35.1	36.1	37.1
Cypriot resident narrow money (M1)	9.1	10.4	10.6	11.1	11.5	10.4	10.4	10.4	10.7	11.2	11.6	12.0	12.5
						(Percent of GDP)							
General government sector credit, net	26.4	31.6	30.1	29.4	40.4	33.5	33.7	34.9	34.2	32.3	30.9	29.7	28.8
Private sector credit excluding brass plates	230.0	253.6	267.2	272.1	278.1	281.7	281.9	266.6	251.1	238.8	227.8	219.4	213.0
Brass plates credit	23.9	17.5	17.4	24.3	27.0	18.6	19.2	18.9	18.3	17.7	17.1	16.5	16.0
Cypriot resident broad money (M2)	236.6	250.2	267.4	251.7	251.9	208.9	211.2	207.0	201.0	196.8	193.3	190.9	188.8
Cypriot resident narrow money (M1)	53.0	61.8	61.2	62.2	64.8	63.1	65.6	64.7	64.3	64.4	63.9	63.7	63.5
						(Annual percentage change)							
General government sector credit, net	...	17.4	-1.6	0.4	36.2	-22.9	-3.4	5.4	1.3	-1.5	-0.2	0.3	0.7
Private sector credit excluding brass plates	...	8.3	8.8	4.6	1.3	-5.6	-4.0	-3.7	-2.6	-0.9	-0.4	0.4	0.9
Brass plates credit	...	-28.1	2.3	44.0	9.9	-35.7	-1.3	0.3	0.6	0.7	0.7	0.7	0.7
Cypriot resident broad money (M2)	...	3.9	10.4	-3.4	-0.8	-22.8	-3.0	-0.2	0.4	2.0	2.5	2.9	2.7
Cypriot resident narrow money (M1)	...	14.5	2.3	4.4	3.2	-9.3	-0.1	0.3	2.8	4.4	3.7	3.8	3.6
Memorandum items:													
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	...	3.4	6.5	1.7	0.3	-20.2	-3.0	-0.6	0.3	2.2	2.7	3.2	3.0
Brass plates deposits (y-o-y percent change)	...	6.2	33.8	-28.3	-9.4	-50.4	-1.0	0.1	0.3	0.4	0.4	0.3	0.3

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

1/ Includes public entities classified outside the general government. 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	4.7	10.6	17.4	24.3	70.7	118.2	156.9
Repurchase	0.0	0.0	0.0	0.0	0.0	6.2	49.5	99.0	142.3
Charges	0.0	1.6	4.7	10.6	17.4	18.1	21.2	19.2	14.6
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	3.7	5.7	6.0	5.7	5.2	4.4	3.4
In percent of exports of goods and services	0.0	3.4	8.2	12.4	13.0	12.2	11.0	9.2	7.0
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	74.7	99.2
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	0.0	0.1	0.2	0.3	0.3	0.9	1.5	1.9

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

Source: IMF staff estimates.

Table 9. Cyprus: External Debt Sustainability Framework, 2009-2021
(Percent of GDP, unless otherwise indicated)

	Actual							Projections								Debt-stabilizing non-interest current account 6/
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019	2020	2021	
Baseline: External debt	544.1	491.9	468.2	448.5	348.0			**364.7**	**360.7**	**351.1**	**337.3**	**323.9**	**310.2**	**302.0**	**296.6**	**-5.3**
Change in external debt	223.9	-52.3	-23.6	-19.8	-100.5			16.7	-4.0	-9.6	-13.8	-13.5	-13.6	-8.2	-5.4	
Identified external debt-creating flows (4+8+9)	2.1	24.3	7.0	-23.7	59.1			13.7	-5.2	-10.7	-9.9	-10.2	-10.7	-9.6	-8.9	
Current account deficit, excluding interest payments	2.5	1.4	-5.8	-3.4	-7.8			-8.2	-8.8	-9.7	-10.2	-10.4	-10.1	-10.0	-9.6	
Deficit in balance of goods and services	5.5	6.2	4.3	3.1	-1.9			-4.0	-4.9	-5.6	-5.8	-5.7	-5.7	-5.7	-5.7	
Exports	40.2	41.3	42.9	42.9	43.9			45.0	45.7	46.1	46.6	47.0	47.5	48.0	48.7	
Imports	45.7	47.5	47.2	46.0	42.0			41.0	40.8	40.6	40.8	41.3	41.8	42.4	43.0	
Net non-debt creating capital inflows (negative)	7.0	1.8	-7.2	-12.8	-15.2			-1.1	-3.3	-4.4	-2.7	-3.3	-4.4	-4.5	-4.4	
Automatic debt dynamics 1/	-7.4	21.1	20.0	-7.5	82.1			23.0	7.0	3.4	3.0	3.5	3.8	5.0	5.1	
Contribution from nominal interest rate	8.2	8.5	9.2	10.3	9.7			8.3	8.6	9.1	9.8	10.5	10.4	10.4	10.4	
Contribution from real GDP growth	5.7	-7.3	-2.2	10.9	28.2			14.7	-1.6	-5.7	-6.8	-7.0	-6.6	-5.4	-5.3	
Contribution from price and exchange rate changes 2/	-21.3	19.9	13.0	-28.6	44.3			...	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	221.7	-76.5	-30.6	3.9	-159.5			3.0	1.1	1.1	-3.9	-3.2	-3.0	1.3	3.4	
External debt-to-exports ratio (in percent)	1352.4	1191.4	1091.1	1044.8	792.1			810.6	790.0	761.1	724.0	689.5	653.8	628.5	609.5	
Gross external financing need (in billions of US dollars) 4/	50.9	103.0	93.2	79.9	81.1			46.0	43.9	41.9	41.5	42.6	42.9	43.6	42.5	
in percent of GDP	205.0	424.8	392.8	324.1	382.3	5-Year	5-Year	219.1	201.7	183.9	172.6	168.2	160.9	157.5	147.5	
Scenario with key variables at their historical averages 5/								**364.7**	**384.2**	**405.1**	**422.2**	**440.3**	**459.0**	**480.7**	**506.8**	**14.9**
						Historical	Standard									
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation									
Real GDP growth (in percent)	-1.9	1.3	0.4	-2.4	-5.4	-1.6	2.6	-4.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8	
GDP deflator in US dollars (change in percent)	7.1	-3.5	-2.6	6.5	-9.0	-0.3	6.9	3.3	3.1	3.1	3.3	3.2	3.0	2.1	2.1	
Nominal external interest rate (in percent)	2.7	1.5	1.8	2.3	1.9	2.0	0.5	2.4	2.4	2.6	3.0	3.3	3.4	3.5	3.6	
Growth of exports (US dollar terms, in percent)	-6.1	0.3	1.7	4.0	-11.9	-2.4	6.5	1.3	5.1	5.9	6.4	6.3	6.3	5.2	5.2	
Growth of imports (US dollar terms, in percent)	-14.8	1.5	-2.8	1.3	-21.3	-7.2	10.3	-3.5	3.1	4.3	5.9	6.6	6.5	5.4	5.4	
Current account balance, excluding interest payments	-2.5	-1.4	5.8	3.4	7.8	2.6	4.5	8.2	8.8	9.7	10.2	10.4	10.1	10.0	9.6	
Net non-debt creating capital inflows	-7.0	-1.8	7.2	12.8	15.2	5.3	9.5	1.1	3.3	4.4	2.7	3.3	4.4	4.5	4.4	

Source: IMF staff estimates.

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

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

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

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

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

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

Table 10. Cyprus: Restrictive Measures on Transactions

(Euros)

	2013			2014		
	27-Mar	2-Aug	22-Nov	24-Feb	31-Mar	31-May
Cash withdrawals (per day per person)						
Natural person	300	300	300	300	Free	Free
Legal person	300	500	500	500	Free	Free
Cashless payments/transfers w/o justification (per day per account)						
To other credit institutions in Cyprus						
Natural person (per month)	5,000	15,000	15,000	20,000	50,000	Free
Legal person (per month)	5,000	75,000	75,000	100,000	200,000	Free
For the purchase of goods and services w/o mandatory justification (per transaction) 2/	5,000	300,000	No limitation	No limitation	No limitation	No limitation
To institutions abroad						
Transactions within normal business w/o Committee's approval	5,000	500,000	1,000,000	1,000,000	1,000,000	1,000,000
Payments via debit or credit card (per month)	5,000	No limit	No limit	No limit	No limit	No limit
Exports of euro notes or foreign currency per person per journey	1,000	3,000	3,000	3,000	3,000	3,000
Monthly transfer of deposits/funds abroad regardless of the purpose	5,000	5,000	5,000	5,000	5,000	5,000
Opening of new accounts is prohibited except: to deposit funds from abroad, for term deposits created with cash for a minimum of three months, for loans related to new customer credit facilities	Yes	No 1/	No 1/	No 1/	No 1/	Free
It is prohibited to add new beneficiaries in a current account and cash cheques	Yes	Yes	Yes	Yes	Yes	No
Transactions of international customers of foreing banks exempted from restrictions	No	Yes (15 banks)	Yes (16 banks)	Yes (16 banks)	Yes (16 banks)	Yes (16 banks)
Mandatory rollover of maturing term deposits by 1 month (in percent of deposit value)	90%	80%	80%	None	None	None
Termination of fixed term deposits prior to maturity	Only to repay a loan within same institution	Additional transactions allowed	Additional transactions allowed	Additional transactions allowed	Free 3/	Free 3/

Sources: Central Bank of Cyprus; Ministry of Finance Cyprus.

1/ Or subject to prior approval by the committee.

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

3/ Subject to banks' consent.

Table 11. Cyprus: Selected Reforms - Measures Completed

Measures	Completion time	Macrofinancial implications
Fiscal Consolidation and fiscal structural reforms		
Implemented a reform of the COLA wage indexation mechanism in the public sector by extending its freeze to the end of the program and limiting its application to 50 percent of the price index thereafter	December 2012	Strengthen fiscal sustainability
Adopted the 2013 and medium term budget with consolidation measures of about 4.5 percent of GDP	December 2012	Strengthen fiscal sustainability
Reformed the General Social Insurance Scheme and to government pension scheme, and freeze public sector pensions	January 2013	Reduce implicit government liability
Rolled over and extended the maturity of €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and rolled over the €1.9 billion recapitalization bond of Laiki	June 2013	Facilitate government financing
Adopted the 2014 budget with consolidation measures of about 2.3 percent of GDP	December 2013	Strengthen fiscal sustainability
Adopted a law on Fiscal Responsibility and Budget Systems	February 2014	Strengthen budget formulation and execution
Resolving, recapitalizing, and restructuring financial institutions		
Independently assessed banking sector capital needs	February 2013	Identify capital shortfall
Adopted a modern bank resolution law	March 2013	Minimize fiscal costs
Resolved Laiki bank and disposed of Greek operations	March 2013	Strengthen financial sector stability
Completed BoC recapitalization and exit from resolution	July 2013	Strengthen financial sector stability
Recapitalized Hellenic Bank from private sources	October 2013	Strengthen financial sector stability
Recapitalized and consolidated the coop sector	March 2014	Strengthen financial sector stability
Strengthening supervision and regulation and restructuring private sector debt		
Harmonized NPL classification to best practice	September 2013	Strengthen financial sector stability
Unified supervision of CCIs and banks under the CBC	September 2013	Protect consumers
Passed legislation to prohibit banks and coops from lending to their independent board members and removing board members in arrears on debts to their banks	September 2013	Strengthen oversight of bank credit-risk management practices
Finalized a code of conduct for banks and an arrears management framework	September 2013	Assist debt restructuring
Established the legal framework for a credit register	November 2013	Allow banks to make better informed loan decisions
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 12. Cyprus: MEFP Commitments		
Measures	Deadline	Rationale
Financial Sector Policies		
Restructuring financial institutions		
CBC to complete an assessment of CCB's implementation of effective local and risk management programs for the CCIs	End-January 2015	Ensure appropriate risk management practices
CBC to complete with the assistance of an independent consulting firm a comprehensive technical assessment of BoC's restructuring plan	End-February 2015	Identify areas requiring strengthening
Restructuring private sector debt		
CBC to require banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring	End-June 2014	Ensure external independent assessment
Authorities to amend legislation to allow for the seizure and sale of loan collateral through private auctions to be conducted by mortgage creditors, without government interference (except for primary residences)	End-June 2014	Address lack of timely foreclosure processes
Task force on title deeds to develop recommendations	End-June 2014	Facilitate the issuance of title deeds
CBC to require banks and coops to submit action plans to address operational deficiencies	End-June 2014	Assess debt restructuring capacity
Authorities to conduct an assessment of the impact on lenders of various options in developing the insolvency law strategy	End-June 2014	Ensure adequate incentives for debt restructuring
CBC to finalize the verification of the banks' compliance with the code of conduct and the assessment of arrears management policies and practices of banks and coops	End-July 2014	Assess compliance with policies
CBC supervisory units to report their findings on the first quarterly report of the coops to the CBC Board	End-July 2014	Monitor progress toward restructuring targets
Authorities to prepare a strategy for the reform of the debt restructuring legal framework to be approved by the Council of Ministers	End-July 2014	Ensure adequate incentives for debt restructuring
Authorities to identify the core functions of the Land Register and amend legislation, as necessary	End-September 2014	Address backlog and delays in the issuance of title deeds
CBC to require banks and coops to submit action plans to address potential shortcomings related to compliance with the code of conduct and arrears management policies and practices	End-September 2014	Assess compliance with policies
CBC to request by end-May the internal audit department of BoC and the coops to submit a special examination report on lending and debt restructuring practices	End-September 2014	Assess governance
CBC supervisory units to examine the implementation of banks' and coops' action plans and submit main findings and recommendations to the CBC Board	End-November 2014	Assess debt restructuring capacity and compliance with policies
Authorities to adopt legislation for the effective rehabilitation of viable companies and for procedures for licensing and regulation of insolvency practitioners	End-December 2014	Facilitate return to normal operations of viable but troubled companies
Authorities to modernize personal insolvency legislation	End-December 2014	Facilitate modern personal insolvency procedures
Authorities to complete a review of the rules of civil procedure and other court rules	End-December 2014	Identify potential inefficiencies
Amendments to foreclosure legislation to allow for sale of collateral through private auctions to become effective for primary residences	End-December 2014	Ensure adequate incentives for debt restructuring
CBC to complete assessment of internal auditors' main findings and take appropriate action	End-January 2015	Assess governance
Authorities to review the private sector debt restructuring legal framework to assess results and define additional measures as needed	End-June 2015	Review effectiveness of debt restructuring framework
Strengthening supervision and regulation		
CBC to set the minimum bank capital requirement at 8 percent CET1 under Pillar 1	End-June 2014	Harmonize benchmarks to new capital definitions
Authorities to appoint a reputable advisory firm to manage the disposal of the assets of Laiki	End-June 2014	Wind down Legacy Laiki
Authorities to adopt amendments to the resolution law	Mid-July 2014	Strengthen the independence and effectiveness of the Resolution Authority
Authorities to task the appointed advisory firm with finalizing an action plan for the disposal of the assets	End-July 2014	Wind down Legacy Laiki
CBC to complete the revision of the governance directive on the interaction between banks' internal audit units and bank supervisors, in line with best practice	End-July 2014	Strengthen governance
Authorities to complete the operationalization of the credit register	End-September 2014	Allow banks to make informed loan decisions
Authorities to transfer the management of Laiki's voting rights in BoC to independent and reputable firms or international institutions	End-September 2014	Wind down Legacy Laiki
CBC to request a standalone assessment against the "Basel Core Principles for Effective Banking Supervision" to be completed	End-December 2015	Assess supervisory effectiveness

Table 12. Cyprus: MEFP Commitments (concluded)

Measures	Deadline	Rationale
Strengthening the AML framework		
CBC to implement an inspection program in the course of 2014 covering 4 banks by end-June and another 7 banks by end-December	End-June 2014; End-December 2014	Resume onsite AML supervision
Authorities to make available free basic information on all companies registered in Cyprus through the Registrar of 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
Authorities to amend the company law	End-October 2014	Streamline registration process and strengthen enforcement powers of the Registrar
Authorities to be able to access adequate, accurate and current beneficial ownership information on all types of legal persons registered in Cyprus	End-January 2015	Streamline registration process and strengthen enforcement powers of the Registrar
Structural Fiscal Reforms		
Social welfare		
Council of Ministers to approve the final design of the reformed social welfare system, including decisions on the type, level and eligibility criteria for GMI	Mid-June 2014	Strengthen social safety net to protect vulnerable groups during the downturn
Authorities to complete IT pilot testing phase	End-June 2014	Strengthen social safety net to protect vulnerable groups during the downturn
Authorities to implement the social welfare reform	End-June 2014	Strengthen social safety net to protect vulnerable groups during the downturn
Authorities to establish a monitoring unit to assess the GMI outcomes	End-June 2014	Strengthen social safety net to protect vulnerable groups during the downturn
Authorities to identify a list of social benefits outside the GMI and other contingency measures	Mid-July 2014	Ensure budget neutrality
Authorities to update the costing of the GMI and, if needed, rationalize other benefits outside the GMI	End-September 2014	Ensure consistency with medium-term fiscal targets
Revenue administration		
Authorities to prepare a plan, specifying the modalities to recover debt, which include case-by-case installment schemes, set-offs, and other options	End-June 2014	Gauge the size and nature of tax debt
Authorities to adopt the law consolidating the two existing tax authorities into a single Department of Taxation	End-June 2014	Enable revenue administration reform
Project team to prepare an assessment of performance for the first five months of the year with remedial actions as needed	End-June 2014	Mitigate the risk of revenue loss during the integration process
Authorities to conduct two joint pilot field audits for large taxpayers	End-June 2014	Mitigate the risk of revenue loss during the integration process
Authorities to finalize all remaining planned field audits for high-risk taxpayers	End-June 2014	Mitigate the risk of revenue loss during the integration process
Authorities to appoint the new management team of the new department	End-July 2014	Enable revenue administration reform
Authorities to implement a common taxpayer database	End-September 2014	Ensure a unified view of the taxpayer
Authorities to complete the single registration process	End-December 2014	Ensure a unified view of the taxpayer
Authorities to establish an integrated unit for large taxpayers in the new department	End-December 2014	Improve efficiency of revenue administration
Public debt management		
Public Debt Management Office to complete a comprehensive database of guarantees	Mid-July 2014	Address risks associated to government guarantees
Authorities to establish an investor relation function within the PDMO	End-July 2014	Prepare to re-access capital markets in due time
Public Debt Management Office to prepare first quarterly risk assessment report on the stock of guarantees	End-September 2014	Address risks associated to government guarantees
Authorities to put in place institutional arrangements and procedures to manage guarantees and to deal with debt restructuring and recovery of costs	End-September 2014	Address risks associated to government guarantees
Council of Ministers to adopt a comprehensive medium-term debt management strategy	End-October 2014	Prepare to re-access capital markets in due time
Authorities to describe procedures to manage guarantees in a manual and/or guidelines	End-January 2015	Address risks associated to government guarantees
Privatizations		
Authorities to have a fully operational privatization unit	End-June 2014	Initiate preparation for the privatizations
Authorities to complete the selection process for strategic and financial advisors for the three privatization transactions	End-September 2014	Initiate preparation for the privatizations
Authorities to update the regulatory framework for the ports administration (CPA)	End-December 2014	Initiate preparation for the privatizations
Authorities to adopt legislation to convert the telecommunications company (CyTA) into a limited liability company	End-December 2014	Initiate preparation for the privatizations
Authorities to privatize the telecommunications company (CyTA) and the commercial activity of the ports administration (CPA)	End of program	Finalize privatization
Authorities to privatize the electricity company (EAC)	Mid-2018	Finalize privatization
Program financing and monitoring		
Parliament to approve an amended central bank bill	End-June 2014	Provide additional financing and lower public debt
CBC and MoF to sign a Memorandum of Understanding	End-June 2014	Provide additional financing and lower public debt
Authorities to complete a second valuation of the assets on behalf of the CBC	End-July 2014	Provide additional financing and lower public debt
Authorities to finalize a debt-to-asset swap to reduce public debt by approximately €1 billion	End-July 2014	Provide additional financing and lower public debt
CBC to transfer an additional €0.2 billion to the budget	End of program	Limit financing needs

Table 13. Cyprus: Conditionality for the Fourth Review

Measures	Timing	Status
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	Not met. Requirement achieved in May.
Government approval of the final design of the reformed social welfare system	End-March 2014	Not Met. Requirement expected to be achieved by mid-June.
Merger of the credit cooperative sector into a maximum of 18 institutions	End-March 2014	Met
Appoint an independent firm or international institution to be entrusted with the voting rights of legacy Laiki in BoC and manage the disposal of Laiki's assets abroad	End-April 2014	Not Met. Requirement expected to be partially achieved by end-June.
Submission to Parliament of the new Cyprus Tax Department's enabling law	End-April 2014	Not Met. Requirement achieved on May 8.
Completion of the assessment of the operational capacity of cooperative credit institutions' loan workout units	End-May 2014	Met
CBC supervisory units to submit to the CBC Board the first quarterly report regarding BoC's/coops performance against selected operational and financial targets	End-May 2014	Not met. The requirement related to the report on BoC was achieved on time; for the coop sector, it was not achieved.

Appendix I. Cyprus: Letter of Intent

Nicosia, June 16, 2014

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

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

We have made progress with policy implementation under the program. Fiscal performance through end-March continued to exceed expectations, and, as a result, we have met all end-March and continuous performance criteria (PCs). Despite some delays, we have made progress toward complying with the requirements of structural conditionality. We have met two structural benchmarks (SBs) related to the consolidation of the coop sector and the assessment of its operational capacity. We have achieved the requirements of a third SB partially and those for two SBs with a delay. We expect to complete fully or partially the requirements of another two SBs in June.

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

- In the financial sector, the key challenge is to address non-performing loans (NPLs). We will intensify the supervisory monitoring of banks' progress with debt restructuring and advance preparations for the implementation of the reform of the debt restructuring legal framework. At the same time, we are relaxing domestic payment restrictions, being mindful of the need to safeguard financial stability. Finally, we remain committed to strengthening bank supervision and to the implementation of the AML /CFT framework.

- Having modestly revised our primary fiscal deficit targets in line with the improved 2014 growth outlook, we remain committed to maintaining prudent budget execution, especially in light of still high macroeconomic uncertainty.

- We are advancing with our ambitious structural reform agenda. We remain committed to implementing a welfare reform protecting vulnerable groups this year. We are also taking steps to reform the revenue administration and to fight tax evasion and non-compliance. At the same time, we plan to strengthen the management of public debt and of fiscal risks related to government guarantees. Finally, we are advancing with preparatory steps to privatize state-owned enterprises.

Financing of our program remains adequate. The central bank has transferred last year's profits to the budget and we are making progress toward reducing public debt through a debt-to-asset swap with the CBC.

Based on the above, we request the following:

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

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

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

- Establishment of new or modified SBs on the following: (i) a strategy to reform the debt restructuring legal framework (end-July); (ii) quarterly CBC report on coops' progress with restructuring targets (end-July); (iii) entrusting the management of Laiki's voting rights in BoC to an independent third party (end-September); (iv) CBC assessment of banks' and coops' action plans to address deficiencies in debt management capacity and practices (end-November); (v) approval of a new debt management strategy (end-October); (vi) adoption of legislation to modernize personal and corporate insolvency procedures and regulate insolvency practitioners (end-December 2014); and (vii) assessment of governance issues related to bank preferential lending practices (end January-2015) (Table 3).

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

Sincerely,

/s/	/s/
Harris Georgiades Minister of Finance	Chrystalla Georghadji Governor of the Central Bank of Cyprus

Attachment I. Cyprus: Memorandum of Economic and Financial Policies

A. Recent Developments and Outlook

1. **Our economy continues to adjust to correct large imbalances accumulated before the crisis.** As a result, GDP contracted by 5.4 percent last year, reflecting significant declines in financial and construction sectors, which had grown at unsustainable levels in the past. Our tourism and service sectors helped to cushion the adjustment, and the overall contraction was less than 6 percent expected at the time of the third review. Still, the recession is taking a heavy toll on our economy and society, with the unemployment rate rising to very high levels and disposable incomes falling. This has led to an increase in non-performing loans (NPLs), now close to 140 percent of GDP for the core domestic banking sector, which are constraining banks' ability to provide liquidity to the economy, further hampering the ability of businesses to create jobs.

2. **We have revised our macroeconomic framework to reflect a less deep but more prolonged economic adjustment.** In light of the better-than-expected outturn in 2013 and available data for the early months of 2014, we revised our projection for GDP growth in 2014 to -4.2 percent (from -4.8 percent). However, we expect the adjustment to take more time and the recovery to be weaker, as domestic demand, especially private consumption, is weighed down by the need to reduce very high levels of private sector debt. As a result, growth is projected to reach only 0.4 percent in 2015, increasing to 1.6 percent in 2016. Risks to the outlook remain significant. On the external front, increased geopolitical tensions related to the Ukraine conflict could affect our service and tourism sectors negatively. Domestically, delays in dealing with the large NPLs could exacerbate negative feedback between the economy and the banks, further hampering the recovery.

B. Financial Sector Policies

Restructuring private sector debt

3. **Ensuring that banks are effectively addressing the high level of NPLs is a key priority.** Having recapitalized the banking sector and met our end-March **structural benchmark** on consolidating the coop sector, achieving progress in reducing NPLs—now about half of total loans—is essential to restore confidence and resume the provision of credit to the economy. To this end, the CBC has intensified its supervisory monitoring of banks' efforts with debt restructuring, which focuses on three key areas:

- ***Assessment of debt restructuring capacity, policies and compliance with the Code of Conduct***: The CBC has completed the in-situ assessment of the operational capacity of banks' and coops' units to deal with NPLs (existing **structural benchmarks**, one achieved with delay, the other on time). Deficiencies have already been identified in the case of banks, related to building up capacity and training, IT systems, independence of arrears management units, and performance monitoring against quantitative targets. Despite some delays due to capacity constraints, the CBC is also committed to finalizing the verification of the banks' compliance with the code of conduct and the assessment of arrears management policies and practices of banks and coops by end-July. On this basis, banks and coops will be required to submit to the CBC their action plans to address: (i) operational deficiencies (by end-June), and (ii) potential shortcomings related to compliance with the code of conduct and arrears management policies and practices (by end-September). The responsible CBC supervisory units will examine the implementation of these plans and submit the main findings and recommendations to the CBC Board by **end-November** (**new structural benchmark**).

- ***Monitoring of progress toward restructuring targets***: In April, BoC submitted to the CBC first quarterly reports on the implementation of their restructuring plan and on progress related to a set of key performance indicators on selected operational and financial targets. The coops have done so in May. The responsible CBC supervisory units are assessing these quarterly reports regularly. They have reported their findings on the first report to the CBC Board for BoC and remains committed to do so for the coops by **end-July** (**modified structural benchmark**).

- ***Governance assessment***: The CBC has requested the internal audit department of BoC (including transferred Laiki operations) and of coops to submit by end-September a special examination report on lending and debt restructuring practices of BoC and coops with respect to loans related to former and/or current managers, directors, members of committees and major shareholders of the groups with the aim to identify decisions that may have led to disproportionate losses in net present value terms. By **end-January 2015,** the CBC will complete its assessment of internal auditors' main findings and take appropriate action, including by requiring the institutions concerned to take civil action where applicable (**new structural benchmark**).

4. **The reform of the debt restructuring legal framework is critical to ensure adequate incentives for debt restructuring**. To this end, we have established a project group and have conducted consultations with stakeholders on reform proposals. Given the complexity of the task and the need to consult widely, we will need additional time to prepare a reform strategy to be approved by the Council of Ministers by end-July **(new structural benchmark)**. In developing the insolvency law strategy, by end-June we will conduct an impact assessment of various options on lenders. We remain committed to amend foreclosure legislation by end-June, with immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect by end-December in line with the adoption of the insolvency law). The new foreclosure legislation will allow for the sale of loan collateral through private auctions to be conducted by mortgage creditors, without interference from government agencies. By end-December, we will adopt legislation on household and corporate insolvency in line with international best practices and establish procedures for the licensing and regulation of insolvency practitioners (**modified structural benchmark**).

Normalizing financial flows

5. **We continue to relax remaining domestic payment restrictions consistent with preserving financial sector stability**. We have substantially relaxed restrictions, in line with our roadmap published in August 2013, fully liberalizing domestic transfers and abolishing restrictions on term deposits and cash withdrawals, as key milestones on restructuring and recapitalizing the financial sector had been reached. Looking forward, we will continue to monitor market and bank liquidity conditions closely and ensure that remaining relaxations of domestic payment restrictions envisaged in our roadmap remain consistent with financial sector stability. Further progress under the program is needed before considering actions related to restrictions on the capital account.

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

Strengthening supervision and regulation

7. **We are strengthening banking regulation and supervision ahead of the establishment of the pan-European Single Supervisory Mechanism (SSM)**. We have increased resources in line with the CBC's intense supervisory work program, and are working with the banks to prepare for the ongoing ECB Comprehensive Assessment. Building on these efforts we will work on three fronts:

- ***Capital***: With the entry into force of the new capital definition in CRD_IV and CRR and in line with the harmonized benchmark in the comprehensive assessment, the CBC will set the minimum bank capital requirement at 8 percent CET1 under Pillar I by end-June. In line with CRD_IV, the CBC will request significant banks to maintain capital buffers in excess of minimum Pillar I requirements based on conservative assumptions and take prompt action if needed. In addition, the CBC has instructed banks to submit by end-June estimates of the potential impact of upcoming NPL and provisioning EU rules on domestic banks' profitability and coverage ratios.

- ***Bank resolution***: Legacy Laiki remains under resolution, and will need to be wound down. In this regard, we remain committed to transfer the management of its voting rights in BoC to independent and reputable firms or international institutions by **end-September** (**modified structural benchmark**). In addition, we will appoint a reputable advisory firm to manage the disposal of the assets of Laiki by end-June (existing **structural benchmark**). The firm will be tasked with finalizing, by end-July, an action plan for the disposal of the assets. Separately, we remain committed to strengthen the independence and effectiveness of the Resolution Authority through the adoption of amendments to the resolution law by mid-July, aiming to ensure that decision makers are isolated from conflicts of interest.

- ***Bank internal audit and credit register***: Despite some delays, the CBC stands ready to complete: (i) the revision of the governance directive on the interaction between banks' internal audit units and CBC bank supervisors, in line with best practices (by end-July); and (ii) the operationalization of the credit register, the development of options to use it for supervisory purposes, in line with best European supervisory practices, and the finalization of the content of the additional data to be collected by the credit register (by end-September).

Strengthening the AML framework

8. **We remain committed to strengthening the implementation of the AML/CFT framework**. We are working on two fronts:

- ***AML bank supervision***: After having strengthened the AML/CFT supervisory function for financial institutions, the CBC has resumed inspections of banks. Under the new supervisory plan, one onsite inspection has been completed and the CBC will inspect three additional banks by end-June, and another seven by end-December. The CBC remains committed to apply appropriate supervisory and enforcement measures in case of deficiencies and non-compliance with the AML/CFT legal framework.

- ***Registrar of Companies***: We are in the process of making available free basic information on all companies registered in Cyprus and will complete this process by end-June. By end-October, we will amend the company law with the aim to modernize it by, inter alia, streamlining the process of registration and strengthening the enforcement powers of the Registrar to ensure adequate updating of information and de-registration of non-compliant companies. Subsequently, by end-January 2015, in line with the action plan approved by the Council of Ministers also addressing the Global Forum requirements, competent authorities will be able to access adequate, accurate and current beneficial ownership information on all types of legal persons registered in Cyprus based on the Registrar of Companies' information.

C. Fiscal Policy

9. **We have adjusted the 2014 primary fiscal deficit target to 1.6 percent of GDP on a cash basis**. This implies a modest tightening of 0.4 percent of GDP, reflecting the upward revision in the growth projection for 2014, expected to result in an improved revenue performance. Already, higher-than-projected tax revenues, along with continued prudent budget execution of discretionary spending, have helped to meet the end-March fiscal targets with a comfortable margin (0.6 percent of GDP). Our revised fiscal forecast remains conservative and takes into account additional needs resulting from the materialization of contingent liabilities associated with called loan guarantees (also see below). Our medium-term fiscal strategy aims to gradually reduce our primary deficit to 1 percent of GDP in 2015, a surplus of 1.8 percent of GDP in 2016, so as to attain a surplus of 4

percent of GDP by 2018, which is needed to place public debt on a sustained downward path.[1] This guides the budget ceilings in our fiscal-strategy statement, which was finalized in May.

D. Structural Fiscal Reforms

10. **A key priority is to strengthen our social safety net to protect vulnerable groups during the downturn.** To this end, we will introduce a new Guaranteed Minimum Income scheme (GMI) aiming to cover all those in need and to reduce poverty in our society, while preserving work incentives. We remain committed to implementing the reform following its approval by the Council of Ministers at mid-June (existing end-March **structural benchmark**), the completion of the IT testing phase, and adoption of the welfare law by end-June (**existing structural benchmark**). We will do so in a budget-neutral manner:

- ***For 2014***: Financing included in the 2014 budget is estimated to fully cover GMI costs in the second half of 2014, as public assistance and other benefits will be incorporated into the GMI. To prepare for potential additional costs this year, by mid-July, we will identify (i) a list of social benefits outside the GMI, for which we will review the beneficiary profiles and eligibility, (ii) other contingency measures, to ensure budget neutrality in 2014. Moreover, by end-June, we will establish a monitoring unit to assess the GMI outcomes (i.e. number of applications and costs, targeting accuracy, coverage, impact on poverty) and be in a position to further evaluate the costing of the GMI.

- ***For 2015 and beyond***: On the basis of an impact assessment of the welfare reform and as part of the budgetary process of 2015, by end-September, we will update the costing of the GMI and, if needed, we will rationalize other benefits outside the GMI to ensure that the reform remains consistent with 2015 and medium-term fiscal targets.

11. **We are also taking steps to strengthen our revenue administration**. This is key to enhancing revenue collections so as to preserve the sustainability of our public finances.

- ***Short-term measures to increase collections***: Taxes owed but not paid are high, amounting to an estimated 6 percent of GDP. To help recover these, as a **prior action** for the review, new legislative amendments will be adopted by parliament and regulations finalized to establish self-assessment and provide the revenue administration with the authority to prohibit the alienation of immovable assets, seize movable assets, and garnish bank accounts. Such actions will be taken after other procedures have been exhausted and the tax debt is undisputable. Powers related to garnishing bank accounts would not require a court order but could allow a short appeal period, so as to safeguard taxpayer interest.

[1] These targets are consistent with the respective ESA95 targets presented in the MoU between the EC and the authorities. These targets include expected dividends of €100 million per year in 2015-16, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

- ***Revenue administration reform***: The enabling law consolidating the existing two tax authorities into a single Department of Taxation was submitted to Parliament with a slight delay on May 8 (existing end-April **structural benchmark**) and was adopted on June 5. As a next step, we will appoint the new management team of the new department by end-July. To ensure a unified view of the taxpayer we will implement a common taxpayer database by end-September and complete the single registration process by end-December. Also by end-December, we will establish an integrated unit for large taxpayers in the new department (existing **structural benchmark**).

- ***Monitoring***: To mitigate the risk of revenue loss during the integration process, we will intensify the monitoring of monthly performance indicators (including registration, filing and payment, auditing and debt collection), which has been delayed. In this regard, the revenue administration reform project team will prepare by end-June an assessment of performance for the first 5 months of the year with remedial actions as needed. At the same time, we are conducting two joint pilot field audits for large taxpayers, which we will complete by end-June. Regarding the planned eight field audits for high-risk taxpayers, we have finalized four and will complete the rest by end-June. We will initiate collection procedures following these assessments, as needed.

12. **We are working to enhance the management of fiscal risks arising from government guarantees.** The stock of government guarantees is large, at €3 billion (20 percent of GDP) and is not systematically monitored. To address associated risks, we have increased the resources of the Public Debt Management Office (PDMO), which, by mid-July, will complete a comprehensive database of guarantees, crosschecked with financial institutions and purged of called guarantees. In this regard, we have already concluded an agreement between the government and a foreign bank for the restructured payment of one set of called guarantees (1 percent of GDP) and are working to finalize the restructuring process for the payment to a domestic bank of an additional set of called guarantees(0.5 percent of GDP) by mid-July. Looking forward, the PDMO will prepare quarterly risk-assessment reports on the stock of guarantees; the first report will be finalized by end-September and will be included in the fiscal risk statement in the 2015 budget. Also by end-September, we will put in place institutional arrangements, including clear responsibilities within the Ministry of Finance and between it and line ministries, and procedures to manage guarantees and to deal with debt restructuring and recovery of costs associated with called guarantees. These procedures will be described in a manual and/or guidelines to be prepared by end-January 2015.

13. **We are developing a medium-term debt strategy aimed at paving the way for a sustainable return to market access.** Significant official financing (€10 billion) at favorable conditions meet most of our financing needs during the program period. However, the debt maturity profile is not sufficiently smooth and exhibits a relatively high concentration of debt repayment obligations amounting to €8 billion following the end of the program in May 2016 and until end-2020, of which €2.7 billion is in 2017 alone. In this context, and taking into account market conditions (yields have been on a declining trend since the program was approved), we are preparing to re-access capital markets in due time. In this regard, we will establish an investor relation function within the PDMO by end-July. Moreover, the PDMO will develop of

comprehensive medium-term debt-management strategy aimed at: (i) smoothing our debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing monitoring and the risk assessment of contingent liabilities from government guarantees (see above). The Council of Ministers will adopt the updated strategy by **end-October (new structural benchmark)**.

14. **We remain committed to privatizing state-owned enterprises.** This is expected to improve economic efficiency, reduce our public debt, and encourage foreign direct investment. To this end, we have appointed the head of the privatization unit and are working on hiring additional staff, with the aim to have a fully operational unit by end-June. By end-September, we will complete the selection process for strategic and financial advisors for the commercial activities of the ports administration (CPA), the telecommunications company (CyTA), and the electricity company (EAC). We remain committed to privatizing CyTA and the commercial activities of CPA before the end of our program. In this regard, the regulatory framework for CPA will be updated by end-December via parliamentary approval of the respective legislation. Also by end-December, legislation will be adopted to convert CyTA into a limited liability company. We are also committed to complete the privatization process for EAC by mid-2018, after unbundling its activities and other preparatory steps.

E. Program Financing and Monitoring

15. **We are making progress with measures which provide additional financing for our program and lower public debt.** The CBC transferred €180 million of central bank profits to the government in April, and an additional €200 million is expected to be transferred during 2015-16, in line with CBC duties under the Treaties and the Statute. In line with practice in other European countries, we also plan to transfer the rights and liabilities associated with issuing coins from the CBC to the Treasury, which is expected to contribute €100 million in additional financing. To this end, we will amend the Central Bank Bill, expected to be approved by Parliament by end-June, when a MoU between the CBC and Ministry of Finance will also be signed. Finally, we remain committed to finalizing a debt-to-asset swap, which will reduce our public debt by €1 billion (about 6 percent of GDP), to be conducted in accordance with the CBC rules and the Treaties by end-July. To facilitate the transfer, the government has completed a valuation of the assets, and, to ensure compliance with the Treaty, a second valuation on behalf of the CBC will be completed before end-July.

16. **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 currency practices.

17. **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	
	Mar-14			Jun-14	Sep-14	Dec-14	Mar-15
	Target	Adjusted target 4/	Actual				
Floor on the general government primary balance 2/	-22	-23	90	6	40	-253	116
Ceiling on the general government primary expenditure 2/	1,504	1,505	1,476	3,158	4,784	6864	1520
Ceiling on the stock of general government debt	18,399		18,203	18,697	18,172	18994	19139
Ceiling on the accumulation of new general government guarantees 2/	0		-53	127	207	312	0
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0		0	0	0	0	0
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		-39	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ The primary balance and primary spending targets were adjusted down and up respectively by 0.6 million reflecting compensation payments to pension funds in Q1 2014.

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

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

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

Table 3. Cyprus: Existing and Proposed Conditionality	
Measures	Timing
Prior Action for the Fourth Review	
Adoption of legislation and regulations to fight tax evasion	Before Board Meeting
Proposed New and Modified Structural Benchmarks	
Approval by Council of Ministers of the strategy for reforming the debt-restructuring legal framework	End-July 2014
CBC supervisory units to submit to the CBC Board the first quarterly report regarding the coops' performance against selected operational and financial targets	End-July 2014 (modified SB)
Appointment of an independent firm and/or international institution to be entrusted with the voting rights of legacy Laiki in BoC	End-September 2014 (modified SB)
Approval by Council of Ministers of the debt-management strategy	End-October 2014
CBC submission of assessment of banks and coops implementation of action plans to address operational deficiencies and potential shortcomings related to compliance with the Code of Conduct and arrears management policies and practices	End-November 2014
Adoption by parliament of legislation to modernize personal and corporate insolvency procedures and to regulate insolvency practitioners assisting in the restructuring process	End-December 2014 (modified SB)
CBC assessment of internal audit on governance of bank debt restructuring	End-January 2015
Existing Structural Benchmarks	
Implementation of a new social welfare system	End-June 2014
Establishment of an integrated large taxpayers unit	End-December 2014

Attachment II. Cyprus: Technical Memorandum of Understanding

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.

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.

1. 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)

2. 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.

3. 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.

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

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

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

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

Ceiling on the General Government Primary Expenditure (performance criterion)

5. 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.

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

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

7. 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.

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

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

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

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

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

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

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

- Upwards (downwards) by the amount of any increase (decrease) of the disbursement of EIB and/or Council of Europe Development Fund loans to be guaranteed by the government in 2014 relative to the amounts presented in Table 1 of the MEFP. The annual provision of guarantees cannot exceed €312 million.

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

11. 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)

12. 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)

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

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

14. **Adoption of measures to fight tax evasion (prior action)**

Specification. The measures will include the following:

- Amendments of relevant legislation to establish self-assessment for all income taxpayers;

- Legislation and regulations to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to prohibit the alienation of immovable, seize movable assets and garnish bank accounts Powers related to garnishing bank accounts would not require a court order but could allow a short appeal period.

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

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

Table 1. Cyprus: Reporting Requirements

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

Table 1. Cyprus: Reporting Requirements (Concluded)

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

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

Attachment III. Cyprus: Memorandum of Understanding on Specific Economic Policy Conditionality (European Commission)

The economic adjustment programme is addressing 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

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

Progress since February

The authorities continued to implement the reform of the financial sector. With respect to the regulatory and supervisory framework, the operational integration for the supervision of cooperative credit institutions by the Central Bank of Cyprus was completed. The directives on loan origination and on provisioning were implemented and banks submitted their action plans for complying with the provisioning and disclosures directive. The assessment of the operational capacity of financial institutions to work-out non-performing loans was carried out, in the context of rising arrears. Due to internal resource constraints, the publication of the first Financial Stability Report had to be rescheduled for end-December 2014.

Restructuring of the financial sector has progressed well. The Cooperative Central Bank was effectively recapitalised by the State with the ESM notes on 10 March 2014. The merger of the individual coops into 18 institutions was completed as envisaged by end-March and the capital injections in the individual institutions have been completed in April. The appointment of qualified executive and senior management and the improvement of governance are ongoing. Bank of Cyprus is proceeding with implementing its restructuring plan and has agreed upon the key performance indicators to be communicated to the public on the restructuring plan implementation progress. Hellenic Bank submitted to the CBC its business plan in March. Banks have established specialised units to effectively deal with non-performing loans. The significant banks are participating in the on-going Comprehensive Assessment of the ECB, due to be completed by the end of October 2014. Further progress was achieved with the liberalisation of restrictive measures.

A. Regulation and supervision

Maintaining liquidity in the banking sector

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. The Cypriot authorities will ensure, in timely consultation with the EC, ECB, IMF and informing the ESM, that the relaxation of remaining domestic payment restrictions is consistent with financial sector stability and in line with the agreed strategy. Further progress under the program is needed before considering actions related to restrictions on the capital account.

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. The additional government guarantees for the issuance of bank bonds of up to EUR 2.9 billion in nominal value could be used as collateral against liquidity, if necessary to safeguard financial stability, in line with State aid rules.

The Bank of Cyprus and the Cooperative Central Bank submitted their capital and funding plans in April 2014. The CBC will continue to receive the updated plans **on a quarterly basis** and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the gradual easing of restrictive measures, and the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.

Regulation and supervision of banks and cooperative credit institutions

The authorities are proceeding with the establishment of the central credit register, which will be operational **by end-September** for credit assessment purposes. The CBC has received technical support on the use of the credit register for supervisory purposes and will, **by end-September**, develop options for the use of the credit register in line with best practices and finalise the content of the additional data to be collected by the credit register. The CBC has started preparations to harmonise the credit register at the euro area level, as a part of a broader process coordinated by the ECB, which is due to be completed in 2016.

Having reviewed its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning, the CBC introduced regulatory amendments. A new loan origination directive was adopted in October 2013, though implementation has so far been hindered by lack of financial information to enable an effective assessment of the repayment capacity of borrowers. The new provisioning and disclosure directive will be fully implemented by the time of the publication of the 2014 annual accounts. For the co-operative credit institutions, the requirements of the new provisioning and disclosure directive will be fully applied in their 2013 annual accounts. Following a request by the CBC, banks will report on the potential impact of newly introduced and upcoming EU rules on their profitability and coverage ratios **by end-June**.

The authorities will present an action plan to improve the enforcement of the requirement that the corporate financial statements are prepared on a regular and timely basis by end-September, with a view to introducing any necessary amendments to the legal framework **by end-November**.

BoC and the coops submitted in April and May 2014, respectively, a quarterly report describing the progress with the implementation of the restructuring plans. The reports contain a set of key performance indicators including selected operational and financial targets developed by the CBC and communicated to these banks. The CBC units responsible for the supervision of BoC and coops will assess these and subsequent reports **on a quarterly basis** and submit their conclusions and proposed actions to the CBC Board within four weeks of the receipt of the reports.

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

The CBC will request **by end-May** the internal audit department of BoC (including transferred Laiki operations) and of coops to submit **by end-September** a special examination report on lending and debt restructuring practices of BoC and coops with respect to loans related to former and current managers, directors, members of Committee and major shareholders of the groups, with the aim to identify decisions that have led to disproportionate losses in net present value terms. The CBC will complete its assessment of internal auditors' main findings and take appropriate action, including by requiring the institutions concerned to take civil action where applicable, **by end-January 2015**.

The independently audited consolidated accounts of the cooperative credit institutions for the year 2013 will be published **by end-June**.

The CBC will have sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The current recruitment of experienced staff should be finalised **by end-June**. The CBC will further assess the need to increase its staff, taking into account the new tasks undertaken under this Memorandum of Understanding and the tasks imposed by the creation of the Single Supervisory Mechanism **by end-October,** and address the identified needs **by end-December**.

In light of the new responsibilities taken on by the CBC, the revision of the Resolution Law and the transition to the Single Supervisory Mechanism, the Authorities will review the governance of the CBC **by end-June** and adopt the necessary legislative amendments **by end-September**.

The authorities, in consultation with EC, ECB and IMF and informing the ESM, reviewed the effectiveness of the Resolution Authority, including its composition and governance, in March 2014. The amendments to the Resolution Law are to be adopted **by mid-July**.

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

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

Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers. A framework for targeted private-sector debt restructuring is being established.

- Following the completion of the merger process for the cooperative credit institutions, an assessment of the operational capacity of the CCB's loan workout unit will be completed **by end-May**.
- Banks will be required to report **quarterly** on restructuring progress and management of NPLs. The first report, with reference date end-March, will be submitted **by end-June**, using specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.), which were approved by the CBC in consultation with EC, ECB and IMF and informing ESM. Furthermore, banks will report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).
- The CBC will, with assistance of an external expert, review banks' arrears management policies and practices, taking into account international best practices. The preliminary findings of this review will be presented to the EC, ECB and IMF, and informing the ESM, **by mid-July.** The review will be completed **by end-July** and serve as a basis for further

policy recommendations on the arrears management processes in credit institutions. Following the review, revisions of the Arrears Management Directive and of the Code of Conduct will be introduced as needed, taking into account the developments and timelines in the Single Supervisory Mechanism, **by end-September.** The responsible CBC supervisory units will examine the implementation of the banks' action plans to correct deficiencies identified by the external expert and submit the main findings and recommendations to the CBC Board **by end-November**.

- **By end-June**, the CBC will introduce requirements for banks and coops to submit agreed-upon procedure reports prepared by their external auditors on banks' effectiveness of debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016.
- The role of the Financial Ombudsman with regard to handling complaints on compliance with the arrears management process was clarified by end-March. The necessary legal amendments to the Law on the Financial Ombudsman are to be adopted, in consultation with the EC, ECB and IMF and informing the ESM, **by end-June**.
- 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 Cypriot authorities will prepare, **by mid-July**, an action plan for removing impediments for lenders to obtain adequate updated information on the financial situation of delinquent borrowers, under sufficient safeguards. These impediments will be fully removed **by end-December.**
- In order to encourage a market for distressed assets, the Cypriot authorities will prepare, **by end-June**, a report identifying impediments to transfer individual loans to third parties.

<u>Increasing financial transparency</u>

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

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).
- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- The supervisory competent authorities are reviewing their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions.

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

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

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

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

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

The authorities will finalise the transposition of CRD IV and national discretions under the CRR **by end-June**. As part of this process, the authorities will fix the Common Equity Tier 1 ratio at 8% under Pillar 1 in line with the harmonised benchmark applied under the baseline scenario of the ECB Comprehensive Assessment. In no circumstances will the implementation of CRD IV and CRR lead to any distribution of capital by the banks which were found in the PIMCO exercise to face a capital shortfall. In line with CRD IV, the CBC will request significant banks to maintain capital buffers in excess of the minimum Pillar 1 requirement based on conservative assumptions and to take prompt action if needed.

Management of legacy Laiki

In order to enhance the recovery value from the disposal of the assets of Laiki, the Resolution Authority instructed the Special Administrator to appoint a well-recognised and independent consulting or auditing firm(s) or international institution(s) to be entrusted with the voting rights associated with Laiki's shares participation in BoC. This appointment will be completed **by end-September.** The finalisation of the appointment of an advisor to provide services associated with the management of the disposal process shall be completed **by end-June**. As part of the terms of reference for the appointment of the advisor agreed in consultation with the EC, ECB and IMF and informing the ESM, an action plan for the full disposal of the assets will be developed **by end-July,** with a view to maximize value for creditors.

<u>Restructuring of Bank of Cyprus</u>

BoC has progressed with the implementation of the restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, to strengthen confidence in the bank, the CBC agreed with BoC on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public, together with the financial accounts.

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

<u>Restructuring and recapitalisation of cooperative credit institutions</u>

The final restructuring plan for the cooperative sector was submitted to the EC in January 2014. . On the basis of that plan and the commitments submitted by the Cypriot authorities, the Commission approved restructuring aid for the cooperative credit institutions as compatible with the internal market on 24 February 2014. The cooperative credit institutions that benefited from public capital injections are subject to specific management rules and restrictions and to a restructuring process, which is being scrutinised by an external monitoring trustee. The monitoring trustee will submit quarterly reports on governance and operations, as well as ad-hoc reports as needed and is working under the direction of the EC. In line with the EU State aid rules, the trustee will, inter alia, verify proper governance and the use of commercial-basis criteria in key policy decisions and assessing the soundness of strategies to deal with loan arrears. The monitoring trustee shall have access to Board meeting minutes, and be observer at the executive committees and other critical committees, including risk management and internal audit functions.

The merger of individual cooperative credit institutions into 18 entities was completed in March. These mergers were designed to achieve viability, efficiency and profitability. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones. Following the completion of the merger process and the establishment of the final governance structure of the sector, the CBC will review its affiliation directive **by end-July**.

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 Cooperative Central Bank was established, to ensure that the Cooperative Central Bank adopts sound policies, 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.

As part of the implementation of the restructuring plan, the Cooperative Central Bank has utilised external expertise to develop and implement policies and practices in the areas of arrears management and corporate restructuring. The recommendations made and deemed necessary by the authorities will be implemented. In addition, it will be ensured that the recruitment of executive and senior management of the CCB and CCIs takes place in line with international best practices and the established selection criteria, and will be completed **by end-May**. Moreover, to strengthen confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance

Management unit on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public.

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

C. Legal framework for private debt restructuring

All legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.

The authorities established a Task Force to prepare a study assessing the magnitude of registered, but untitled, land sales contracts and underlying mortgages and to develop recommendations **by end-June**.

The authorities will, in consultation with EC and IMF and informing the ECB and ESM, prepare a comprehensive reform framework to be endorsed by the Council of Ministers **by end-July**, establishing appropriate corporate and personal insolvency procedures. A draft of the reform framework as well as an impact assessment of various options on lenders will be completed **by end-June**, and shared with the EC, ECB, IMF and the ESM. On the basis of that framework, corporate and personal insolvency legislation will be adopted, which will include licensing and regulation of insolvency practitioners **by end-December**.

The legal framework in relation to foreclosures and the forced sales of mortgaged property will be amended in consultation with the EC and the IMF and informing the ECB and the ESM, and adopted **by end-June,** with immediate effect for all mortgaged properties except primary residences (for which provisions will enter into effect **by end-December**, in line with the adoption of the insolvency legislation), to allow for private auctions to be conducted by mortgage creditors, without interference from government agencies.

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

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

II. FISCAL POLICY

Key objectives

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

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

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 and have progressed in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[1] will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.5 of this Memorandum, will not be undertaken over the course of the programme period. The government will modify **by mid-June 2014** the bill amending the road vehicles and traffic law so that it will not include the provision for a tax amnesty for the payment of annual road tax.

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

[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 5.5, second bullet-point, indent 3

EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-2020 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

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

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

Fiscal policy in 2014

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of EUR 275 million (1.7% of GDP) in 2014[2] corresponding to a headline deficit of 5.3% of GDP (respecting the 16 May 2013 Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus). To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014 (Annex 1).

Fiscal policy in 2015-16

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 258 million (1.6% of GDP) in 2015, corresponding to a headline deficit of 5.1% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus). In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 201 million (1.2% of GDP), corresponding to a headline deficit of 2.4% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus)[3]. These targets and the underlying updated budgetary projection will be embedded in the 2015-2017 Fiscal Strategy Statement, which will be adopted by the Council of Ministers **by Q2-2014**.

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] ESA95 budgetary targets: These targets are not directly comparable to, but remain consistent with the respective cash-based budgetary targets agreed between the authorities and the IMF in the context of the economic adjustment programme.

[3] These targets do not include expected dividends of EUR 100 million per year, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

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

III. 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) take further steps to control the growth of health expenditure; (3) enhance tax revenues by improving tax compliance and collection; (4) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (5) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (6) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

A. 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.

Health care reform

B. 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) taking into account the findings of the functional review of the Ministry of Health, carry out health sector reforms, including restructuring all public hospitals/public health facilities, the Ministry of Health, the HIO, and other associated facilities/organisations based on a Reform Plan to be approved by the Council of Ministers **by Q2-2014**. The reform plan will provide for the autonomization of all public hospitals/public health facilities. All necessary legislative changes to be approved by the House of Representatives **by end-November 2014** aiming at full implementation **by Q2-2015**; Public hospitals complete the shadow-budgeting for all inpatient cases on diagnoses-related groups **by Q3-2014** and for all in- and outpatient activities **by Q4-2014**;

c) taking into account the economic conditions, the implementation of the necessary complementary reforms, the results of the updated actuarial study, and after consultation with the programme partners, implement a National Health System (NHS), to be fully in place **by mid-2016**.

1. The NHS will be developed and implemented based on the fundamental principles of free choice of provider, social equality and solidarity, financial sustainability and universal coverage of a minimum benefit basket.
2. Implementation will be carried out in three stages. **By mid-2015**, in the first stage of NHS, primary care consultation services will be covered. **By 1 January 2016**, outpatient specialist care and outpatient pharmaceuticals will be added to the benefits covered. Full implementation of NHS will be achieved **by mid-2016**.
3. NHS will be initially based on a single payer agency. The system may evolve into a multiple insurance system provided that the necessary preconditions for achieving efficiency and affordability gains (i.e. consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be ensured.
4. The detailed road map for the implementation of the NHS will be agreed with programme partners **by Q2-2014**. The amended bill of NHS will also determine and clarify the respective role, governance and responsibilities (notably concerning the strategic policy, budget control, monitoring, audit and regulation) of the Ministry of Health and the HIO and will be approved by the House of Representatives **by Q4 2014**.
5. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS.
6. An Implementation Advisory Team will be established **by end-June 2014**, drawing on national and international expertise, to assist the Ministry of Health with the implementation of NHS and health sector reforms. A study by an independent consultant, to be chosen in consultation with programme partners, will be undertaken to evaluate the functional and financial sustainability of the NHS operated by single or multi payer agencies; the study will also assess how and when the precondition mentioned in paragraph c)3 (ie consumer information and transparency, contestable markets, freedom to contract, fiscal viability of insurance agencies, competition regulation and risk-adjustment) can be achieved.

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, capacity planning) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded;
e) initiate the tendering of the IT-infrastructure necessary for implementing the NHS **by Q2-2014**;
f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q2-2014**;
g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

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

<u>Public financial management</u>

C. 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 Fiscal Responsibility and Budget System Law (FRBSL), including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance **prior to the granting of the fifth disbursement of financial assistance**;

- improve the risk-assessment analysis associated with government guarantees. To this end, submit for consultation with programme partners **by mid-July 2014** an advanced draft of the risk assessment report prepared by the Public Debt Management Office, with a view to a final version **by Q3-2014**. The report shall identify guarantees that are expected to result in calls in the current and following year;

- adopt a comprehensive medium-term debt-management strategy, **by end-October 2014,** aimed at: (i) smoothing the debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing risk-assessment of contingent liabilities from government guarantees. This will help paving the way for a sustainable return to market access in due time.

- implement guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by Q2-2014**. The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the implementation of the guidelines for public investment management; and

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

State-owned enterprises and privatisation

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

- the law regulating the creation and the functioning of SOEs at the central and local levels will be adopted by the HoR **by mid-June 2014**. The law will enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure. No additional SOEs will be created until the law has been adopted;
- the Cypriot authorities will submit for consultation with programme partners a plan with detailed timelines for the review of those SOEs that are under internal review **by Q2-2014**; and
- each SOE will submit a strategic plan to the competent minister for approval, in consultation with programme partners, and in line with the FRBSL and SOEs Law provisions **by Q4-2014.**

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

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

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

- establish the Privatisation Unit through the appointment of its Head and its experts, in line with the provisions of the Privatisation Law; the Unit will be fully operational **by June 2014**;
- appoint independent advisors for the CPA privatisation **by Q2-2014**, in accordance with the privatisation plan;
- appoint independent advisors for the privatisation of CyTA and EAC **by Q3-2014**, in accordance with the privatisation plan;
- approve, through the Council of Ministers and on the basis of the recommendations of the advisors, a detailed plan for the privatisation of CyTA, including the main characteristics of the transaction, **by Q4-2014.** CyTA will be converted into a Limited Liability company **by December 2014;**
- appoint independent advisors with relevant expertise and develop a plan with detailed intermediate steps and timings for disposing of the identified real estate assets **by Q3-2014**.

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

<u>Revenue administration, tax compliance, and international tax cooperation</u>

F. The Cypriot authorities will continue reforming the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection and the fight against tax fraud and evasion, with a view to increasing fiscal revenue.

In order to complete the agreed short-term measures, the following actions will be undertaken without delay and in no case later than by Q2-2014**:**

- attributing personal responsibility for payment of company taxes to those, who - in the case of non-listed companies - truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying withholding taxes is a criminal offence;
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, including by providing authority to garnish assets or prohibiting the alienation or use of assets, including property and bank accounts, by the taxpayer. The garnishing of bank accounts will not require prior court approval, but may allow for a short appeal period for the tax payer during which the relevant amount remains frozen; and
- 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.

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

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis, as well as on an evaluation of different risk treatment strategies. To further progress, the authorities will
    - make the data from the IRD available to selected staff by the tax administrations via one platform, to be used for integral risk identification and analysis **by Q2-2014**;
    - cleanse the income tax registers **by Q2-2014** and VAT registers **by Q4-2014**, by removing inactive cases and put in place a process to maintain the registers up-to-date;
    - further improve the joint work programme for large and high risk taxpayers and provide a progress report **by Q2-2014** and finalise the compliance risk management module for large taxpayers **by Q3-2014**, with a view to setting up the integrated large taxpayer unit of the new tax department (see below) **by Q4-2014**; and
    - **by Q3-2014**, elaborate an integral strategy for the prosecution of tax fraud as a criminal offence, including an evaluation of the required investigative and legal resources needed in the new tax department.

- The establishment of a new integrated function-based tax administration, integrating the existing Inland Revenue Department and VAT Service, based on the adopted integration plan. As next step, the authorities will, **prior to the fifth disbursement of financial assistance**, enact the enabling legislation for establishment of the new tax agency **by 1 July 2014**. The legislation should include provisions for a fixed term of office for the new Commissioner of Taxation and sound principles for rotation in occupying the office of the Commissioner of Taxation.

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

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

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;

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

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

- **prior to the fifth disbursement of financial assistance,** the authorities will submit to the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes the follow-up report detailing the actions to address the shortcomings identified, with a view to achieve full compliance. The authorities will continue with the swift implementation of the commitments taken to reverse the negative opinion by the OECD Global Forum and provide a progress report to programme partners **by Q2-2014.**

In addition, the authorities will monitor closely further progress in responding timely to tax information requests by EU and third countries. The authorities will submit to the programme partners quarterly performance updates (within 14 days of the end of the quarter).
In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending on 31 December 2013, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD. **In 2015**,

the Cypriot authorities will provide to the European Commission a report on the results of audits conducted in 2014. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country.

Immovable property tax reform

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

- implement a General Valuation (GV) for all immovable properties. The new values of immovable properties shall be determined on the basis of tangible building- and plot-related characteristics **by Q2-2014**;
- implement the recurrent immovable property tax based on the updated valuations for the tax year **2015**, at the latest. The design of the immovable property tax shall ensure progressivity and proceeds consistent with measure I.27 of Annex 1.

Necessary legislative changes should be adopted by the House of Representatives **by early July 2014,** following consultation with programme partners. Legislation specifying the frequency of the mandatory update of the values in line with international best practices should be enacted by **Q1-2015**, following consultation with programme partners.

In order to ensure a smooth and timely implementation of the new immovable property tax and to minimise the operational risks, the authorities will present to the programme partners **by end-June 2014**:

- a communication strategy aiming at informing of the goals of the property tax reform, the implications for citizens and the procedures of the new reform;
- a comprehensive objections' management strategy to effectively and timely deal with possible valuation complaints.

The strategies need to be clear and practical, explicitly defining the required steps and resources, and the envisaged timelines.

In addition, the authorities will:

- **by Q4-2014,** conduct an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV and identify possible missing parameters. Refine, if needed, the CAMA in light of this assessment **by Q2-2015;**
- conduct an assessment of the variance between GV assessed values and market price **by Q4-2014;** and
- implement **by Q2-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope for shifting revenues from transaction fees and taxes to recurrent taxation. The study will also provide an initial review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property **by Q2-2014**.

Public administration reform

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

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

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

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

The sectoral element will examine:

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

and comprises two batches:

- the first batch is undertaken by the World Bank and the UK public administration and covers the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. Based on the findings of this first batch, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q2-2014.** The relevant legislation in relation with the reforms in Agriculture, Education, local government indicated as high priority will be adopted by the House of Representatives **by Q3-2014**. The relevant legislation indicated as high priority on the Companies Registrar will be adopted **by October-2014.** The reform will start to be implemented **by Q4-2014**, in accordance with the reform plan.
- the second batch will cover all remaining Ministries (Labour, Welfare and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defence, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Directorate General for European Programmes, Coordination and Development (ex Planning Bureau) being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provisions of 3.4 and 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented **by Q4-2015.** They will include cost estimates and implementation timelines with detailed intermediate steps. Based on the findings of this review, the Cypriot authorities will agree

on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q1-2016.** The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q2-2016**. The reform will start to be implemented **by Q3-2016**, in accordance with the reform plan.

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

Welfare system

J. 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, Welfare 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:

- adopt the final design of the reformed welfare system by the Council of Ministers **by mid-June 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, along with provisions on the mandatory participation of beneficiaries to active labour market programmes;
- **by end-June 2014** establish a monitoring unit to assess the GMI outcomes (ie. number of applications and costs, targeting accuracy, coverage and impact on poverty);
- provide for consultation with the programme partners **by end-June 2014** a list of social benefits outside the GMI of which the beneficiary profiles and eligibility will be examined and **by mid-July 2014,**contingency measures to ensure fiscal neutrality of the reform in 2014.
- By **Q3-2014,** on the basis of an assessment of the possible fiscal impact of the welfare reform and as part of the budgetary process for 2015, update the costing of the GMI, and identify possible additional rationalization of social benefits outside the GMI in order to achieve fiscal neutrality of the reform;
- ensure that a comprehensive database and the necessary IT requirements, including all required interfaces with different databases to allow for the comprehensive verification of eligibility criteria, are in place to support the administration of the reformed welfare system **by end-June 2014**; and
- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour, Welfare 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 Q2-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation providing for the new guarantee minimum income scheme (GMI) will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted by Q2-2014**.**

IV. 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

A. 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. A tripartite agreement will be pursued with social partners by Q4-2014 **for the suspension of wage indexation in the private sector until 2016 and the application thereafter of the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation).**

Minimum wage

B. 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

C. 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 3.10.

D. The Cypriot authorities will continue the implementation of measures to address the identified shortcomings of the system of activation policies, including:

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

ii. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q3-2014**; and

iii. measures to ensure the effective cooperation between the public employment services, the social welfare services and the benefit-paying institutions in the activation of the unemployed who are recipients of social assistance, including by establishing clear procedures for the automatic exchange of information and a transparent system linking benefit receiving with job-search efforts.

E. 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 employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will submit by end-May 2014 **the National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative including also the implementation of the Youth Guarantee, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies and be coherent with the reform of the social welfare system (section 3.10) and the agreed budgetary targets. For this purpose, the authorities will submit** by end-May 2014 **a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.**

V. GOODS AND SERVICES MARKETS

Key objectives

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

Services Directive and regulated professions

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.

On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector (such as lawyers, engineers, architects), the Cypriot authorities will eliminate by law the requirements that are not justified or proportional **by Q3-2014**.

Competition, transparency and sectoral regulatory authorities

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

- continuing to provide sufficient and stable financial means, as well as qualified personnel in order to enhance its effective and on-going operation **by Q2-2014;**
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers. The amended law will be adopted by the HoR **by June 2014, at the latest**; and
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q2-2014**. The CPC may seek technical assistance to achieve this objective.

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

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

Housing market and immovable property regulation

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

The Cypriot authorities will:

- define binding administrative deadlines for the issuance of title deeds upon receipt of the certificate of final approval **by Q2-2014**. Moreover to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers, an amending bill concerning the Street and Building Permit Law will be submitted to the House of Representatives **by Q3-2014**, after consultation with the programme partners;
- prepare a joint action plan to streamline the processes within the DLS and between the DLS, the Local and District Authorities and the Ministry of Interior Technical Services **by Q2-2014**; This plan should detail the resources required across authorities, streamlined processes if needed, set clear deadlines for any consultations required for issuing a certificate of final approval, as well as means to enforce those deadlines;
- ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex- officio" issuance of title deeds, required certificates and permits). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. To that end, **by mid-July,** provide to programme partners granular data on the stock of backlogs of permits, deeds, and certificates and a strategy identifying ways to reduce this backlog and continue publishing the quarterly progress reviews, starting **in Q3-2014**;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**; and
- improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**. To that end, provide detailed statistics on court backlogs and duration of court proceedings to programme partners on a quarterly basis starting **in Q4-2014**, submit a draft action plan for the elimination of court backlogs, including the electronic filing of new documents **by end-October 2014,** and enact legislation to establish an Administrative Court **by Q4-2014.**

Tourism

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 tourism action plan twice per year, including an assessment of its implementation based on performance indicators, **by Q1** and **Q3** every year, starting from 2014. An update of the first progress report will be presented to the programme partners **by Q2-2014**.
- present a plan enhancing the coordination of the various tourism stakeholders and relevant authorities **by Q2-2014**. The plan shall include concrete actions and a roadmap leading to an effective mechanism for coordination.
- start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity.. The action plan approved by the Council of Ministers in May 2014 will be implemented **as of Q3-2014** and will be reviewed annually by the Cypriot authorities, in consultation with the programme partners.

Energy

The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to 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. This plan should take into account the relevant technical and commercial uncertainties and risks and should cover: the required investments, associated costs, financing sources and methods, ownership structure; major planning risks and bottlenecks; a projection of the revenue streams over time; and an appropriate sales framework for the off-shore gas supply for both exports and domestic markets aimed at maximising revenues. Next update **by Q2-2014.**

       Prior to finalisation of the forthcoming energy sector Government Agreement (GA) and its supplementary agreements between the Republic of Cyprus and the Contracting Parties to a Production Sharing Contract, the Cypriot authorities will undertake a financial and budgetary impact analysis of the GA and its supplementary agreements. The impact assessment will evaluate in detail the potential financial and budgetary impacts on the general government position of the envisaged LNG project 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 and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets. The outline should take into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, the prospects of privatisation of SOEs in the energy sector, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include a description of the sequence and timing of the major changes envisaged: the institutional framework; the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the setting-up of wholesale markets for gas and electricity; the customer's free choice of supplier; and the full unbundling of gas suppliers and customers,. The Cyprus authorities will in this context consider the intended use and duration of the available 'isolated market' and 'emergent market' derogations. An advanced intermediate draft will be provided **by Q2-2014,** with a view to a final outline **by Q4-2014**; and

3. an 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. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. The resource fund, established in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules should be provided for in the FRBSL and the specific law on the resource fund and detailed in implementing legislation of FRBSL. An advanced draft of the specific law will be submitted to programme partners for consultation **by Q2-2014,** before its submission to the House of Representatives.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time and collated in one summary document. For some of the technical aspects of the above key elements, technical assistance, where requested, will be provided.

VI. TECHNICAL ASSISTANCE

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

7. Growth Strategy

7.1 The Cypriot authorities will develop a comprehensive and coherent growth strategy that will help the economy to move to a sustainable growth path. The growth strategy will take into account the on-going public administration reform, public financial management reform, the commitments in the Cyprus Economic Adjustment Programme and relevant Union initiatives. The growth strategy will aim at, inter alia, creating a more attractive business environment, addressing administrative complexity, implementing more streamlined and simpler procedures, and it will also take into account the Partnership Agreement for the implementation of the European Structural and Investment Funds.

By **Q3-2014**, the Cypriot authorities will assign a single body to develop, coordinate, and enforce this growth strategy. Also **by Q3-2014**, the authorities will provide, in consultation with the programme partners, an action plan for the development, and implementation of the growth strategy. The Cypriot authorities may request technical assistance to further develop this strategy.

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.

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

I.37 A further targeting of social pensions;

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

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

Revenue measures

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

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

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

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

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

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

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

Annex 2

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

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

3			
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Compliant Q2-2014
2	**<u>Reliance/introduced business</u>**		
	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Compliant
	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Compliant
3	**<u>Suspicious Transaction</u>**		

	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.	Partially complian t Q2 - 2014
4	**Transparency of beneficial ownership**		
4. 1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC). 4.1.2. In the case of nominees, either a) require nominee directors[4] 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).	Complian t Complian t

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

4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant Ongoing
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Compliant
5	**Supervision of financial institutions**		
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,[5] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant

[5] 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.[6] 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.[7]	Ongoing
5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[8] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Compliant
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Partially compliantQ2 – 2014
5.	**Establish Formal**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate	Q2 –

[6] FATF Immediate Outcome (IO) 3

[7] See BCP 2.6c

[8] 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 beneficiarie loans (and of their beneficial owners).

4	**AML/CFT Training Program**	implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance; - risk assessment systems	2014
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing
5.5	**Implement adequate supervision**	5.5.1.a. CBC to establish corrective actions and follow-up on the cases revealed by Deloitte. 5.5.1.b. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Compliant Partially compliant Q2 - 2014
		5.5.2 On a quarterly basis, in the context of the programme review, starting Q4 2013 the CBC will on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Ongoing
		Subsequent to the successful development of the tools stipulated under 5.2 and 5.3, the CBC will undertake the following: 5.5.3.1 Implement and adjust the new risk-based offsite analytical tool(s) using the results of	Q2 - 2014

		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.	
		5.5.4.1 CBC to start implementing the new examination/verification procedures in line with the inspection program for 2014, and to adjust/fine-tune the procedures using the results of the pilot inspections. 5.5.4.2 CBC to update the institutional risk profile and supervisory strategy based on the results of the pilot inspection.	Q2 - 2014
6.	**Supervision and monitoring of lawyers, accountants and TCSPs**		
6. 1	**Align resources with risks** **Establish an effective 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.	Ongoing
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).	Ongoing (CBA and ICPAC) Q3-2014 (CySEC)

		6.2.2.1 Implement the new offsite analytical tool(s) through pilot reviews of a selected group of business and professionals. Adjust/fine-tune the offsite analytical tool(s) using the results of the pilot reviews. 6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise. 6.2.2.3 Apply the risk-based off-site analytical tools, assign ML/TF risk profiles, and developed customized supervisory strategies to all business and professions under monitoring.	Q2-2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.3	**Develop risk-based tool(s) for Onsite inspections prior to implementation**	6.3.1 Design and develop a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program	Q2 – 2014 (CBA and ICPAC) Q3-2014 (CySEC)
6.4	**Establish Formal AML/CFT Training Program**	6.4.1 Establish formal AML/CFT training program and develop and deliver customised AML/CFT training courses. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools - customer acceptance policies - customer due diligence (CDD) - monitoring of transactions - identification and reporting of STR - recordkeeping - compliance function - risk assessment systems etc.	Q2– 2014 (CBA and ICPAC) Q4-2014 (CySEC)
6.5	**Implement adequate supervision**	6.5.1. On a quarterly basis, in the context of the programme review, starting Q4-2013, the CySEC, CBA and ICPAC will, on a confidential basis, share anonymised information with the programme partners by granting access, to supervisory assessments and information about enforcement actions applied for non-compliance and /or violations of laws and regulations.	Ongoing

		Subsequent to the successful development of the tools stipulated under 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)

<u>Annex 3</u>

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.9 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour, Welfare 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 the Directorate General for European Programmes, Coordination and Development (ex Planning Bureau), is being 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 [9]

ii. Authority for the Supervision of Cooperative Societies [10]

iii. Competition Protection Commission

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

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

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No.14/319
FOR IMMEDIATE RELEASE
June 30, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fourth Review Under the EFF for Cyprus and Approves €84 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Cyprus's performance under an economic program supported by a three-year, SDR 891 million (about €1 billion) extended arrangement under the Extended Fund Facility (EFF). The completion of this review enables the disbursement of SDR 74.25 million (about €84 million), which would bring total disbursements under the arrangement to SDR 371.25 million (about €420.2 million). The Executive Board also approved the modification of end-June fiscal performance criteria.

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

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

"The Cypriot authorities are to be commended for their achievements during the first year of their economic program. They recapitalized and restructured the financial sector, removed domestic payment restrictions, implemented an ambitious fiscal consolidation, and initiated important structural reforms. As a result, macroeconomic and fiscal outturns have been better than expected, and Cyprus recently re-accessed international capital markets. Looking ahead, challenges and risks remain, and full and timely policy implementation will be critical to the program's continued success.

"Building on the progress made in strengthening the financial sector, efforts should focus on addressing the high level of non-performing loans, which is hindering the provision of credit and the resumption of growth. Swift implementation of the new debt-restructuring legal framework is essential to provide adequate incentives to voluntary loan workouts. The authorities also need to intensify supervisory monitoring of banks' loan restructuring efforts, further strengthen overall supervision and regulation, and fully implement the anti-money laundering framework.

"The full elimination of domestic payment restrictions has helped to support activity and strengthened confidence. Further progress with restructuring and normalizing banks' liquidity and funding will be needed to allow the removal of external capital controls while safeguarding financial stability. Adequate provision of liquidity by the Eurosystem remains essential.

"The authorities' ambitious fiscal consolidation and prudent budget execution have helped reduce the fiscal deficit. Given lingering macroeconomic uncertainty, the authorities should continue to implement the budget cautiously. Further well-paced fiscal adjustment is needed in the medium term to ensure debt sustainability. Fiscal efforts should be complemented by structural reforms to protect vulnerable groups, modernize the revenue administration, strengthen debt and fiscal risk management, and privatize state-owned assets," Ms. Lagarde said.

Statement by Mr. Menno Snel, Executive Director for Cyprus,
and Mr. Ektoras Kinaris, Advisor to the Executive Director
June 30, 2014

Introduction

Cyprus continues its strong performance under the program. As staff acknowledges, significant progress has been made towards the program's objectives in its first year of implementation, with the fourth review serving as another successful milestone in Cyprus's difficult but necessary adjustment path. The program remains well on track, with all performance criteria observed with considerable margins. Despite an ambitious structural reform agenda, compliance with the requirements of structural conditionality is being resolutely adhered to. Even as some minor delays were sometimes inevitable, requirements for all seven structural benchmarks were observed by the time of this review, though two were partially completed and are very close to finalization.

Evidently, political ownership and commitment to program objectives remain strong, as the authorities share their international partners' strategy to render the Cypriot economy in a healthy state. Of course, the society's soberness throughout these reforms has been a noteworthy lever in the authorities' efforts. In another vote of confidence, the outcome of the recent European elections underlines the still-prevailing broad support for the government's adjustment efforts.

On the back of a largely successful first program year, 2014 has carried forward much of the positive momentum, with several encouraging developments since the last review. The Economic Sentiment Indicator recorded its twelfth consecutive increase in May, to 99.3 from 93.5 in March, reaching its highest level since 2010. Tourist arrivals have also shown a promising recovery in April and in May, confirming earlier signs of a successful season. In the banking system, deposits recorded the first net inflow in April since December 2012, signifying the gradual return of trust and triggering the abolition of all domestic payment restrictions. Moreover, in another tangible proof of support from our European partners and the international community, in May 2014, the EBRD made the decision to complement Cyprus' international bailout program. The EBRD has announced that it expects to invest between €500-€700 million in Cyprus through 2020 to help the country overcome transition challenges that have emerged and to strengthen the financial sector, making it more robust to future shocks and improving its governance. The EBRD has stated that it will also support the authorities' privatisation program and it will assist in corporate restructuring while also providing finance to small- and medium-sized enterprises, in support of the objectives of the adjustment program.

Developments on financial markets were among the most positive. With rating agencies reversing a long trend of successive downgrades, sovereign bond yields continued their steep downward trend, reaching their lowest level since May 2011. On the back of these positive developments, and in coordination with its international partners, Cyprus decided to capitalize on its efforts by attempting an early return to international markets. In this regard, on June 18, €750 million were raised in a sale of five-year notes, marking the island's return to the markets after three years, and more than a year earlier than envisaged under the bailout program. The debt issuance, which was four times oversubscribed, not only reduces the Republic's average interest cost but also improves the debt maturity profile which is currently front loaded in the post program years, as staff correctly points out. In addition, the funds aim to improve BoC's liquidity by reducing its exposure in Laiki's recapitalization bond.

Notwithstanding this generally supportive backdrop, the authorities are aware that significant challenges remain. With this in mind, the authorities wish to reiterate that these positive developments will not in any way trickle down to complacency. On the contrary, they encourage their efforts to reform and strengthen the economy.

Macroeconomic developments

Fundamentals continue to improve at a gradual yet promising rate, even as they are far from satisfying when seen in absolute terms. The recession continued to moderate as GDP growth fell by 4 percent y-o-y in the first quarter of 2014, reaffirming that last year's resilience was not a one-off. In particular, performance of tourism continued to hold well, whereas the shipping and professional services recorded a smaller downturn than expected. Similarly, consumption fell by less than anticipated with positive net exports further dampening the impact. Overall the first quarter of 2014 over-performed earlier expectations, contributing to an upward revision in program projections for this year's outcome (-4.2 percent from -4.8 percent in the third review). The authorities project a somewhat more favorable outcome than that of Fund staff for 2014 and beyond.

Following a steep increase in 2013, unemployment is also starting to show some nascent signs of stabilization albeit at an uncomfortably high level. In part, this may be an unavoidable adjustment as the imbalances unwind. The harmonized unemployment rate has fallen from a peak of 16.9 percent in 2013 to 16.4 percent in April, 2014. Though it is still forecasted to edge upwards in 2014, there are several mitigating factors that are contributing to this moderating trend. For instance, the persistent sharp declines in nominal and real labor costs have been able to contain employment cuts, also resulting in the associated competitiveness benefits. Notwithstanding, this trend also reflects a shrinking labor force both from migration outflows and from a shrinking public sector workforce which has been significantly reduced over the last year through early retirements. The public sector is expected to be further reduced going forward through retirement schemes in the state-owned enterprises as they gear up for privatisation, with the Telecoms company already reaching an agreement to reduce its staff by a quarter. Overall, the labor market has proven more flexible than originally anticipated with recent data suggesting that employment is bottoming out.

Inflation dynamics will need to be carefully monitored. Reflecting the ongoing wage and price adjustment, core inflation edged up to 0.2 percent in the first quarter, after having turned negative in the fourth quarter of 2013. These levels warrant caution; on the one hand, they help restore competitiveness, but on the other, they can act as a countering force in the authorities' efforts to resume growth and reduce the debt overhang.

The current account has seen a sharp improvement, highlighting the economy's ability to adjust. The deficit narrowed to -1.9 percent of GDP in 2013 from -6.9 percent in 2012. While the improvement was mainly due to a drop in goods' imports, there has also been some improvement in the exports of domestically produced goods. The services balance too showed an improvement, as tourism revenues increased. The deficit is expected to further improve going forward as competitiveness is being reestablished.

Fiscal

In spite of the recessionary environment, fiscal performance through end March continued to outperform expectations for the quarterly estimate, suggesting a continuation of the good performance evidenced in 2013. The primary balance recorded a surplus of 0.6 percent of GDP in Q1, 2014, comfortably meeting the Quantitative Performance Criterion which suggested a small deficit. This largely reflects better than projected revenue performance, in both tax and non-tax revenues, ending up 0.5 percent of GDP above the estimate. Expenditure too came in lower than original estimates, driven by lower intermediate consumption and capital expenditure.

For 2014, the authorities' primary deficit target was further reduced to 1.6 percent of GDP, from 2 percent of GDP in the third review and 3.3 percent before that. While the latest revision reflects the impact of higher growth, it also assumes some improvement on a cash basis. Throughout the program, the authorities have repeatedly demonstrated their commitment to do all that is feasible to meet – at a minimum - their fiscal targets and intend to keep their strong track record of delivery on the challenging deficit objectives for the coming years. Should downside risks to growth materialize, the authorities take note of staff's view that flexibility may be required to allow automatic stabilizers to operate. This notwithstanding, the authorities do not expect to face this dilemma as the preliminary indications for the first half of the year remain reasonably encouraging. In addition, the adoption of legislation and regulations to fight tax evasion last week - a prior action for this review- serves as another structural layer for safeguarding and strengthening future revenues.

Financial sector

Arguably, financial sector reform was and remains the cornerstone of this program and its prospects. The reforms to date have been bold and numerous, with notable adherence to an ambitious timetable of concrete steps aiming towards the stability and reconstitution of the banking system. Since the last review, requirements for another five financial sector structural benchmarks were observed (one partially), though admittedly the transition to the

SSM and preparations for the comprehensive assessment of the banking system are testing the already limited capacity. As detailed in the report, a much broader range of measures and initiatives is being carried out to ensure the system's return to a healthy state.

More than a year later from the bail-in of uninsured depositors and the imposition of restrictive measures in the economy, the financial system finds itself much closer to a stable state. Systemwide deposit outflows have continued to normalize with net inflows recorded in April and in May. Though these were attributed to non-resident deposits into foreign banks, this development also heralds a faint return in international clients' confidence. Trust between domestic depositors, however, remains dispersed as there is evidence that citizens continue to hold substantial amounts of cash outside the banking sector in homes and safe deposit boxes at banks.

The report accurately highlights the criticality of addressing the high level of NPLs. Indeed, NPLs in Cyprus are the highest in Europe though it would be useful to recall NPL growth is at par with PIMCO's projections and that their definition is based on a relatively more stringent definition, in line with the definition the European Banking Authority is expected to adopt by the end of this year. Even so, these clearly stand at unacceptably high levels and bringing them down will be the authorities' and the banks' ultimate test. A considerable amount of technical assistance has been provided on this issue to date, bringing together expertise from the Fund, third party specialists and extensive knowledge from other country experiences. While this is an exercise that implies reform at many levels – banks, supervision, legislation and civil institutions – much of it is has been finalized or close to completion, thereby laying the foundations and incentives for healthy debt restructurings. For instance, banks have established specialized units to deal with troubled borrowers while external consultants assist in refining the units' operational efficiency. This complements the Central Bank's Arrears Management Framework, the Code of Conduct for borrowers and creditors, and the loan origination directive. At the same time, the authorities are revamping their legal and operational framework to provide tools that will promote the voluntary workout of non-performing loans. More recently, legislation has been drafted which will facilitate the forced sales procedure by enabling mortgage creditors to conduct private auctions. While this will help create an efficient foreclosure procedure, it will ultimately discourage strategic defaults and incentivize voluntary debt restructuring. Finally, the insolvency framework reform is being accelerated and once enacted should further assist in cleansing unrecoverable loans from banks' balance sheets.

Undeniably, witnessing tangible results of these efforts will take a while as appropriate time will need to be given to allow loan resolutions to work through the system. With deleveraging being the core priority, credit growth continues to be inhibited and staff rightly flags concerns over access to credit, though demand is also a factor. According to the latest Bank Lending Survey, further tightening of credit supply for households is expected for the second quarter of 2014, while the weakness in the demand of credit is likely to persist.

Meanwhile, the banking system's challenging liquidity position and the cautious approach due to the upcoming comprehensive assessment add to these constraints. Though banks were able to decrease their reliance on exceptional funding in the first quarter of 2014, it still remains high. The authorities and banks are exploring ways to improve the cost and amount of liquidity within their limited toolkit. In this sense, the recent ECB policy initiatives are welcome, though their impact still remains to be fully appreciated.

Finally, the gradual liberalization of restrictive measures continued apace and in line with the four stage roadmap. Restrictive measures relating to cash withdrawals, cashing of cheques and limits on transfers within Cyprus were lifted in the last few months, epitomized by the abolition of the last domestic restriction on opening new current accounts at end-May. With the opening of current accounts, payments within Cyprus are totally free, leaving only the cross-border capital controls in place.

Structural reforms

The authorities continue to implement difficult, yet necessary structural reforms that span across the whole economy. With significant parts of the reform agenda already in motion, these will increasingly facilitate the adjustment and the economy should soon start to reap the associated benefits. Progress is being made, inter alia, in a wide range of the goods and services market such as regulated professions, public administration review, public financial management, housing market, health, pensions, tourism and energy.

More notable, and given the need for society's support throughout the adjustment period and beyond, reform of the social safety net is a key objective of this administration. To this end, the structural benchmark requirement pertaining to the government approval of the Guaranteed Minimum Income reform was achieved. Through improved targeting, this reform is expected to increase coverage by 20 percent over the existing scheme and reduce poverty by as much as 70 percent in absolute terms, while maintaining budget neutrality. At the same time, the scheme will be governed by a single administrative framework yielding efficiency gains and reducing benefit abuse.

Ambitious reforms of the tax revenue and public administration are also envisaged in the program, aimed at improving tax compliance, fighting tax evasion and making the public sector more effective in performing its tasks. In early June, a law that enabled the consolidation of the existing two tax authorities was passed, which should improve collections efficiency. Building further on this progress, the parliament approved last week, as a prior action for this review, legislation that will significantly aid the fight against tax evasion. Specifically, the new legislation gives increased powers to the tax authority including the authority to prohibit the alienation of immovable assets, seize movable assets, and garnish bank accounts.

Not least, since the approval of the privatization plan in March, steps have been taken to prepare the first SOEs for their sale, namely the port authority and the telecoms company. Their structures are being refined to increase their value and overall appeal to private investors. Moreover, the head of the privatization unit has been appointed, bringing in significant M&A expertise, while the rest of the unit's staffing is proceeding as envisaged and should be operational soon.

Conclusion

Cyprus' adjustment program continues to carry forward much of last year's positive momentum. Through decisive action to address its economic difficulties and restore stability, the authorities continue to meet their commitments to international partners despite their strained capacity. In return, green shoots continue to emerge. The recession is moderating, fiscal performance is exceeding expectations yet again, the financial system is stabilizing absent of all domestic restrictions and, after three difficult years, international debt markets have once again opened up for Cyprus. Importantly, these clear indications that the recovery process is solidifying, fuel the authorities' determination and efforts to continue along the agreed path. The authorities are fully aware that these improvements need to be sustained as there remain many challenges to overcome before the economic recovery is complete. Nevertheless, they remain confident that with continued support and guidance from their partners, they will move closer to their objectives with each review. In support of the continuing efforts by the government and the people of Cyprus, the authorities are requesting the Board's approval of the completion of the fourth review and associated modifications of performance criteria.