Statement by the European Commission, ECB and IMF on the First Review Mission to Cyprus
July 31, 2013

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia during July 17-31 for the first quarterly review of Cyprus's economic program, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The program's objectives are to restore financial sector stability, strengthen public finance sustainability, and adopt structural reforms so as to support long-run growth, while protecting the welfare of the population.

Our overall assessment is that Cyprus's program is on track. All the fiscal targets have been met as a result of significant fiscal consolidation measures underway and prudent budget execution. The authorities have taken decisive steps to stabilize the financial sector and have already been gradually relaxing deposit restrictions and capital controls. While the authorities have started to implement the program with determination, risks remain substantial. Continued full and timely policy implementation is essential for the success of the program.

The short-run economic outlook remains difficult and subject to considerable uncertainty. Recent indicators support the program's projections of a contraction in output of about 13 percent cumulatively during 2013-14. Encouragingly, confidence indicators have improved somewhat from the lows hit in April. But the labor market has weakened more than anticipated, and unemployment has continued to rise. Growth is expected to recover modestly starting in 2015, driven by non-financial services.

Financial sector policies have been geared toward restoring confidence in the banking system. The authorities have taken difficult but necessary steps to fully recapitalize Bank of Cyprus, thus allowing it to exit resolution and return to normal operations. Aiming at supporting economic activity while ensuring financial sector stability, they are developing a milestone-based roadmap for the gradual removal of capital controls and administrative restrictions in an orderly and predictable way. The authorities have also set out a clear agenda to restructure and recapitalize other financial institutions, including the cooperative credit sector, before the end of the year, using program resources where necessary, and without involving depositors. Banking sector regulation and supervision is also being strengthened, including the integration of the supervision of the cooperative credit sector into the Central Bank of Cyprus. The authorities have developed an action plan to strengthen the implementation of the AML framework.

On **fiscal policy**, the ambitious package of measures already implemented and a prudent execution of spending are yielding results, with the primary fiscal deficit in the first half of the year better than the program target for the same period. Over the longer run, the government’s fiscal policy remains anchored in achieving a primary fiscal surplus of 4 percent of GDP by 2018, needed to place public debt on a firmly downward path.

Major **structural reforms** are being designed to modernize fiscal institutions. To improve efficiency, revenue administration will be substantially overhauled, including by integrating the internal revenue and the value added tax services departments. At the same time the authorities will take measures to fight tax evasion and boost revenue collection, which can also help during the current downturn. The authorities are also embarking on a fundamental reform of the social welfare system to provide better protection of vulnerable groups. The core of the reform is the introduction, by mid-2014, of a guaranteed minimum income (GMI) scheme together with the elimination of duplicate benefits. The GMI will provide assistance to those who do not have sufficient income to cover basic needs, thus effectively expanding the coverage of public assistance, while remaining within the budgetary envelope.

Next steps: Approval of the conclusion of this review is expected to be considered by the Eurogroup and the Executive Board of the IMF in September. Approval would pave the way for the disbursement of €1.5 billion by the ESM, and about €86 million by the IMF.