EUROPEAN COMMISSION

STATEMENT

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Statement by the European Commission, ECB and IMF on the Fifth Review Mission to Cyprus

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia during July14-25, 2014 for the fifth review of Cyprus's economic programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. Cyprus's programme seeks to ensure the recovery of economic activity to preserve the welfare of the population by restoring financial sector stability, strengthening public finance sustainability, and adopting structural reforms to support long-run growth.

Staff-level agreement was reached on policies that could serve as a basis for completion of the fifth review. The authorities have continued to meet the fiscal targets with significant margin in the first half of the year, as a result of prudent budget execution. In the financial sector, banks are advancing with their restructuring plans and capital raising while supervisory monitoring of their actions and operational capacity to address non-performing loans has been enhanced. Structural reforms are proceeding: the authorities have implemented a welfare reform providing a guaranteed minimum income for all those in need, have commenced the integration of the revenue administration, and have strengthened the administration's powers to fight tax evasion.

The macroeconomic outlook remains broadly unchanged compared to the fourth review. Output in 2014 is expected to contract by 4.2 percent, with growth in the tourism sector cushioning weak activity in other sectors. Unemployment remains very high, although signs of stabilization are emerging. Growth in 2015 is projected at 0.4 percent, with the recovery constrained by the high level of private sector debt. Risks remain significant, related to constraints to the supply of credit, as well as to the ongoing crisis in Ukraine.

Reversing the rising trend of non-performing loans is critical to restoring credit, economic growth, and the creation of jobs. Putting in place without delay an effective legal framework for foreclosure and insolvency is essential to ensuring adequate incentives to borrowers and lenders to collaborate to reduce the level of non-performing loans. Moreover, the debt-restructuring supervisory framework needs to be further strengthened. Ongoing efforts by banks to proactively raise capital in the private markets are welcome. Such efforts will also be conducive to a smooth transition to the Single Supervisory Mechanism following the completion of the pan-European comprehensive assessment and should therefore help to strengthen the banks' resilience to shocks and ability to revive lending.

Banks and the coop sector should continue to implement their restructuring plans. Further reducing operational costs, ensuring stable funding, strengthening arrears management capacity and processes, and improving governance are key ingredients for a healthy banking sector that can support the economy and allow for the gradual relaxation of

capital controls according to a revised milestone-based roadmap. To prevent vulnerabilities from re-emerging and preserve the integrity of the financial sector, the authorities need to further strengthen supervision and regulation and step up the implementation of the Anti Money-Laundering (AML) framework, in particular with respect to AML supervision of banks.

The authorities have pursued a cautious fiscal policy, which helped allow them to over-achieve fiscal targets consistently. Such prudence should continue, in light of lingering risks. In particular, next year's budget needs to be based on conservative assumptions, ensure the fiscal neutrality of the new welfare reform, and help achieve a smooth path towards the medium-term primary fiscal surplus target of 4 percent of GDP in 2018 that will put public debt on a sustained downward path.

The authorities should maintain the structural reform momentum. With the welfare reform adopted, the authorities must focus on its implementation to ensure that vulnerable groups are protected during the downturn. They also need to advance the implementation of the revenue administration reform by taking further steps toward the integration of the two tax departments under a unified and more effective administration. This should be complemented by continued efforts to combat tax evasion and non-compliance and strengthen the management of public debt and of fiscal risks. Timely implementation of the privatization plan is necessary to increase economic efficiency, attract investment, and reduce public debt.

Given still high risks, continued full and timely policy implementation remains essential for the success of the programme.

Conclusion of this review is subject to the approval process of both the EU and the IMF. The matter is expected to be considered by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF in late September. Their approvals would pave the way for the disbursement of €350 million by the ESM, and about €86 million by the IMF.

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