Cyprus: 2014 Article IV Consultation
Concluding statement of the IMF Mission
July 30, 2014

1. **Cyprus accumulated large imbalances, which were exposed in the crisis.** In the years preceding the crisis**,** significant foreign inflows led to a rapid expansion of the banking sector to eight times the size of the economy. Easy credit fuelled a housing boom and an increase in private-sector indebtedness to one of the highest levels in the euro area. Surging imports relative to exports—exacerbated by an erosion of competitiveness as wage growth exceeded productivity—resulted in a steep rise in the current account deficit. And public debt swelled due to a loose fiscal policy after entry into the eurozone in 2008. These imbalances were exposed in the crisis, which culminated in a collapse of the banking sector.

2. **To address the crisis, the authorities embarked on an ambitious adjustment program supported by official financing**. The program, underpinned by €10 billion (60 percent of Cyprus's GDP) in financial assistance, aims to restore financial sector stability and public finance sustainability so as to pave the way for growth. Resolute measures were taken upfront. The two largest banks were resolved and the resulting merged institution was recapitalized consistent with protecting debt sustainability, while payment restrictions and capital controls were put in place to safeguard financial sector stability. The cooperative credit sector was also recapitalized and restructured. To help strengthen the public finances, the authorities implemented an ambitious package of fiscal measures, including key structural reforms of the public sector wage indexation mechanism and the pension system.

3. **While significant progress has been achieved, overcoming the legacy of the crisis will be challenging**. Following the recapitalization of the banking sector, the authorities removed all domestic payment restrictions. These achievements, together with better-than-expected economic and fiscal performance, allowed Cyprus to re-access international markets earlier this year. Still, public and private sector debt remain very large and the unemployment rate, at over 15 percent, is unacceptably high. Rising non-performing loans (NPLs) and tight capital and liquidity buffers limit prospects for the resumption of credit growth, output growth, and job creation, as well as for the removal of capital controls. Addressing these challenges successfully hinges on continued firm policy implementation. Continued euro area recovery and support from European policies will also contribute to restoring growth and stability in Cyprus.

4. **The economy is undergoing a deep but unavoidable adjustment, and the outlook is subject to risks**. Output contracted by 5½ percentage points in 2013, as consumption and investment declined abruptly following the crisis. Still, the recession was less severe than initially expected, with the fall in financial sector activity and construction cushioned in part by resilient tourism. The recession is projected to continue this year, with a modest recovery expected to take hold in 2015, and a gradual increase in growth toward 2 percent over the medium term. Risks remain significant, related to uncertainty about the magnitude and pace

of private sector deleveraging and the ability of banks to address NPLs, as well as to geopolitical tensions over Ukraine-Russia.

5. **The stabilization of the banking sector is a major achievement; but several challenges need to be addressed to restore the sector's ability to support the economy.** Following actions taken to recapitalize and restructure the banks and coops, aggregate deposit flows have broadly stabilized. A number of critical and interrelated issues still need to be dealt with to ensure banks' long-run viability, enhance confidence, and facilitate the relaxation of capital controls:

- ***Addressing the rise in NPLs***—now more than half of total loans and 140 percent of GDP—is critical to strengthening banks' balance sheets and reducing private sector indebtedness. The Central Bank of Cyprus developed an arrears-management framework to guide loan restructuring negotiations, and banks have put in place structures and policies to implement it. Still, progress has been slow, due to weak incentives for both lenders and borrowers to come to mutually-agreeable solutions. A streamlined foreclosure framework is urgently needed to promote payment discipline, where capacity exists, and facilitate restructuring, where ability to pay is constrained by the downturn. This will need to be complemented by a reform of the insolvency framework, to guide the restructuring process for viable borrowers and provide solutions to address the debt of non-viable ones. At the same time, the Central Bank needs to further strengthen the arrears-management framework, ensure that banks' enhance their operational capacity, and increase supervisory monitoring of banks' efforts toward achieving long-term debt restructuring solutions.

- ***Boosting capital buffers and advancing restructuring*** are key to ensuring banks' long-run viability and the resumption of lending. Financial institutions have been recapitalized on the basis of an independent assessment under conservative assumptions. Nevertheless, in light of still high macroeconomic uncertainty, and given the ongoing pan-European comprehensive assessment, banks will need to ensure adequate capital buffers to deal with potential additional shocks. In this regard, the recent announcement by Bank of Cyprus regarding its successful raising of €1 billion in capital in the private markets is welcome. At the same time, banks and the coop sector need to continue their restructuring efforts by further reducing operational costs, strengthening capacity and processes, and improving governance.

- ***Relaxing capital controls*** is predicated on a normalization of bank funding. Reliance on central bank support remains significant, which reduces the availability of collateral for other uses. Further efforts are needed to address this issue, including by increasing access to market funding. In this context, the relaxation of capital controls will need to be gradual and underpinned by a transparent milestone-based strategy and by continuous monitoring and analysis of deposit and liquidity trends. Adequate provision of Eurosystem liquidity remains essential.

- ***Strengthening supervision*** is needed to prevent vulnerabilities from re-emerging. The Cypriot authorities are working toward full harmonization of their regulatory and supervisory framework with pan-European rules. At the same time, domestic supervisory capacity needs to be further strengthened to ensure a smooth transition to the Single Supervisory Mechanism. The authorities also need to continue to enhance the implementation of their AML/CFT framework, including by better integrating prudential and AML/CFT supervision.

6. **A substantial fiscal consolidation has been implemented.** The authorities have put in place an ambitious package of measures of close to 7 percent of GDP in 2013-14, broadly balanced between revenues and spending. The effort has helped to sustain tax revenues despite the deep recession and to unwind part of the increase in public sector wages and social transfers in the run up to the crisis. Moreover, the authorities executed the budget prudently, further tightening discretionary spending in the face of unusually high macroeconomic uncertainty. These efforts resulted in a decline in the fiscal deficit in 2013. This year, the primary deficit is expected to fall further, to about half its 2012 level.

7. **However, with public debt high and still rising, significant medium-term consolidation is needed.** An additional fiscal effort of permanent nature will be required to achieve and sustain the authorities' primary surplus target of 4 percent of GDP by 2018, consistent with the objective of bringing public debt down to around 100 percent of GDP by 2020. The adjustment should be gradual and aim to balance short-run cyclical considerations with long-run sustainability objectives. A growth-friendly consolidation would need to focus on fully unwinding the spending increases preceding the crisis, while protecting capital expenditures. There is scope to further reduce the public sector wage bill, complemented by reforming the pay structure to better link pay with performance and eliminate automatic increments before the wage freeze expires in 2016. Further savings could be achieved by reforming the education sector and pensions.

8. **With important structural reforms initiated, the focus needs to be on implementation.** The authorities have legislated sweeping reforms in many areas: (i) the pension system; (ii) the public sector wage-indexation mechanism; (iii) the welfare system; (iv) public financial management; and (v) revenue administration. These initiatives are essential to ensuring the sustainability of the fiscal consolidation efforts. Looking forward, the authorities need to ensure that reforms are fully implemented and operations are not disrupted during the transition period. Privatization efforts should also continue. Given the ambitious agenda, additional medium-term reforms, such as of the healthcare system and public administration, would need to be implemented prudently, to minimize fiscal risks. They should also be carefully sequenced, to avoid capacity overload. Finally, in developing their new growth-enhancing strategy, the authorities should focus on measures to address key bottlenecks and improve competitiveness.

9. **Cyprus has come a long way in addressing the crisis.** The financial sector has been stabilized, substantial fiscal consolidation has been implemented, and sweeping structural reforms are underway. The cost of the crisis has been large, and painful but necessary measures have imposed an unavoidable cost on the population. Looking forward, significant challenges remain, and they will not be resolved overnight. The authorities will need to stay focused on and committed to adopting the necessary policies to advance their adjustment program in order to pave the way for sustainable growth.

We thank the authorities for their hospitality and open and constructive discussions.