EUROPEAN COMMISSION

STATEMENT

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

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia 6-17 May 2014 for the fourth 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.

Cyprus's programme remains on track. Fiscal targets for the first quarter of 2014 were met with a considerable margin, reflecting better-than-projected revenue performance and prudent budget execution. Progress has been made with the recapitalisation and consolidation of the cooperative credit sector, and banks are advancing with their restructuring plans. This has allowed for a significant liberalisation of domestic payment restrictions, in line with the government's roadmap. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

While the recession this year is expected to be somewhat less severe than anticipated, the outlook remains challenging. The contraction of output for 2014 has been revised down to 4.2 percent from 4.8 percent, given the better-than-expected outturn for 2013 and other recent indicators pointing to gains in confidence. Unemployment remains very high, and large non-performing loans are constraining the ability of banks to supply credit to the economy. As a result, the recovery is now expected to be more subdued than previously forecast, with growth projected at 0.4 percent in 2015 and gradually improving thereafter, as domestic demand is weighed down by the need to reduce very high levels of indebtedness.

The first key challenge is to effectively reduce non-performing loans. This is essential to allow for a resumption of credit to the private sector to support growth and job creation. Reforming the legal framework for foreclosure and insolvency is paramount in order to provide balanced incentives to borrowers and lenders to negotiate and reach agreement on restructuring of non-performing loans, while avoiding undue hardship. At the same time, the supervisory authorities need to intensify their monitoring of banks' effective action to collect and restructure debt in compliance with the existing Code of Conduct and arrears management framework. The authorities are also strengthening supervision and regulation and the implementation of the Anti Money-Laundering framework.

A second challenge is to maintain public finances on a sustainable path. The authorities are making progress in this area, having consistently exceeded programme fiscal targets. Still, prudent budget execution should be maintained, given still high macroeconomic uncertainty and downside risks which may weigh on fiscal outcomes. Over the medium term, the authorities will need to steadily reduce the fiscal deficit and gradually achieve a primary fiscal surplus of 4 percent of GDP in order to put public debt on a sustained downward path.

The third challenge is to strengthen institutions. The authorities are preparing to launch the reform of the welfare system, introducing a guaranteed minimum income scheme to protect vulnerable groups during the current downturn. They are also making progress with reforming the revenue administration to increase its effectiveness and efficiency; they need as well to strengthen collection powers to resolutely address tax evasion and non-compliance. Along with efforts to improve public financial management, they will need to take steps to address the management of fiscal risks. Firm implementation of the government's privatisation plan remains essential to increase economic efficiency, attract investment, and reduce public debt.

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

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 by early July. Their approval would pave the way for the disbursement of €600 million by the ESM, and about €86 million by the IMF.

Contacts :

Simon O'Connor (+32 2 296 73 59)

Vandna Kalia (+32 2 299 58 24)

Audrey Augier (+32 2 297 16 07)

For the public: **Europe Direct** by phone **00 800 6 7 8 9 10 11** or by e-mail