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.

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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

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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.

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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

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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.

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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.

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