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The Economic Adjustment Programme for Cyprus First Review - Summer 2013

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EXECUTIVE SUMMARY

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

Staff concluded that Cyprus' economic adjustment programme is on track. The authorities have taken decisive steps to stabilise the financial sector and have been gradually relaxing deposit restrictions and capital controls. The fiscal targets have been met as a result of significant fiscal consolidation measures underway and prudent budget execution. Structural reforms have been taken forward in important areas, although delays and partial compliance were observed in a number of cases. While the programme has been implemented with determination so far, downside risks remain substantial. Continued full and timely policy implementation is essential for the success of the programme.

The short-run economic outlook remains difficult and subject to considerable uncertainty. Recent indicators support the programme's projections of a contraction in output of about 13% cumulatively during 2013-2014. Encouragingly, business and, to a lesser extent, consumer confidence indicators, have improved somewhat from the troughs in April. However, the labour market has weakened, and unemployment is rising faster than anticipated in the spring. Growth is expected to recover modestly starting in 2015, driven by revamped and more competitive non-financial service sectors.

Financial sector policies have been geared toward restoring confidence in the banking system, aiming at supporting economic activity. Confidence in the banking sector deteriorated in the first part of the year, and deposits have gradually left the banking sector. Therefore, the authorities have taken difficult but necessary steps to fully recapitalise Bank of Cyprus, thus allowing it to exit resolution and return to normal operations. The authorities have also set out a clear agenda to restructure and recapitalise the cooperative credit sector, before the end of 2013, using programme resources where necessary, and without involving depositors. A milestone-based roadmap for the gradual removal of capital controls and administrative restrictions was agreed to ensure an orderly and predictable exit. Banking sector regulation and supervision are also being strengthened. The authorities have developed an action plan to strengthen the implementation of the Anti-Money Laundering 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 programme target for the same period. Overall, the Cypriot authorities have implemented its budgetary policy in compliance with the requirements of the MoU. Over the longer run, the government's fiscal policy remains anchored in achieving a primary fiscal surplus of 4% of GDP by 2018, needed to place public debt on a firmly downward path.

Major fiscal-structural and structural reforms are being designed to modernise Cyprus' institutional framework and to provide a sound basis for economic growth. Revenue administration will be overhauled, including by establishing an integrated function-based tax administration and taking measures to fight tax evasion. Reforms in the areas of pensions, health, public administration and social welfare are also being undertaken, the latter aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and the elimination of duplicate benefits. The authorities have initiated work on a privatisation strategy, but timely and concrete steps are still needed. In product and services markets, first important steps have been taken on energy, housing, tourism, regulatory authorities and regulated professions, but concrete follow-up will be required.

A successful completion of the first review should pave the way for the disbursement of EUR 1.5bn by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme to 47% of the overall international assistance of EUR 10bn.

LIST OF TABLES

LIST OF GRAPHS

LIST OF BOXES

1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the MoU as agreed at staff level on 2 April 2013 between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). On 24 April 2013, the European Stability Mechanism (ESM) Board of Governors approved the MoU and its signing by the Commission on behalf of the ESM. Vice-President Olli Rehn signed the MoU on 26 April 2013.

The 3-year programme entails an external financing by the ESM and the IMF of some EUR 10bn, for possible fiscal financing needs and support to the banking system. Around 90% of the programme envelope will be financed by the ESM while the remainder will be financed by the IMF under an Extended Fund Facility.

A joint EC/ECB/IMF staff mission visited Nicosia from 17 to 31 July 2013 for the first review mission and concluded that the economic adjustment programme is on track.

The Cypriot authorities have made a determined start with the implementation of the programme. Financial sector reforms have been launched, although with delay in some cases. The fiscal policy measures are being implemented as agreed and the 2013 budget execution remains on track on the back of a careful expenditure control. The 2013 deficit target is likely to be revised due to the exceptional compensation of pension funds, but the consolidation effort remains intact and subsequent annual programme targets are within reach. Although implementation of programme commitments have started in all key areas, delays and partial compliance have been more prominent in the areas of fiscal-structural and structural reforms, where progress has been mixed.

A successful completion of the first review should pave the way for the disbursement of EUR 1.5bn by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme to 47% of the overall international assistance of EUR 10bn.

The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to the programme. Annex 1 contains a comprehensive monitoring table with an assessment of programme conditionality, while background tables are presented in Annex 2 and 3. Programme documents are in Annex 4.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONMIC DEVELOPMENTS AND OUTLOOK

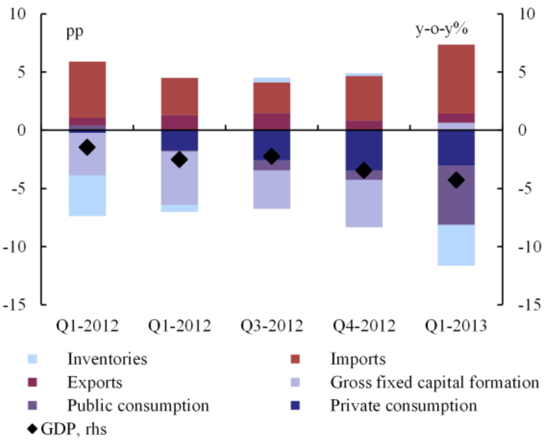
The macroeconomic environment is characterised by high uncertainty, amid on-going unwinding of macroeconomic imbalances. Consumer confidence remains at historically low levels, while labour market conditions are gradually worsening and weighing on private consumption. Following a sharp fall in April 2013 business sentiment has improved somewhat but remains at low levels. Investment plans are put on hold, due to tight credit supply conditions and significant uncertainty about future business prospects. The necessary fiscal consolidation measures have contributed to the downward path for domestic demand, and external demand remains subdued. All in all, recent developments suggest an intensification of the recession, in line with the programme forecast.

Real GDP declined 4.7% y-o-y in the first quarter, accelerating from -3.5% y-o-y in the fourth quarter of 2012 (Graph 2.1)**.** The fall in activity reflected a contraction in private and, particularly, public consumption. On the other hand, gross fixed capital formation displayed an annual increase, driven by one-off licensing acquisitions for hydrocarbons explorations. The underlying growth momentum of gross fixed capital formation, however, remained weak. The weak domestic demand imposed a significant drag on imports of goods and services. With exports of goods and services displaying a small increase compared to the same period of last year, net exports provided a significant positive contribution to GDP growth. Inventories recorded a negative contribution as destocking regained strength.

The declining activity in the first quarter was broadly based across the main economic sectors. Value added in construction underwent a further sharp contraction, continuing the correction that followed years of excessive expansion. Value added in manufacturing continued its downward trend as the turnover of durable and capital goods proved particularly weak, while the weakening of tourist arrivals and the simultaneous disruptions to financial intermediation weighed on the services sector.

The current account deficit stood at EUR 502m in the first quarter, widening further compared to the same period in 2012. This was attributable predominately to the increased income account deficit and to the reduced services' balance surplus. However, the domestic demand contraction led to a decrease in the goods balance deficit, on the back of lower imports and increased exports.

Graph 2.1: **Real GDP and contribution to growth**



Source: Eurostat.

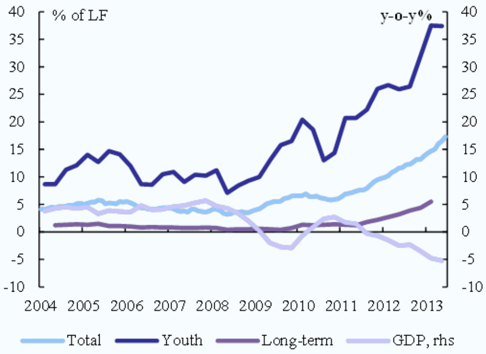
Employment continued to adjust to the weakening of the economy. Declines in all major sectors, i.e. manufacturing, construction, services and public administration, were observed in the first quarter of 2013. While the adjustment in employment gradually pushed unemployment above 15% of the labour force, the participation rate fell, partly reflecting emigration of foreign workers. Box 2.1 takes a closer look at recent unemployment developments.

The annual change in unit labour costs moved into negative territory in the first half of 2012 where it has remained ever since. Despite past wage rigidities in some sectors, labour market adjustment to declining growth also took place on the wage side. This was reflected by a gradual moderation in the annual rate of change of compensation per employee, which has brought it below productivity growth for the first time in more than five years.

Box 2.1: Recent Unemployment Developments

Following the outbreak of the global financial crisis, unemployment in Cyprus increased moderately from a level below 4% of the labour force, amongst the lowest in Europe, stabilising around 6.6% towards the end of 2009. It is only during 2011 that the renewed weakness affecting the Cypriot economy set the unemployment rate on a steep upward trend. In June 2013, the seasonally adjusted unemployment rate had reached the level of 17.3%, compared to 11.7% 12 months before, the steepest increase observed in the EU.

Graph 1: Unemployment and GDP



Source: Labour Force Survey and Eurostat.

Youth unemployment for the population aged 15-24 has generally displayed a rate between 2 and 2½ times that of total unemployment, and this ratio has not changed during the crisis, with the youth unemployment rate increasing from 27.8% in 2012 to 37.8% in the second quarter of 2013. Such a level is very high, with only Greece, Spain, Portugal and Italy displaying higher rates in the EU. When considering youth unemployment, it is useful to express it as a percentage of the overall youth population: in this case, the youth unemployment ratio was 10.8% in 2012, reaching 14.3% in the first quarter of 2013, while the rate of young people not in employment, education or training (NEET rate) in 2012 was 16%.

The number of long-term unemployed (unemployed for 12 months or more) increased steadily since the second quarter of 2011, reaching 5.5% of the labour force in the first quarter of 2013. The share of long-term unemployed over total unemployment is still relatively low, around 13% in the first half of 2013, due to the increased new inflows into unemployment. The number of people who have been unemployed between 6 and 12 months has also increased, both in absolute terms as well as in relative terms compared to total unemployment.

Long-term unemployment will likely constitute a serious challenge for the future, as the probability of finding a job generally decreases with unemployment duration, due to erosion of human capital and skill depreciation, negative signalling effects, and reduced intensity of job search stemming from discouragement. In this respect, training and activation schemes combined with job search assistance are crucial in ensuring that unemployed workers remain attached to the labour market. Also in terms of poverty and social inclusion, long-term unemployment is associated with an increase in the risk of poverty. In Cyprus, unemployment benefits expire after 6 months, and the current system of social assistance does not in all cases ensure an appropriate coverage of the long-term unemployed.

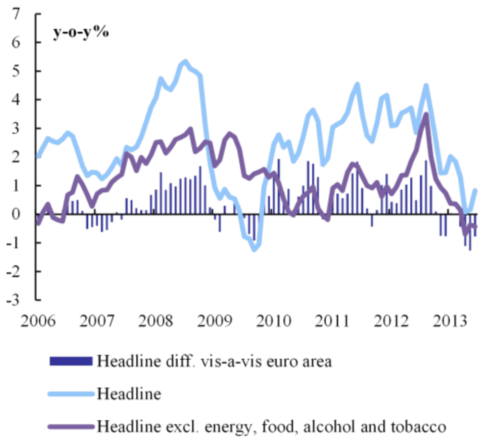
The drastic surge in unemployment observed so far can be considered as being mostly cyclical, given the sharp recession and the consequent drop in the opening of job vacancies. There are strong risks, however, that unemployment will remain at high levels for a prolonged period of time, due to increased long-term unemployment and skill mismatch associated with a sectoral reallocation of the labour force.

The Cypriot economy will have to return to a sustainable growth path in order for new job opportunities to materialise. At the same time, the flexible and decentralised wage setting framework in Cyprus provide support for a rather rapid adjustment and regain of competitiveness. Also, migration flows and, in particular, return migration of foreign workers, which constitute more than one fifth of the labour force may contribute easing labour market pressures.

Low domestic cost pressures and sizable spare capacity have contained inflation. HICP inflation has been on a downward path since last year (Graph 2.2). The reductions in the prices of the housing component as well as in the prices of clothing and footwear offset the VAT hikes and the higher taxes on alcoholic beverages and tobacco, which were implemented as of early

2013. The gradual narrowing of the positive HICP inflation differential vis-à-vis the euro area turned negative in last part of 2012, partly explained by the weak underlying inflation.

Graph 2.2: **HICP inflation**



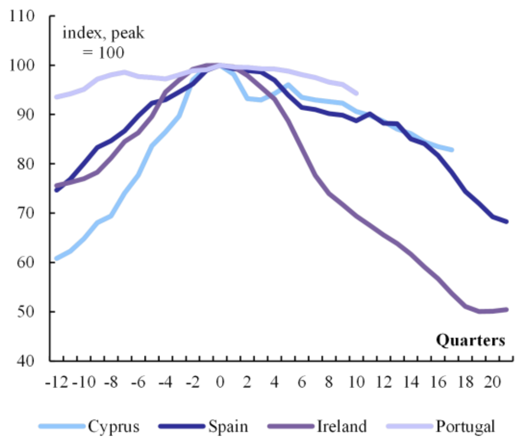
Source: Eurostat.

The downward adjustment in nominal residential property prices continued in the first quarter of 2013 (Graph 2.3). Demand for housing remained weak, reflecting the confluence of a number of factors such as the need to unwind previous excessive growth, tight credit conditions and the deteriorating labour market prospects as unemployment continued its upward movement and wage inflation hovered in negative territory. The decline in the number of sale contracts observed in the first part of 2013 continued.

Real GDP declined by 5.2%y-o-y in the second quarter of 2013, according to the 14 August flash estimate. ([1]) Large uncertainty in the composition of growth persists, in particular due to the restructuring of the banking sector and the imposition of administrative measures on financial transactions to safeguard financial stability.

For the second quarter of 2013, short-term indicators for household consumption suggest a continuation of the underlying weak trend. Consumer confidence remained weak and only showed a marginal improvement in the second quarter (Graph 2.4). At the same time, the bail-in of depositors and the accelerating unemployment rate reduced wealth and income prospects, further weighing on consumption. And the already-sluggish consumption of durable goods is expected to further weaken as tight credit conditions hold back spending. Household demand remained weak despite the fact that savings diminished further down as households tried to mitigate the adverse impact of the deteriorating economic situation. At the same time, HICP inflation moderated further in the second quarter.

Graph 2.3: **Nominal house prices**



(1) Nominal house price peak in Cyprus refer to Q3-2008, in Spain and Ireland to Q2-2007, and in Portugal to Q4-2008.
Source: Central Bank of Cyprus and ECB.

Activity in the corporate sector is also expected to have remained weak. Some improvement in the business sentiment was observed throughout the second quarter, although it remained at low levels. While investment plans were put on hold, the investment to GDP ratio remained at historically low levels. However, with capacity utilisation declining, investment activity is likely to have remained weak in the second quarter. Survey indicators of employment expectations remained subdued, as business transactions, domestic as well as international, were adversely affected by the administrative measures in place. Lost access to working capital due to the bail-in of depositors and the freezing of deposits in Bank of Cyprus further weighed on firms' activity.

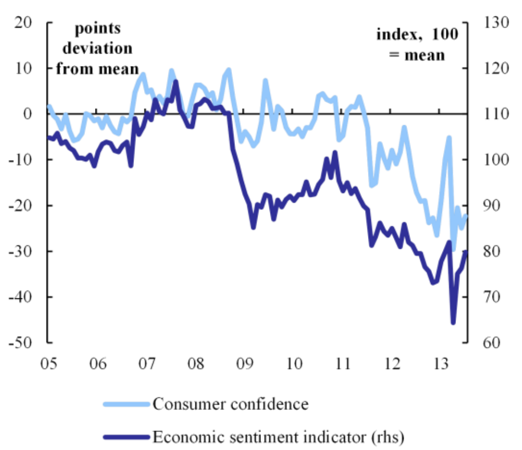
([1]) The Q2 flash estimate was released after the finalisation of the macroeconomic forecast, and has not been taken into account. The forecast will be reviewed and updated, if needed, during the second review mission in the autumn of 2013.

Table 2.1: **Main features of macroeconomic forecast**

	2012 Curr. prices (EUR m)	2012 % of GDP	2010	2011	2012	Updated forecast 2013	Updated forecast 2014	April forecast 2013	April forecast 2014
			Annual percentage change						
GDP	17,887	100	1.3	0.5	-2.4	-8.7	-3.9	-8.7	-3.9
Private consumption	11,948	66.8	1.5	0.5	-3.0	-12.4	-5.7	-12.3	-5.5
Public consumption	3,588	20.1	1.0	-0.2	-1.7	-8.9	-3.7	-8.9	-3.6
Gross fixed capital formation	2,295	12.8	-4.9	-13.1	-23.0	-29.5	-12.0	-29.5	-12.0
Exports (goods and services)	8,137	45.5	3.8	4.4	2.3	-5.5	-2.5	-5.0	-2.5
Imports (goods and services)	8,127	45.4	4.8	-0.7	-7.2	-16.5	-6.8	-16.0	-6.5
GNI (GDP deflator)	17,185	96.1	2.4	4.3	-6.6	-5.5	-4.4	-5.5	-4.4
Contribution to growth: Domestic demand			0.2	-2.2	-6.1	-13.8	-5.5	-13.7	-5.5
Inventories			1.8	0.5	-0.9	0.0	0.0	0.0	0.0
Net exports			-0.7	2.2	4.4	5.0	1.6	5.0	1.6
Employment			-0.2	0.5	-4.1	-7.8	-3.7	-6.6	-3.1
Unemployment (1)			6.3	7.9	11.9	17.0	19.5	15.5	16.9
Compensation per employee			2.6	3.3	1.6	-7.5	-5.0	-7.5	-5.0
Unit labour costs, whole economy			1.1	3.2	-0.1	-6.6	-4.7	-5.4	-4.2
Real unit labour costs			-0.9	0.5	-2.0	-7.2	-5.8	-5.9	-5.2
GDP deflator			1.9	2.7	2.0	0.6	1.1	0.6	1.1
Harmonised index of consumer prices			2.6	3.5	3.1	1.0	1.2	1.0	1.2
Terms of trade			-0.9	-2.1	-1.2	-1.6	-1.0	-1.6	-1.0
Merchandise trade balance (2)			-26.8	-24.2	-21.6	-18.1	-16.8	-18.1	-16.8
Current account balance			-9.2	-4.8	-4.8	-1.9	-0.6	-1.9	-0.6

(1) Eurostat definition, % of the labour force, (2) as a percentage of GDP.
Source: Eurostat and Commission services.

Graph 2.4: **Confidence indicators**



(1) Seasonally adjusted.
Source: Commission services.

The spill-overs from the financial sector to the real economy are likely to have imposed a significant drag on economic activity in the second quarter, mainly via concerns over financial sector stability in the short and medium terms. At the same time, the unsustainable developments in the real economy induced adjustments in the financial sector. Amid declining lending, deposits were gradually finding their way out of the banking sector, rendering efficient financial intermediation even more difficult. SMEs financing in Cyprus is discussed in Box 2.2. Foreign investors were adopting a wait-and-see attitude, as future prospects remained uncertain. International transactions were hampered by restrictions on capital flows.

Real GDP is expected to decline drastically by 8.7% in 2013 as a whole, unchanged compared to the forecast underpinning the programme as signed on 26 April 2013. The envisaged contraction reflects several factors, namely, the immediate restructuring of the banking sector and its impact on net credit growth, the longer-lasting deleveraging of corporate and household balance sheet, the fiscal consolidation pursued, and the high degree of economic uncertainty which will strain domestic demand and investment (Table 2.1). In addition, the temporary imposition of capital controls and withdrawal restrictions combined with the related uncertainty are expected to hamper international capital flows and to reduce business volumes in both domestic and internationally-oriented companies. The bail-in of uninsured depositors is expected to cause a loss of wealth, which will also affect private consumption and investment and reduce imports.

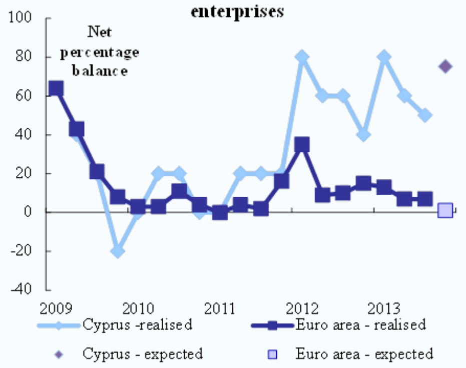
Box 2.2: SMEs Financing in Cyprus

Financing conditions for SMEs are currently difficult in most parts of the EU. New lending volumes are low and declining. This is primarily a result of banks restricting the supply of credit in order to deleverage and build capital.

Cyprus is a case in point which has one of the most leveraged corporate sectors in the EU and where capital access is today heavily restricted. Uninsured deposit-holders of the two biggest banks in Cyprus have suffered substantial losses, 100% of deposits in CPB (EUR 4bn) and 47.5% in BoC (EUR 4bn) having been bailed-in. A significant part of these uninsured deposits represents working capital of SMEs

Almost all businesses in Cyprus are SMEs (enterprises employing less than 250 persons with an annual turnover of less than EUR 50m), even if this definition may not always correspond to the selection of SMEs made by banks, which classify them by size and/or total portfolio. According to the latest data from the Central Bank of Cyprus, there are close to 62,000 active SMEs in Cyprus, ([1]) while the total portfolio of loans can be estimated at EUR 1.2bn at mid-2013. Credit terms have been significantly tightened, also in comparison with other euro area Member States (Graph 1).

Graph 1: **Credit standards - loans to enterprises**



Source: Bank Lending Survey and CBC.

The number of SMEs holding deposits in banks affected by the bail-in was significant, both for CPB (29,342) and BoC (12,880). The estimated total losses of these companies sum up to almost EUR 1bn (6% of GDP).

Current EU policy instruments provide financing for SMEs through a number of different channels, including grants and financial instruments. Operational Programmes (OPs) under the Structural and other EU funds have provided some EUR 23bn of financing to SMEs over the period 2007-2013. These OPs have supported SME aid schemes (grants) managed by Member States and regions, as well as financial instruments (new loans, guarantees, equity/venture capital products) managed by the EIF (currently EUR 1.2bn) and by national public and private financial intermediaries or fund managers (EUR 7.7bn).

In addition, various EU financial instruments under direct management contributed with some EUR 1.5bn in 2007-2013. Furthermore, Commission services are preparing a proposal to use EU funds in a joined instrument for SMEs financing under the new Multiannual Financial Framework (MFF) starting in 2014.

The majority of resources available from the European Investment Bank (EIB) and the European Investment Fund (EIF) to support SMEs in Cyprus are currently exhausted, as agreements with BoC, CPB and the Central Cooperative Bank are fully allocated to SMEs. Additional support is being evaluated within the context of on-going developments.

The EIF's JEREMIE initiative offers EU Member States the opportunity to use part of their EU Structural Funds to finance SMEs by means of equity, loans or guarantees, through a revolving Holding Fund. In 2011, the EIF signed two portfolio guarantee instruments with BoC. These, together with the funded risk sharing agreement signed in 2010 and a new one planned to be implemented in Q3-2013, are expected to create new SMEs lending of EUR 40m. JEREMIE financing offers attractive terms for the SMEs, providing therefore an important support to Cypriot SMEs during this difficult period of economic crisis.

On the basis of the JEREMIE experience, the EIB is targeting, in collaboration with the EIF, a new global loan of at least EUR 100m to support Cyprus' SMEs through the establishment of a SMEs Entrepreneurship Fund, a special fund aimed at making available the most appropriate financial products, given the exceptional circumstances of the country. This Fund will be managed by the EIF and is expected to create new SMEs lending of circa EUR 200m. Together with EIF's partner banks, the Cypriot State would bear the full risk of the Fund's financial performance and cash flows.

Looking ahead, SMEs financing will embrace a number of important challenges, considering the exceptional circumstances and constraints under which Cyprus is operating.

First of all, the roll-out of the SMEs Entrepreneurship Fund should be further prepared by the EIB and the EIF. Furthermore, recapitalising and restoring confidence in the banking sector is essential for the SMEs sector. Such recapitalisation should allow the EIB to resume direct lending to the banks in support of the SMEs.

Key SMEs projects should be selected in a way that they can benefit from EU co-financing in the new MFF (2014-2020), despite current budget restrictions and debt sustainability constraints. Considering the general economic slowdown, the involvement of the Cypriot authorities will be crucial for the success of such projects.

([1]) Total SMEs are domestic and exclude brass plates. No data are available on non-active SMEs.

Table 2.2: **Key macroeconomic and budgetary developments, 2011-2016**

	2011	2012	2013	2014	2015	2016
Real GDP (1)	0.5	-2.4	-8.7	-3.9	1.1	1.9
Output gap (2)	1.1	0.1	-5.8	-6.6	-3.0	0.8
General government balance (3)	-6.3	-6.3	-6.5	-8.3	-6.3	-2.9
Primary balance (3)	-3.9	-3.1	-2.4	-4.3	-2.1	1.2
Cyclical-adjusted balance (4)	-6.9	-6.3	-5.8	-5.4	-4.9	-3.3
Structural balance (4)	-6.7	-6.7	-5.6	-5.4	-4.9	-3.3

(1)Percentage change, (2) % of potential output, (3) excl. compensation of pension funds, estimated to amount to 1.8% of GDP in 2013 (accruals), (4) percent of GDP.
Source: Commission services.

Projections of economic activity point to the recession prevailing in 2014, although to a milder extent than in 2013. On the back of balance sheet adjustments, gross fixed capital formation is expected to continue its decline. The fiscal consolidation measures and increasing unemployment are likely to continue to weigh on private and public consumption, although to a lesser extent than the preceding year. The contraction in domestic demand is likely to be mirrored by shrinking imports, while uncertain external conditions and a shrinking financial services sector are constraining exports. The current account balance is projected to improve considerably as imports of goods and services decrease further and as the full effect from the divestments of the foreign operations of Cypriot banks is to be realised. Overall, the Cypriot economy is expected to contract by around 15% cumulatively in 2012-2014. Although Cyprus is facing a significant restructuring of its economy, the business-friendly environment and the well-educated labour force still remain supportive to growth in the medium-to-long term.

Compared to the April, Programme Forecast 2013 the macroeconomic projection remains broadly unchanged. Overall activity is unchanged, however, private consumption has been revised slightly down as the unemployment rate is projected to increase faster than previously envisaged. This is reflected also in the downward revision of imports.

Macroeconomic risks remain important and tilted to the downside. On the domestic front, downside risks are associated with domestic credit conditions and a further deterioration of confidence in the banking system. Moreover, there is a non-negligible risk of household and corporate defaults propagating through the economy. A further worsening of labour market conditions may lead to a more prolonged loss of business and consumer confidence. Also, the concerns over financial sector stability could have stronger spill-overs on related professional business services and financial services' exports. More generally, the transition to a more varied growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and whose absorption will require flexible factor and product markets. Upside risks for the Cypriot economy relate mainly to possible improvements in the external outlook and in the outer years, investments in the energy sector and a more competitive tourist sector could contribute increasingly to economic growth.

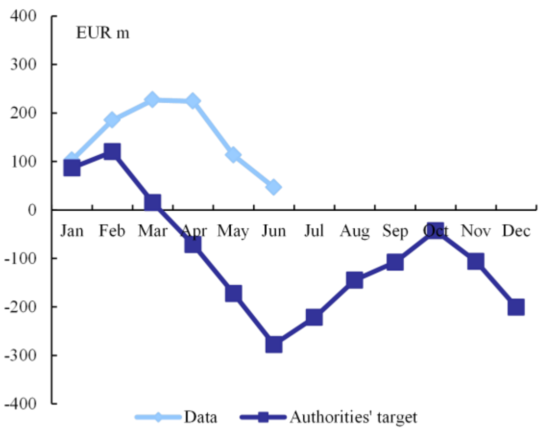
2.2. FISCAL DEVELOPMENTS AND OUTLOOK

In line with programme targets, the 2013 budget aims to reduce the primary balance deficit by ¾% of GDP and achieve a general government deficit of 6.5% of GDP. Under difficult macroeconomic circumstances, the considerable fiscal consolidation measures, amounting to approximately 4.7% of GDP over 2012-13, are envisaged to reduce the structural deficit by 1¼% of GDP in 2013. The fiscal adjustment is slightly tilted to the expenditure side.

The January-June 2013 budget execution data suggests that budgetary developments remain on track vis-à-vis the annual targets set in the MoU and the intermediate monthly and quarterly targets established by the

authorities([2]). Over this period, the primary balance for the central government (incl. the Social Security Fund) showed a moderate surplus in cash terms ([3]), compared to a sizeable deficit targeted by the Cypriot authorities, a difference of around 2% of GDP (Graph 2.5). This markedly better half-year outcome allowed the IMF's Q2 Quantitative Performance Criteria (QPC) for the general government primary balance and primary spending ceiling to be achieved with a significant margin.

Graph 2.5: **Central government budget primary balance, cash data, 2013**



Source: Ministry of Finance.

The general government budget execution data (in ESA95) for the first half of the year confirms the trends suggested by the cash data (Table 2.3). Despite adverse macroeconomic developments and the decrease in employment, both the primary balance as well as the overall budget balance exceeded their targeted values, by 1.6% of GDP and 2.3% of GDP, respectively. Further, a year-on-year comparison for the first two quarters shows an improvement in both the primary and the overall balance of 2.2% of GDP. This overperformance of expenditures in ESA95 terms (see Table 2.3) is mainly driven by tight expenditure control for current and capital expenditure. The sizeable consolidation measures undertaken by the authorities, e.g. with regard to public sector wage policy, have supported this half-year outcome. Moreover, one-off revenues amounting to 1.6% of GDP and comprising the sale of licences for gas exploitation and higher dividends due to extraordinary CBC profits, have improved the budget balance. Given the weak macroeconomic outlook and the projected further reduction in employment in the third and fourth quarter of the year, it is likely that the budgetary outcome in the remainder of the year will gradually worsen.

In cash terms, revenues from both direct taxes and social contributions have performed somewhat better than expected. Compared to the authorities' target, revenues from these two sources were for the first half of the year approximately 0.6% of GDP higher than targeted. The better-than-anticipated performance was driven by the increased collection of taxes on interest and (deemed) dividends and the fact that wage cuts in the broader public sector are in cash accounting terms treated as direct taxes. ([4]) This mitigated the adverse impact on income tax revenue due to falling wages and employment in the private and public sector as well as falling profits. The year-on-year fall in cash revenues from corporate and personal income taxes in the first two quarters of the year is significant (19% for corporate income tax and 18% for personal income tax). An even steeper decline in income tax paid by self-employed might indicate problems with tax compliance. Overall, the over-performance in taxes on income and wealth and social contributions is not expected to persist. This is because the large fall in banking sector deposits since March 2013 and the decrease in deposit interest rates will likely harm revenues from the tax on interest income. Furthermore, the negative employment trends will eventually show up in the

([2]) Two different data sets are used in the assessment of fiscal developments. The Ministry of Finance sets monthly targets in cash terms for the Central Government budget execution cash data and publishes outcomes on a monthly basis, around 25 days after the end of the respective month. According to the national definition, the central government covers a wider range of public entities than the central government concept in ESA95, including also both revenue and expenditure of the Social Security System, as well as transfers to the Local Authorities and Semi-government entities. CYSTAT publishes General Government budget execution accrual (ESA95) data on a quarterly basis, for which the Ministry of Finance has also established quarterly targets. The two sets of data are not fully comparable, but complement each other well.

([3]) Cash data are used for the monthly monitor. IMF's QPCs are set on a quarterly basis for some headline items, which are also on track when assessing Q1 and Q2 fiscal performance.

([4]) Savings from wage cuts in entities outside the central government are transferred to central government through other direct taxes.

Table 2.3: **General government budget, ESA95, Q1 and Q2 2013**

in million euros unless otherwise stated

	2013 data		2013 Cypriot authorities' projections		*Cumulative diff*	Cypriot authorities' annual target
	Q1	Q2	Q1	Q2	(% of GDP)	
Total revenue	**1,431**	**1,618**	**1,686**	**1,386**	*-0.1*	**6,769**
Taxes on production and imports	452	705	613	609	*-0.4*	2,518
Current taxes on income and wealth	412	370	402	322	*0.3*	2,114
Social contributions	346	398	365	336	*0.3*	1,389
Other current resources	222	145	305	118	*-0.3*	746
of which						
Other current resources	126	41	61	62	*0.3*	290
Sales	96	104	244	57	*-0.6*	456
Capital transfers received	1	0	0	0	*0.0*	2
Total expenditure	**1,409**	**1,843**	**1,742**	**1,917**	*-2.5*	**7,858**
Total current expenditure	1,505	1,778	1,670	1,818	*-1.2*	7,399
of which						
Intermediate consumption	156	203	183	195	*-0.1*	918
Compensation of employees	610	580	617	637	*-0.4*	2,694
Social transfers	450	756	548	664	*0.0*	2,615
of which						
Social transfers other than in kind	449	755	545	661	*0.0*	2,605
Social transfers in kind	0	1	2	3	*0.0*	10
Interest	176	111	187	214	*-0.7*	693
Subsidies	31	19	36	10	*0.0*	96
Other current expenditure	83	109	98	98	*0.0*	383
Total capital expenditure	-96	65	73	100	*-1.2*	459
of which						
Gross fixed capital formation	52	58	67	94	*-0.3*	436
Other capital expenditure	-149	6	6	6	*-0.9*	22
General government balance (ESA95)	**23**	**-226**	**-57**	**-531**	*2.3*	**-1,089**
% GDP	*0.1*	*-1.4*	*-0.3*	*-3.2*		*-6.6*
General government primary surplus	**199**	**-115**	**131**	**-318**	*1.6*	**-395**
% GDP	*1.2*	*-0.7*	*0.8*	*-1.9*		*-2.4*

Source: CYSTAT and Ministry of Finance.

collection of social security contributions and personal income taxes, while increasing corporate losses are expected to significantly reduce the revenues of corporate income taxes.

Revenues from taxes on production and imports show signs of weakness and collection year-to-date up to June was around 0.4% of GDP lower than projected by the authorities. Analysing cash data to investigate the underlying reasons shows that this is in particular due to a significant drop in Land and Survey fees collections, associated with the continued contraction in the real estate market as well as a significant decline in excise duties collected. The latter can be explained by cyclical conditions and the stronger-than-expected behavioural changes in the demand for tobacco products and a steep decline of new motor vehicle purchases. Nevertheless, the year-to-date decline, compared to the same period last year, in taxes on production and imports remains lower than the decline projected for 2013 in the April programme forecast. This is mostly due to VAT collection turning out better than expected, in spite of the shrinking tax base. The hikes in the VAT rate of 2 percentage points and 1 percentage point in March 2012 and January 2013, respectively, seem to have helped to secure rather stable VAT receipts.

Other current resources were 0.3% of GDP lower than projected by the authorities, driven by a shortfall in sales of 0.6% of GDP. This shortfall is driven by a reclassification of signing fees for gas exploitation, which have been shifted from being recorded as sales to being treated as

Table 2.4: **Fiscal accounts, projection of 2013 and 2014 fiscal targets**

in million euros unless otherwise stated	Updated projection		April projection*	
	2013	**2014**	**2013**	**2014**
Total revenue	**6,674**	**6,270**	**6,674**	**6,238**
Taxes on production and imports	2,315	2,269	2,321	2,208
Current taxes on income and wealth	1,847	1,711	1,795	1,720
Social contributions	1,385	1,394	1,389	1,273
Other current resources	1,116	886	1,158	1,026
of which				
Other current resources	663	381	659	551
Sales	453	505	499	474
Capital transfers received	11	10	11	11
Total expenditure	**7,738**	**7,594**	**7,739**	**7,574**
Total current expenditure	7,173	7,097	7,176	7,055
of which				
Intermediate consumption	857	831	865	910
Compensation of employess	2,613	2,544	2,592	2,456
Social transfers	2,573	2,665	2,593	2,610
Interest (1)	669	645	667	657
Subsidies	100	102	97	98
Other current expenditure (2)	361	302	362	325
Total capital expenditure	565	505	562	519
General government balance (2)	-1,064	-1,324	-1,065	-1,336
% GDP	*-6.5*	*-8.3*	*-6.5*	*-8.4*
General government primary surplus (2)	-395	-679	-398	-679
% GDP	*-2.4*	*-4.3*	*-2.4*	*-4.3*

On a cash basis (IMF methodology and recording), interest payments in accruals. For EDP purposes, the Commission services' forecast will follow recording (accruals) and other requirements under Regulation 1467/97, Regulation 472/2013 and the Code of Conduct for Stability and Convergence Programmes. (1) Interest payments (cash estimates); 2013: EUR 516m; 2014: EUR 514m. (2) Excl. payments for compensation of pension funds; 2013: EUR 154m; 2014: EUR 145m (cash estimates).
Source: ECB, IMF and Commission services.

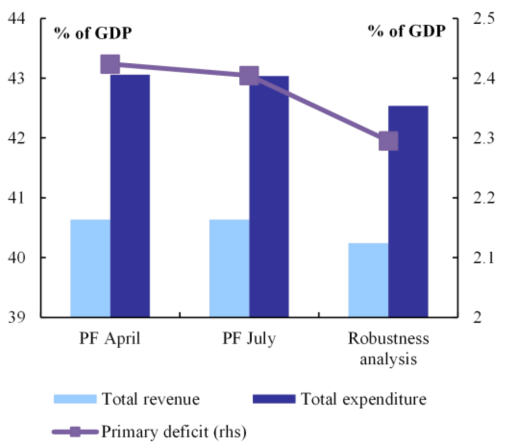
disposal of non-produced assets reducing total expenditure.

In the first half of the year, total primary expenditure was significantly lower than projected. Primary spending was around 1.8% of GDP below the authorities' target for the first two quarters of the year. Current expenditure was 1.2% of GDP lower than projected, mainly due to expenditure restraint in the categories of current transfers, goods and services and wages and salaries. On the contrary, social transfers other than in kind equalled the authorities' target, despite their sharper-than-expected increase in the second quarter of 2013 resulting from the worsening labour market conditions. Capital expenditure showed a negative value over the first six months of the year, driven largely by the above mentioned reclassification of signing fees for gas exploitation and an administrative delay of land annexation compensations during the first half of 2013.

In the updated programme forecast, the overall primary balance, as well as total revenues and total expenditure for 2013 and 2014, remain unchanged from the April programme projection. For 2013, several measures taken by the authorities with regard to direct taxes counteract the negative contribution of wage cuts in both the private and the broader public sector. The projection of indirect tax revenue is broadly unchanged, balanced between relatively resilient VAT collection and other indirect taxes that appear more sensitive to adverse macroeconomic circumstances over the coming quarters. On the expenditure side, the cautious execution of expenditure measures compensates for high social payments driven by the increasingly difficult labour market conditions. For 2014, given the stable fiscal projection for 2013 and the broadly unchanged macroeconomic outlook, the fiscal forecast has been kept unchanged compared to the April programme projection.

However, net of one-offs trends in both direct and indirect tax collection point to significant risks to the future performance of key revenue items. The robustness analysis presented in Graph 2.6 captures a scenario in which the emerging risks of direct and indirect tax shortfalls materialise in the second half of 2013 and off-set the relatively favourable outcome in the first half of the year, which was marked by sizeable one-off revenues. Under these circumstances, the robustness scenario highlights the importance of continued expenditure restraint throughout the second half of 2013 to cushion such adverse developments. It projects a year-end reduction of 0.5% of GDP on the expenditure side, driven by the authorities' commitment to safeguard part of the lower-than-expected expenditure in the first half of the year in order to preserve the programme objectives. In this case, the primary balance outcome would be a deficit of 2.3% of GDP, still in line with the updated programme projection.

Graph 2.6: **Robustness analysis, 2013**



Source: Commission services.

In June 2013, public debt stood at EUR 16.9bn (103% of GDP). The general government's gross debt stock remained broadly stable over the four first months of 2013, reflecting favourable fiscal developments. The first disbursement of programme money by the ESM and the IMF took place in May and June 2013, amounting to EUR 2.1bn and EUR 1bn, respectively. In the absence of significant long-term debt maturities, debt redemption in the first half of 2013 was linked almost exclusively to short-term obligations. Provided that the budget execution remains on track, the debt-to-GDP ratio can be expected to reach 115% at the end of 2013, compared with 86% in 2012.

Cyprus has maintained its limited access to short-term market financing. Issuance activity, apart from renewals of T-Bills of 1 to 3 months at largely stable borrowing costs, mainly comprised a commercial paper, which was offered to domestic investors.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

Developments on financial markets since 2011 were accelerated by deteriorating confidence in the banking sector in the first quarter of 2013, which culminated in mid-March with the decision to significantly restructure the financial sector. The state of both commercial and cooperative credit institutions clearly indicates the need for a swift improvement in liquidity and capitalisation. Deposits, particularly from non-residents, declined gradually throughout the first half of 2013, hindering efficient credit intermediation. Measures were introduced to cap deposit rates in order to reduce the upward pressure on lending rates, as banks bolstered profits by increasing their interest margins.

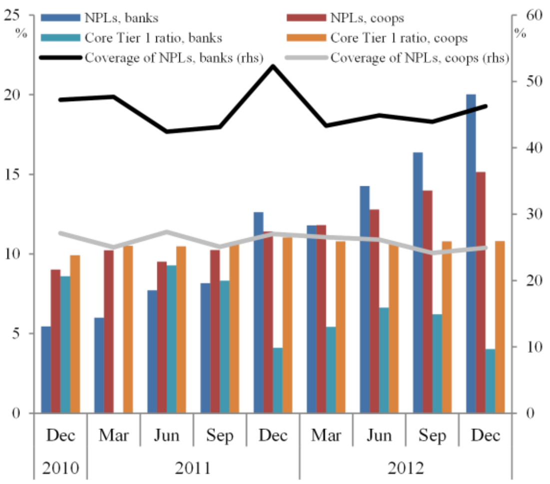
As far as commercial banks are concerned, the non-performing loans (NPLs) ratio ([5]) reached 20% in December 2012 (Graph 2.7), steadily up from 4.3% in June 2010. The coverage ratio of NPLs by stock of provisions stood at 46.3% at end-2012. While this was down from 52.3% in end-2011, the ratio is consistent with its historic average. Nevertheless, it remained significantly below the euro area average of around 60%, implying that Cypriot commercial banks' overall capitalisation compared more unfavourably to euro area banks than a direct comparison of capital adequacy ratios would suggest. The sector's average core Tier 1 ratio declined to slightly above 4%, from 9.3% in mid-2011.

Current financial stability statistics suggest that the sector of the cooperative credit institutions is in somewhat better position. The NPLs ratio

([5]) Loans past-due by more than 90 days compared to total loans, excluding fully collateralized loans in arrears.

reached 15.2% in December 2012, up from 9% in December 2010. The core Tier 1 ratio remained broadly constant at 10.8%. However, these indicators must be put in perspective. First, the coverage ratio of NPLs by the stock of provisions in credit cooperatives was significantly lower, standing only at 25% end-2012. Second, the cooperative sector is subject to significant differences across institutions. Third, in line with the MoU, the change in the definition of NPLs will likely result in a worsening picture of the credit cooperatives, relative to commercial banks, due to the inclusion of NPLs covered by collateral.

Graph 2.7: **Financial soundness indicators**



Source: Central Bank of Cyprus.

Since the political agreement in mid-March on an economic adjustment programme for Cyprus, financial sector developments have been driven by both liquidity constraints and deteriorating asset quality. Against the backdrop of successively relaxed capital controls (Box 2.3), deposit outflows have persisted and have absorbed an important part of banks' liquidity buffers. The squeezed liquidity, together with the erosion of the capital position due to losses stemming from NPLs, has constrained loan growth and contributed to the quicker-than-expected deleveraging of the domestic banking sector.

The decline in deposits since the Greek carve out and the decision to restructure Bank of Cyprus (BoC) and wind down Cyprus Popular Bank (CPB) is significant. The Greek carve out from 24 March, the deposit/equity swap in BoC from 29 April and the deposit write-down in CPB from 20 May accounted together for a very significant part of that decline.

Given its state of resolution, CPB was naturally most affected by the liquidity squeeze. Deposit outflows in CPB were the highest among Cypriot banks. However, even though the monthly deposit withdrawals still exhibited high volatility, the monthly average appears to have diminished gradually since March. This point to a relative stabilisation of the liquidity situation of the banks, the future persistency of which needs to be monitored.

The decline in banks' funding has exerted a strong constraint on the growth of banks' loan books. Total loans to households and firms peaked at EUR 72.8bn in July 2012. Loans moved sideways until February 2013, and since then, they contracted by EUR 4.4bn, equivalent to two thirds of the contraction in deposits. Thanks to this concomitant loan deleveraging, banks' net liquidity outflows have been much lower than the contraction in deposits. Domestic resident borrowers were less affected than other euro area residents and non-residents. Thus, loans to domestic resident private sector continued to grow until March 2013, when they stood at EUR 54.3bn and contracted by EUR 1.5bn only by end-May.

Total loans to non-financial corporations and households declined respectively by 1.3% and 1% y-o-y in June, respectively (Graph 2.8). Housing loans contracted by 2.3% y-o-y, while other lending to households expanded by 2.9% y-o-y. Consumer credit, which has been declining on a yearly basis since August 2012, it accelerated its rate of contraction and declined by 5.2% y-o-y. Bank credit to other financial intermediaries increased, however, by 40.7% y-o-y.

With respect to the cost of credit, the interest on longer-term deposits decreased substantially in May, as a consequence of the capital surcharge introduced by the Central bank of Cyprus (CBC) (see above). Thus, the interest on new deposits with agreed maturity of up to 1 year stood at 2.8% for households and 2.4% for corporates, down respectively from 4.3% and 4.2% in March. The interest rate on new loans to non-financial

Box 2.3: Capital Controls and Administrative Measures in Cyprus

The authorities and the programme partners are closely monitoring capital restrictions. After the extended bank holiday, the authorities decided to implement capital restrictions, in order to safeguard the stability of the Cypriot banking system. The aim was to cause the least possible damage to the real economy and to keep the capital controls in place for the shortest time possible, while gradually lifting them based on an assessment of the liquidity situation of the banks and overall depositor confidence. To this end a Monitoring Board has been established by the authorities for communication with the European Commission, with the ECB, IMF, ESM and EBA participating as observers. The capital controls were implemented by decree enacted by the Ministry of Finance and jointly prepared by the CBC. The relaxation of the capital controls takes the form of an update of the original decree. Since the beginning of August the 19th version of the decree applies.

The initial regime of capital controls was tight. After the bank holiday, strict capital controls had to be implemented in order to avoid excessive liquidity outflows. The controls were designed to allow current transactions for goods and services inside and outside the country, while limiting capital transactions. All banks including the foreign banks were submitted to the restrictive measures, while some entities were exempted including the Central Bank, the state and local authorities. Initially, decrees applied in principle for 7 days, but shorter periods have occasionally been observed, whereas recently decrees are less frequently updated.

Capital restrictions initially affected all types of operations executed by individuals and legal entities:

(i) Payments and/or transfers outside Cyprus, via debit and/or credit and prepaid cards, were not allowed to exceed EUR 5,000 per month per person in each credit institution.

(ii) The termination of fixed term deposits has been forbidden since the first decree, and only for humanitarian reasons the eighth decree introduced the possibility to make limited use of them. Following the 16th decree a termination of fixed term deposit before maturity is allowed for the payment of real estate in Cyprus provided the funds are paid directly into the loan account of the seller of the real estate within the same credit institution.

(iii) Cash withdrawals have been limited to EUR 300 per day and per bank account. With the 10th decree a higher limit of EUR 500 per day was allowed for legal persons.

(iv) The opening of new accounts for new customers has been forbidden, unless the account is credited only with funds transferred from abroad, or for persons not having any account with any credit institution in Cyprus.

(v) All current transactions for good and services or payments "falling within the normal business", from EUR 25,001 to EUR 200,000 were subject to bulk approval by the Committee, established within the Central Bank of Cyprus. All payments above EUR 200,001 were subject to prior individual approval, taking into account the liquidity buffer of the credit institution. These limits have been gradually relaxed over several decrees.

(vi) Finally, exports of cash beyond EUR 1,000 or other currency were prohibited.

A gradual relaxation of capital controls has been taking place. All the way through the 19th decree, capital controls for domestic transactions have become increasingly relaxed, but the free disposal of term deposits at maturity has not been re-established. There are no more restrictions on card payments. Irrespective of the purpose and without presenting justifying documents, natural and legal persons are allowed to transfer up to EUR 15,000 and EUR 75,000 of deposits per month, respectively. Outgoing international payments are limited to EUR 1,000,000 per transaction but are subject to the CBC Committee's approval.

Provisions regarding cash remain restrictive, while the limit on cheque payments to accounts held in other credit institutions has been abolished:

(i) The daily limit on cash withdrawals has been increased to EUR 500 and the maximum cash export has over time increased to EUR 3,000 from EUR 1,000.

(Continued on the next page)

Box (continued)

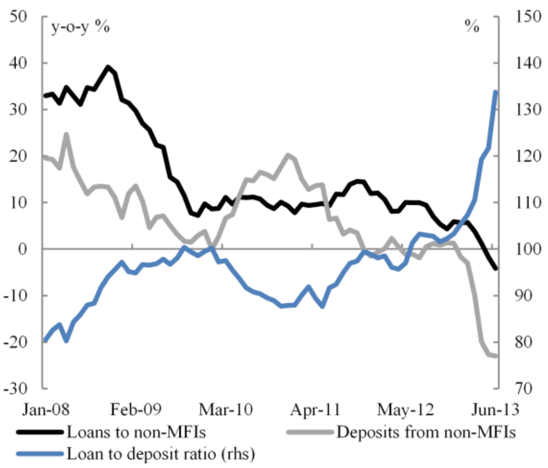
(ii) The threshold of EUR 5,000 per month for payments abroad with cards issued in Cyprus has been abolished.

(iii) Transfers of cash to the areas not under effective control of the government of the Republic of Cyprus remained limited to EUR 300 daily, but if they originate from a salary payment the threshold can be higher.

The 19th decree adopted after Bank of Cyprus has been put out of resolution, introduced two relaxations for domestic banks related to opening new accounts. First, with a view to bring back into circulation money held at home, the opening of fixed term deposit accounts credited with cash is allowed. Second, the opening of current accounts related to new credit facilities is permitted in an effort to overcome credit constraints.

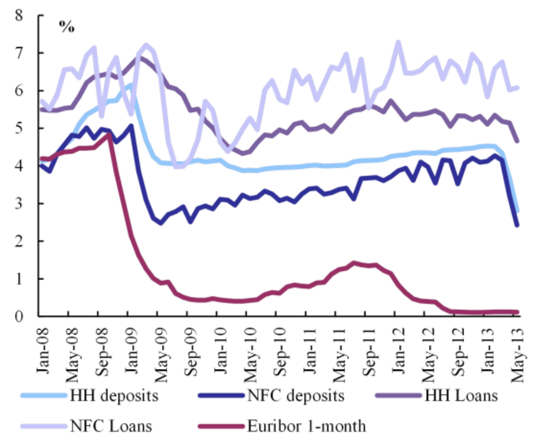
A separate decree for international banks was issued at end-April. It allows branches and subsidiaries of foreign banks in Cyprus to apply for an exemption of their international clients from the restrictive measures. Exempted banks have to provide a list of their international customers to the Central Bank of Cyprus and also deliver a letter of comfort confirming the financial soundness of their parent institutions.

Graph 2.8: **Loans and deposits**



Source: Central Bank of Cyprus.

Graph 2.9: **Interest rates on loans and deposits**



Source: Central Bank of Cyprus.

corporations eased somewhat in April and May to just above 6%, down from 6.8% in March (Graph 2.9). Similarly, new loans to households were priced at 5.0% in May, relative to 5.6% in March. However, given the historic volatility of the cost of credit, caution is warranted when assessing the immediate pass-through from deposit rates to lending rates.

Given banks' liquidity and capital constraints, bank credit will most certainly continue to decline in future quarters. This development should not be interpreted as the result of a credit crunch, but rather as a necessary adjustment of the previous excessive credit expansion. On the one hand, private sector indebtedness went out of control during the boom years. The only way to correct this debt overhang is through a gradual amortisation of the outstanding stock of bank credit as is currently being observed. On the other hand, banks need to clean their balance sheets from the bad investments into sectors of the economy that over-expanded, primarily real estate and construction. In this phase of working-out NPLs, banks naturally focus on capital optimisation, which is likely to delay for some time the return to a situation of credit expansion.

3. PROGRAMME IMPLEMENTATION

The first review mission by staff of the European Commission (EC), European Central Bank (ECB) and International Monetary Fund, (IMF) concluded that the economic adjustment programme is on track.

The Cypriot authorities have made a determined start with the implementation of the programme. Financial sector reforms have been launched, although with delay in some cases. The fiscal policy measures are being implemented as agreed and the 2013 budget execution remain on track on the back of a careful expenditure control. The 2013 deficit target is likely to be revised due to the exceptional compensation of pension funds, but the consolidation effort remains intact and subsequent annual programme targets are within reach. Although implementation of programme commitments have started in all key areas, delays and partial compliance have been more prominent in the areas of fiscal-structural and structural reforms, where progress has been mixed.

The objectives of the necessary fiscal and fiscal-structural measures are enshrined in the MoU and clearly outlined in the introduction to these chapters of policy conditionality. Addressing these challenges is instrumental to ensure that the disposable income of Cypriot households can start growing again over the medium-term and to bring public finances back to a sounder position. Minimising the impact of consolidation on vulnerable groups is explicitly stated as a programme objective and to this end several steps have been taken in designing the programme. Reforms in the areas of pensions, health, and social welfare are being undertaken. The latter is explicitly aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and better targeting of benefits to ensure public support for those most in need. Pension reform steps are largely progressive, including by necessary adjustments to the relatively favourable government employee pension scheme. Health reform steps aim at strengthening the sustainability of the funding structure and will together with the implementation of a National Health System contribute to more equal access to public health services for all parts of the population. The programme contains ambitious reforms of the tax revenue and public administration, which aim at improving tax compliance, fight tax invasion and making the public sector more effective in performing its tasks, including by making it easier to reallocate public sector resources to areas most affected by the economic crisis. With regard to the fiscal consolidation measures a more progressive system have in several respects been initiated, combining an increased taxation of capital (interest income, dividends, immovable property) with higher corporate tax rate, increased excises for certain products with adverse health effects (tobacco and alcohol) and elements of "greening" of the tax system (e.g. higher excises on petroleum products and an environmentally friendly vehicle taxation). Due to the severity of Cyprus' deficit, it has been necessary, however, to also increase the VAT rate. Where reductions in public sector emoluments have been necessary, they are predominantly progressive and targeting also certain benefits and privileges for senior officials.

A summary assessment of compliance with the programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of the individual elements of conditionality with an end-Q2 deadline is found in Annex 1.

The authorities should continue to pursue their ambitious reform agenda and maintain its momentum. It is of primary importance to ensure timely implementation of the necessary reforms in line with the programme conditionality. To this end, political consensus and administrative capacity should be strengthened.

3.1. FINANCIAL SECTOR

In the financial sector, authorities implemented all required policies and measures, though with a number of delays. While the delays and the postponed deadlines are regrettable, they do not constitute sufficient grounds for a decision on non-compliance. The authorities took organisational steps in order to meet all subsequent deadlines without delay.

Table 3.1: **Summary of compliance with policy conditionality for the first review (end-Q2 2013)**

	Status
Financial sector policy	**Compliant with delay.** 1) Restructuring the financial sector has taken more time than initially foreseen due to the complexity of the situation. However, considerable progress has been made: (i) the authorities have designed a strategy to restructure the cooperative credit institutions, but the viability assessment of individual cooperative banks was late on 19 July compared to the end-June deadline; (ii) Hellenic bank has launched a capital raising plan and finally, (iii) administrative restrictions and capital controls have gradually been relaxed. 2) On supervision and regulation, the majority of end-Q2 reforms have been observed on time. The new classification on non-performing loans is in effect since 1 July. A unified data reporting system for both commercial and cooperative banks has been implemented and on 23 July the financial stability indicators in the new framework were available on the website of the Central Bank of Cyprus (CBC). The integration of the supervision of the cooperative credit institutions is ongoing. Monitoring of private sector indebtedness is stepped up with the presentation of the first (internal) quarterly report on 12 July. 3) With regard to troubled borrowers, legislation was passed end-April to grant a grace period of 60 days and legislation is in preparation to better manage arrears and to set up a mediation service. 4) An AML action plan addressing the remaining legal framework shortcomings, as well as the identified AML framework implementation issues, were also agreed and the Cypriot authorities have committed to ensure its implementation, as per the agreed timetable.
Fiscal policy	**Compliant**. Budgetary execution remains on track and both primary spending and deficit ceilings in Q2 are respected. The general government deficit target for 2013 is likely to be revised due to the exceptional compensation of pension funds in CPB, but the fiscal consolidation effort remains intact and subsequent deficit targets remain within reach. The fiscal consolidation measures agreed in the context of the programme for 2013 have been enacted and are being implemented. The effectiveness of the measures has been satisfactory in the first half of the year, with tight expenditure control and additional spending cuts compensating for shortfalls in the budgetary impact of revenue measures. In the wake of fiscal risks, diligent monitoring of budgetary developments will be required.
Fiscal-structural measures	**Partially compliant**. The most important fiscal-structural reform steps with a Q2 deadline have been followed. However, in a number of cases, compliance has been partial or delayed, either because the deliverables went beyond the deadline or because certain shortcomings were identified on substance. In particular, the Cypriot authorities will need follow-up on: (i) the actuarial study for the GSIS; (ii) the approval of an umbrella law covering concrete budgetary processes; (iii) up-do-date valuation of the inventory of SOEs and subsequent steps in the privatisation process; (iv) further specification of the reform plans for the revenue administration and the welfare system.
Labour market	**Compliant.** All labour market-related reform steps for Q2 have been compliant, but the assessment of current activation policies will need to be followed by detailed policy proposals, including to address the lack of consistent data.
Goods and services market	**Partially compliant**. Although non-compliance is found on an individual element for the property market reform (mandatory registration of sales contracts), all other structural areas are either compliant or partially-compliant. Follow-up is needed in particular regarding: (i) some regulated professions still need full elimination of bans on advertising; (ii) a more comprehensive outline on the regulatory regime and market organisation for the energy sector and gas exports.
Data reporting	**Compliant.** The authorities have broadly complied with the data reporting requirements. Shortcomings as regards timely fiscal data reporting and in particular the full coverage of the General Government, are addressed.

Source: Commission services.

The programme partners and the authorities set up regular weekly calls in order to closely monitor progress with the implementation of the conditionality. This has become a useful tool to ensure compliance, together with ad hoc technical assistance missions and the regular review missions.

3.1.1. Maintaining Liquidity in the Banking System

Ensuring that banks have sufficient liquidity buffers remains a crucial building block of the programme. Because of the bail-in of uninsured depositors, the imposition of capital controls and restrictive measures was necessary to safeguard financial stability. The authorities and the programme partners monitor closely the impact of these measures, not only on bank liquidity, but also on the economy at large. Because such restrictions are temporary and proportionate in nature as enshrined in the Treaty on the Functioning of the European Union, the review of the financial sector conditionality concluded that a milestone approach, as regards the progressive removal of the restrictions, should be adopted.

This milestone approach links the relaxation of capital controls directly to further progress with the successful implementation of concrete policy measures. It is results-based, rather than time-bound, and will anchor the public's expectations. According to the newly-set-up roadmap for relaxing the remaining capital controls, restrictions will be removed gradually, first on domestic transactions followed by cross-border transfers. Every subsequent relaxation step will be determined by progress with the restructuring of the banking system as well as by its own impact on financial stability. While restrictive measures on domestic transactions have already been relaxed to a great extent, a return to fully free flow of capital within the domestic financial system will be allowed after finalising the resolution and recapitalisation of Bank of Cyprus (BoC) and approving the restructuring strategy for the cooperative sector. The approval of the restructuring and funding plan for BoC, and the recapitalisation of Hellenic Bank will unlock the restrictions on fixed-term deposits and on transfers between domestic banks, commensurate with the banks' liquidity positions. The opening of new accounts and free cash withdrawals will become possible when financial stability strengthens, as evidenced by a declining trend in cash withdrawals and increasing gross inflows on domestic bank accounts. Finally, free external capital transfers will be allowed insofar as noticeable progress is made with the implementation of the banks' restructuring plans and of the overall programme, subject to recovery of confidence in the Cypriot banking system.

While the April MoU required banks relying on Eurosystem central bank funding or receiving state aid to start submitting quarterly medium-term funding and capital plans from June 2013 onwards, the programme partners have granted an extension of this condition, for BoC to mid-October and for the cooperative sector to end-September. As far as BoC is concerned, its resolution process was not completed by the end of June, which made impossible the submission of the funding and capital plans at that time. Similarly, the credit cooperative institutions, given the low likelihood of raising capital from private sources, decided to apply for state aid before the end of July, i.e. ahead of the expiration of the period granted them for seeking private sector participation. In this context, given the significant change that the sector is about to undergo, any funding or capital plan as of June 2013 would not have been representative. The third systemic institution, Hellenic bank, is not concerned by this requirement of the MoU.

3.1.2. Restructuring and Recapitalisation of Banks

The resolution of Cyprus Popular Bank (CPB) and the restructuring of BoC took longer than initially anticipated. The process was slowed down by a delay in the fulfilment of the independent valuation by KPMG of the assets of the two institutions, which was finalised only in the second half of July, rather than by end June. The results of this independent valuation, and their implications for the restructuring of the bank are detailed in Box 3.1.

Hellenic Bank, for which the stress test identified a capital shortfall of slightly below EUR 300m, launched an ambitious capital-raising plan with the intention of avoiding recourse to state aid. Together with a new rights

Box 3.1: **Restructuring of Bank of Cyprus and Cyprus Popular Bank**

The two banks have been put under resolution by the authorities. Following the PIMCO asset quality review, which revealed substantial capital needs, the Eurogroup on 25 March 2013 agreed on the programme for Cyprus. Given the size of the estimated capital shortfall, and especially its impact on public finances if funded by the government, the authorities chose to fund it through contributions from uninsured depositors. The Central Bank of Cyprus (CBC), as resolution authority and in consultation with the Ministry of Finance, placed Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB) in resolution. Based on PIMCO results, the resolution authority decided to resolve CPB, but to keep BoC active.

Uninsured depositors funded the estimated capital shortfall in both banks. CPB was split into a "good" and "bad" (legacy) part by the authorities. The "bad" part was left behind in CPB, to be liquidated with all hybrid instruments and uninsured deposits. BoC absorbed the "good" part, including all insured depositors and ELA that was granted to CPB, and sufficient assets that were transferred at fair value ensuring an end-of-programme core Tier 1 ratio of 9%. In BoC, the first round of forced conversion amounted to 37.5% of uninsured deposits after all senior and junior bonds have already been converted into equity. Until the finalisation of the asset quality review of the merged group, another 22.5% of the uninsured deposits were frozen to be used in case the initial bail-in proved not the yield the desired capitalisation. In order to protect liquidity, 30% of the uninsured deposits were blocked, while the remaining 10% were to be freely used by the deposit holder.

The measures taken by the authorities in relation to the resolution of BoC and CPB have been challenged before the Cypriot Administrative Courts. On 7 June 2013, the Supreme Court ruled it has no jurisdiction to hear cases seeking to challenge the resolution decrees by way of judicial review as the decrees raise issues of private law and the procedure for judicial review is reserved for actions against acts of the State (or its institutions). The Court considered that as the decrees affected the relationship between a bank and its depositors, they are private law acts. In principle, these acts could form the subject of civil proceedings for i) breach of contract and ii) acts against the state where, in implementing the resolution, the banks had breached the contractual terms of the agreements with the account holders. As a result of this ruling, all cases have been transferred to the District Courts who have jurisdiction to hear private claims of this nature. It is unclear when this will be concluded, but it may be a number of years before the legal procedures have been exhausted. In its judgment, the Supreme Court clarified that the quantum of damages that can be claimed by creditors is capped by the no-creditor-worse-off principle (i.e. that a creditor cannot be treated worse than they would have been in an insolvency procedure). This has the effect of limiting the potential value of claims and requires creditors to demonstrate they would have been better off if either institution had entered into insolvency rather than progressing through the resolution process.

In order to protect the liquidity position of the new BoC the majority of the frozen uninsured deposits are converted into term deposits by the authorities. In the resolution phase, 47.5% of the uninsured deposits were converted into equity, 10% were released and the remaining was frozen. In order to avoid large liquidity outflows and spill-over risks to the whole banking system after the bank exits the resolution, only 5% of the remaining uninsured deposits have been released, while 37.5% is converted into term deposits. A new ministerial decree reschedules the maturity of these deposits into three equal tranches with fixed terms of 6, 9 and 12 months. The deposits can be rolled over once, if this is deemed necessary to safeguard the liquidity position of the BoC. Early termination of these deposits is not possible, but depositors are granted the option to use the time deposits to repay loans in the BoC.

In accordance with the MoU, the new merged BoC Group was taken out of resolution on 31 July 2013 when the recapitalisation was completed. The CBC, as resolution authority, assessed the capital needs, in accordance with MoU, based on the KPMG asset quality review, and finalised the bail-in contribution from the uninsured deposits of BoC at 47.5%. This results in a core Tier 1 ratio of the Group at about 12%, which shall be enough to remain above the core Tier ratio of 9% throughout the programme period as requested in the MoU.

issue, the plan is offering current Tier 1 and Tier 2 bond-holders the option of exchanging their securities for differentiated Cocos (Coco1s and Coco2s), which would maintain the current subordination link, while qualifying for Tier 1 capital. Because the combined amount of Tier 1 and Tier 2 capital bonds is close to EUR 310m, Hellenic Bank has the chance of avoiding state aid if bondholders receive the exchange offers favourably. Both the bank's management and the authorities are doing their best to make the plan a success. Moreover, it is to be noted that a change in the European Commission guidelines with respect to granting state aid to banks makes the bail-in of subordinated debt-holders prior to the application for state aid mandatory. Given the amounts involved, this implies that state aid for Hellenic is highly unlikely, as a failure of the current capital-raising plan would result in a mandatory bail-in that would close the bank's capital shortfall.

The credit cooperative institutions, for which the capital shortfall was estimated at EUR 1.5bn, decided to speed up the process of applying for state aid ahead of the maximum time period granted to them to seek private sector participation, since it became clear that the prospects for raising a sufficient amount of capital from the market were very dim. While the terms of reference for the assessment of the institutions' capital needs and viability were established according to the deadline (April 2013), the actual assessment of the capital needs of the individual cooperative banks was not submitted by June 2013, but rather in mid-July. The viability conditions for the individual cooperative banks will be further reviewed in the context of examining the restructuring plans for the state aid, due by end-September 2013.

As requested by July 2013, the Central Bank of Cyprus (CBC) finalised the strategy for the cooperative sector, consisting of three building blocks. First, the plan includes the merger of individual cooperative credit institutions into a maximum of 18 entities by March 2014 with a view to enhancing the efficiency of the cooperative banks. The cooperative credit institutions that do not achieve viability will be required to merge with viable institutions and the number of credit cooperatives may decline further. Second, a minimum capital requirement for the core Tier 1 ratio of 4% will be introduced at the level of the individual cooperative banks. The purpose is to contribute to overcoming the moral hazard embedded in the mutual guarantee scheme linking the individual cooperative banks, which allows capital levels to be assessed at the consolidated level. It should be noted that, at the consolidated level, the sector remains subject to the general minimum core Tier 1 capital requirement of 9%. These new capital requirements will enter into force by end-December 2013, but the capital will only be injected by the Central Cooperative Bank into individual cooperative credit institutions as mergers are completed. Third, a new governance structure will be established, which clearly allocates accountability and provides for proper incentives to avoid losses and moral hazard. In this context, a relationship framework will also be set up between the state and the Central Cooperative Bank with the aim of defining the role of the state as the main Central Cooperative Bank shareholder. The state will ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions.

3.1.3. Regulation and supervision of commercial banks and cooperative credit institutions

Compliance with the implementation of the regulatory and supervisory changes was satisfactory. A new directive on the definition and classification of non-performing loans (NPLs) was issued on 11 July, after extensive consultation with the programme partners, with effect from 1 July 2013. Banks' first reports with the new classifications of NPLs are expected to be received this year by the end of September, with reference data 30 June 2013. The implementation of the unified data reporting system, foreseen for end-June 2013, has been delayed, not the least because of an extensive consultation process with the programme partners. The authorities have made good progress with the preparatory work for promptly meeting future deadlines, related to the establishment of a single credit register, mandatory supervisory action, the regulatory framework on loan origination, asset impairment and provisioning practices, and the revision of the internal governance directive.

Box 3.2: Anti-Money Laundering

In late March 2013, the Cypriot authorities launched a third party Anti-Money Laundering (AML) audit of the effective implementation of Customer Due Diligence (CDD) measures with particular reference to deposits and loans. The two-pronged audit was performed by the Committee of Experts on the Evaluation of AML Measures and the Financing of Terrorism (Moneyval) and by Deloitte Financial Advisory S.r.l. (Deloitte). A group of experts under the auspices of Moneyval conducted an assessment of CDD compliance in the banking sector and focused on the effectiveness of implementation. This assessment was largely interview-based and the team did not have access to customer data or files in the banks. ([1]) The Deloitte review was focused on the measures implemented by the six largest - at that time - Cypriot banks to prevent criminals from being the beneficial owners of customer deposits in, or loans from, Cypriot credit institutions. ([2]) While identifying no major weaknesses in the legal framework for AML/CFT ([3]) in Cyprus, both reports suggest that there are specific shortcomings in the implementation, by banks and at the supervisory level, of AML preventive measures. The main shortcomings were detected in the following areas:

1. Customer Due Diligence: lack of proper identification and verification of beneficial ownership, ongoing customer due diligence, and the classification of risk profiles.

2. Suspicious transaction reports: inconsistencies in banks' procedures for reporting to the Unit for Combating Money Laundering (MOKAS).

3. Transparency of beneficial owners and shortcomings in the functioning of company registry.

The shortcomings in the implementation by the banks of the AML framework also demonstrated poor monitoring by the Central Bank.

During the first review mission, an AML action plan, which took into account the findings and the recommendations of the above-mentioned audits, was concluded (see Annex 2 of the MoU). The action plan details specific areas where increased attention is required and gives deadlines as to when they should be achieved.

The action plan focuses on the need for improvements in implementation of the preventative measures applied by the financial sector, and improving the supervisory regime. In particular, supervisors of the financial and non-financial sectors will develop and implement a risk-based approach to off-site and on-site AML/CFT supervision. The action plan further elaborates measures that need to be taken to increase the transparency of legal persons and legal arrangements, including improvements to the operation of the Registrar of Companies.

(1) Summary and full report available at: https://wcd.coe.int/ViewDoc.jsp?Ref=DC-PR086%282013%29&Language=lanEnglish&Ver=original&Site=DC&BackColorInternet=F5CA75&BackColorIntranet=F5CA75&BackColorLogged=A9BACE
(2) Summary report available at: http://www.mof.gov.cy/mof/mof.nsf/All/BF019474F0B5DA7AC2257B8D003D3050/$file/Deloitte%20Final%20Report%20Sections%2013.pdf
(3) Combating the Financing of Terrorism.

Implementation of the troubled borrowers' framework is satisfactory too. The directive of the CBC to recommend that banks provide a grace period of 60 days was circulated by end-April 2013. Authorities examined the possible tax, legislative and administrative impediments to a successful private debt restructuring, and concluded that no tax impediments were applicable in Cyprus. Other impediments have been addressed, inter alia, by a Code of Conduct and a Supervisory Framework on Arrears Management finalised end-August (compared to an initial deadline of end-June). The legislation for the mediation service between banks and their clients in order to achieve fair debt restructuring is in preparation, but the deadline of June was missed as it appeared more difficult to strike the correct balance between the interests of the banks and the borrowers. Adoption of the legislation is now scheduled for end-November. As far as the monitoring of household and corporate indebtedness is concerned, the authorities established a quarterly report on the issue by the deadline. Consultation with the programme partners is on-going as to identify the best way of integrating this analytical input into the annual financial stability report published by the CBC.

As far as the supervision of cooperative credit institutions is concerned, it is being integrated within the CBC, despite a delay due to internal resistance. The expertise and know-how of the previously independent supervisor are expected to be preserved within the CBC.

3.1.4. Anti-Money Laundering

An Anti-Money Laundering (AML) action plan was agreed with delay and its implementation will enhance customer due diligence and entity transparency. At the end of March 2013, the Cypriot authorities launched a two-pronged third party AML audit of the effective implementation of customer due diligence measures in the financial sector with particular reference to deposits and loans (see Box 3.2). During the first review mission, a comprehensive action plan, which addresses the findings and recommendations contained in the AML audit reports as well as the identified remaining shortcomings in the implementation of the AML framework, was concluded.

In relation to the entity transparency, the required amendments in the Trust and Company Service Provider (TCSP) and the AML laws were delayed since the authorities considered them to be linked to the agreement on the AML action plan. These changes to the legal framework were now agreed with the programme partners and will be adopted by the House of Representative in early September 2013, prior to the foreseen political agreement on the release of the next tranche of assistance in the 13 September Eurogroup meeting.

The amendments improve the provision of adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements to foreign counterparts. The revision of the directives and the circulars by the supervisory authorities so that clear implementing procedures are laid down in accordance to the relevant legislation and international standards was delayed, partly due to the delayed adoption of the TCSP and AML laws' amendments. Specifically, the Cyprus Bar Association published in early August 2013 its new AML Directive, which replaces the previous one dated February 2009. In some other supervisory authorities, preliminary work was initiated in related areas but the finalisation of the measures is to take place in the third quarter of 2013. Although the overall progress in the AML-related issues is positive and agreement has been reached both with regard to the Action Plan and the remaining changes to the legal framework, Cyprus did not comply fully with the ambitious deadlines previously set.

3.2. FISCAL POLICY

An ambitious but achievable fiscal adjustment path over the medium-term is essential to make Cyprus' public debt sustainable. For this reason, a key objective of the fiscal strategy and the consolidation measures in the programme is to achieve a strengthening of the primary balance over the programme period. The primary balance targets for 2013-2016 and the corresponding headline deficit targets (see Table 2.2) were enshrined in the EDP recommendation adopted by the Council on 16 May 2013, in line with the requirements under the 'two pack'. The first review mission confirmed that the underlying budgetary trends in the first half of 2013 remain in line with the adjustment path established in the EDP recommendation, although the exceptional compensation of pension funds who suffered losses in CPB is likely to lead to a higher 2013 deficit, as indicated in the MoU. This is expected to be a one-off measure. To support debt sustainability, revenues above programme projections will be saved or used to reduce debt. Moreover, fiscal-structural reform steps are envisaged to ensure the achievement and maintenance of high primary surplus in the years to come, which will support the long-term sustainability of public finances and would be necessary to provide fiscal space in view of the diversification of the economy. Finally, sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets.

The general government headline budget deficit for the first half of the year amounted to 1.2% of GDP, which is significantly better than the respective period in 2012 and in accordance with the authorities' half-year target for 2013 in ESA terms. Compared to the first half of 2012, total revenue was slightly higher, driven by extraordinary high non-tax revenues. These one-off revenues mainly comprised the sale of licences for gas exploitation and higher dividends due to exceptional CBC profits. An analysis net of one-offs leads to a less positive assessment of overall revenue trends, although total revenues at this stage remain in line with the projection underpinning the April MoU.

Total expenditure has been kept under strict control and has been restrained for key spending categories. Additional measures have contributed to contain the growth in expenditure for social benefits. While the retirement wave in the public sector led to high lump-sum retirement payments, it also contributed to lower-than-projected wage bill in the first half of 2013. An updated projection of the fiscal accounts (Table 2.4) confirms that the underlying budgetary trends in the first half of 2013 remain in line with the fiscal targets established, for both revenue and expenditure. Overall, the Cypriot authorities have implemented its budgetary policy in compliance with the requirements of the MoU. ([6])

The 2013 deficit, however is likely to be substantially larger due to the compensation for provident and retirement funds in CPB. In the April MoU it was flagged that the social welfare nature of provident and retirement funds justified use of the necessary amount of programme financing to compensate funds in CPB to an extent that would ensure a comparable treatment with such funds in BoC. For this purpose, indicative financing of close to 2.5% of GDP was earmarked for Q3 2013 in the assessment of the Cyprus' financing needs (note to the ESM pursuant to Art. 13.1 of the ESM Treaty). The first review mission established that the rate of compensation will be no larger than 52.5% of the total deposit balance held in CPB based on the remaining balance of deposits in BoC after conversion of 47.5% of deposits into equity. This implies that the total budgetary costs of compensation would amount to around 1.8% GDP, of which about half can be released by the time of the second review of the adjustment programme.

Based on the currently available information, it is expected that the budgetary commitment is fully accounted for in 2013 and thus the corresponding 2013 primary deficit would amount to around 4¼% of GDP with a headline deficit of around 8½% of GDP. The Cypriot authorities have committed to adopt the modalities of this scheme before the release of the second tranche of assistance, after review and consultation of the programme partners. The scheme should take into account the cash-flow and actuarial position of each fund in determining the timing by which the compensation will take place and should minimise the impact on the general government deficit and the structural balance.

Cyprus has implemented the 2013 Budget Law and other fiscal consolidation measures with determination. Part of the fiscal adjustment measures for 2013 were enacted in December 2012, while further measures were enacted via the 2013 Budget Law. These measures were listed in Annex 1 of the April MoU and their budgetary effect is subject to monitoring by the authorities and the programme partners. In addition, as part of the 16 and 25 March 2013 Eurogroup political agreements, an additional set of fiscal consolidation measures of more than 2% of GDP for 2013 were decided as prior actions. All the relevant ministerial decisions and bills were passed by the Council of Ministers and the House of Representatives in the second half of April. The Commission services informed the EWG of its positive assessment of compliance with the prior actions by end-April. With these steps, the total amount of fiscal measures for 2013 amount to around 4.5% of GDP, broadly balanced between expenditure and revenue side measures.

([6]) In the April programme forecast, the licensing fees were booked on the revenues side as sales. CYSTAT reclassified these revenues as negative acquisition of capital ("non-produced assets") after consultation with the ESTAT, thus affecting the profile of public finances.

Box 3.3: Estimating the Impact of Discretionary Revenue Measures

Bottom-up estimates for the budgetary impact of discretionary revenue measures are an important element of assessing compliance with both programme and EDP requirements. The approach is based on a "no-policy change assumption": In any given year and for any given measure in a revenue category, the impact is equal to the difference between the actual outturn in that year and the estimated counterfactual outturn had the measure not been in place. Only measures that have been sufficiently specified and committed to by governments are taken into account. For the counterfactual scenario the assumption is that the respective measure is not in place, while the rest of the programme is still being implemented.

Any estimate based on this definition necessarily has a large margin of error. This is because the impact of the measure is the difference between two unknowns: the expected outturn of a given year and the counterfactual outturn, which is particularly difficult to predict. In addition, the uncertainty never gets completely resolved (the counterfactual scenario never materialises) so that there is little opportunity to learn from past forecast mistakes.

In the case of the Cyprus adjustment programme, whenever feasible several methods were used to arrive at a range of estimates. To account for the high degree of uncertainty in the estimates, generally the most conservative figure was chosen. The below explanation of the methodology is simplified, while in the actual assessment a number of specificities were taken into account, e.g. the issue of the cross-impact of measures (e.g., excise duties have an impact on VAT), the way a specific tax is collected, specific downward or upward risks that are not directly quantifiable, and other methods used to complement the analysis.

For most revenue categories the difference between cash and ESA figures is negligible. The first technique uses data on cash revenue collection until June 2013 and extrapolates the half-year figure to the end of the year using past collection patterns. [1] This is applied to revenues where the collection pattern is rather stable over the years and where the tax rate increases are already reflected to a reasonable degree in cash collection (which usually comes with a lag of at least one month). This is the case for VAT and excise duties. The same technique is used for corporate income tax (CIT), but in this case mostly due to a lack of more suitable methods. It is recognised that this is the tax that is most difficult to predict for a variety reasons, inter alia a lag in collection, possibility to carry-forward losses, etc. For 2014 the estimated outturn is based on estimates of the underlying tax base and standard fiscal elasticities. The second technique uses recent data on the respective tax base (such as total wage bill, resident deposits, etc.), projects the development of the tax base until the end of the year, taking into account developments in the year so far and macroeconomic projections, and then applies the new tax rate to the base.

To arrive at the counterfactual estimate two main techniques are used. For the first group of revenues, where in order to estimate the outturn, collection figures are extrapolated to the end of the year, the counterfactual scenario uses, revenues from the previous year as a starting point. It is then assumed that in the absence of a tax rate increase the underlying tax base would have moved in line with macroeconomic developments. For instance, final private consumption is used as a tax base for VAT revenues and the assumption is that the VAT tax base would have decreased in line with the programme's projection for the nominal decline in private consumption. Given its special nature (e.g. due to the impact of loss carryforwards/-backwards), an exemption applies to the CIT, for which the starting point for the counterfactual revenues is the estimated outturn. Tax base developments are here

(1) It should be noted that for most revenue categories the difference between cash and ESA figures is negligible.

(Continued on the next page)

Box (continued)

Table 1:
Overview of the methodologies used for key revenue categories.

Revenue category	Tax base (proxy)	Method to project outturn 2013	Method to project the counterfactual outturn	Other methods applied
VAT; excise duties	Final private consumption	Extrapolation of cash revenues	Based on outturn of previous year and assuming that tax bases would have evolved in line with overall macroeconomic developments.	Yes
Corporate income tax	Net operating surplus	Extrapolation of cash revenues	Based on the projected outturn for 2013 and assuming that without the tax increase the tax base would have been larger. The assumed elasticity for the tax base with respect to the tax rate is -0.1 for 2013 and -0.3 for 2014.	Yes
Withholding tax on interest income; bank levy	Bank levy: total domestic deposits; Withholding tax: resident deposits * interest rate	Based on a projection of deposits and interest rates	Differential tax on the projected tax base.	Yes for the withholding tax.
Temporary contribution on wages; Pension (GSIS) contribution	Total wage bill (including pensions for the temporary contribution)	Based on a projection of the total wage bill, taking into account macroeconomic developments.	Differential tax on the projected tax base.	No
Immovable property tax	Values of immovable property as of 1.1.1980	Based on the actual values and assuming larger problems with compliance than historically the case due to the steep increase in the tax and the inclusion of many first-time payers.	Actual outturn for 2012. This is because the base is relatively stable and because without the increase one would have assumed no significant change in compliance rates.	No

negatively correlated with increases in the tax rate. The underlying technical assumption is that the tax base is reacting to the increased tax rate with an elasticity of -0.1 in 2013 and, given the lags to be expected, with the elasticity of -0.3 in 2014. For example, for 2013 the elasticity of -0.1 implies that without the tax increase of 25% (from 10% to 12.5%) the tax base would have been bigger by 2.6% (= 2.5/97.5).

For the second group of taxes, for which the estimate of the outturn is based on a projection of the tax base, it is assumed that key variables determining the tax base (e.g. total wage bill, resident deposits, and interest rates) are not affected by the respective tax increases. Instead, the differential impact of the tax rate was applied directly to the projected tax base. This assumption is not straightforward for the withholding tax on interest income, but appears justifiable if one considers that deposit movements this year are predominantly driven by the restructuring of the banking sector and developments in the interest rates. Where appropriate, a discount was applied to account for less than 100% compliance rates (percentage collected out of the theoretically predicted tax revenues) based on historical data. The immovable property tax is a case in point.

Table 1 provides an overview of the methodologies applied to different tax categories. The last column indicates whether other methods were used as well.

As agreed in the April MoU, Cyprus has implemented measures, amounting to at least EUR 351m for 2013. These measures comprise first and foremost the measures decided as part of the 16 and 25 March 2013 Eurogroup political agreements, namely an increase in the statutory corporate income tax rate to 12.5%, an increase in the interest income withholding tax to 30% and an increase in the bank levy to 0.15%. Finally, some further measures, in particular public sector wage cuts and a contribution by public sector employees to their health care scheme were implemented.

Some measures on the revenue side are expected to underperform compared to the fiscal projection underpinning the April MoU. The biggest shortfall will likely occur for the withholding tax for interest income. For constitutional reasons, the increase was enacted only as of 29 April 2013 instead of 1 January 2013. Also the yield of the increase in the bank levy (paid by credit institutions) has been revised downwards, due to a change in legislation on which the programme partners were not consulted. (7) With this change the tax base for 2013 was effectively reduced avoiding financial institutions paying levy on a deposit base substantially higher than the current amount of deposits.

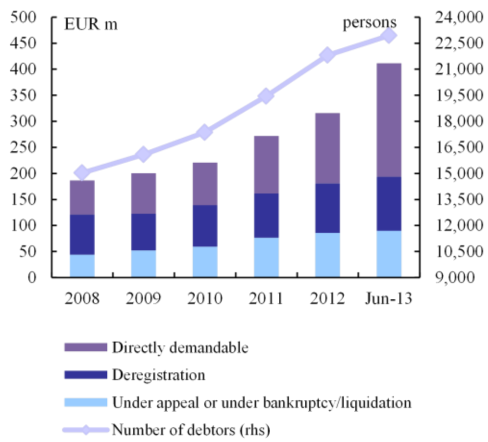
On the expenditure side, Cyprus implemented more than the agreed measures, while other measures over-performed compared to the April assessment. As a consequence, the shortfall on the revenue side was fully compensated, notably by additional social transfer cuts. In particular, housing schemes and benefits for state officials were cut more than originally envisaged.

Two measures with positive budgetary impact were not part of the prior actions: the reform of the motor vehicle tax system and reforms in the educational sector. The authorities presented the programme partners with a reform proposal in June 2013, which was based on environmentally-friendly principles and would ensure that motor vehicle taxes in the future will be largely based on emissions. As a side-effect, the new system will support the recovery of the motor vehicle market by increasing incentives for buying new, less environmentally harmful cars. However, against the background of Cyprus' steeply deteriorating motor vehicle market, generating additional revenues as required in the MoU turned out more difficult than anticipated. It was agreed that the shortfall will be covered by measures in 2014 to reduce overtime pay in the public sector. The reform of the motor vehicle taxes will take effect not later than from the budget year 2014. The educational system is planned to be reformed as of September 2013, ahead of the original deadline of implementation as of the budget year 2014. The reform steps include, inter alia, reducing the number of teachers seconded to the Ministry of Education and Culture and increasing the efficiency of hiring instructors for afternoon and evening programmes. A decision by the Council of Ministers on the implementation of the reform is still pending

The yields for a number of other revenue side measures have also been revised downwards. The possible underperformance of energy excises is largely owed to the deterioration of the cyclical conditions. Also revenues from excises for alcohol and tobacco products so far performed worse than expected. It remains to be seen whether this is a temporary effect, i.e. due to front-loading of purchases before the tax increase. Furthermore, the previous yield for the lottery tax was erroneously set too high as the underlying data provided by the authorities contained an error. The yields for the VAT increases were revised upwards and for the corporate income tax only slightly downwards, which is largely due to a change in methodology for assessing their yields, while actual collection trends also for these taxes show signs of weakness.

Fiscal developments require careful monitoring to ensure that the attainment of the MoU targets is not jeopardized by fiscal risks. Risks to fiscal performance remain tilted to the downside. The uncertain macroeconomic environment carries with it risks of lower-than-projected real and nominal GDP growth, although at this stage such risks have not materialised. Also, the observed tendency of under-performance of certain revenue side measures may relate not only to the level of economic activity but also to shifts in the revenue elasticity. Further, given the severity of the downturn and weaknesses in the tax administration, compliance risks exist. Although there are no signs of widespread non-compliance, tax arrears are growing and the number of debtors has risen significantly since the on-set of the economic crisis (Graph 3.1).

Graph 3.1: **Outstanding VAT and debtors**



Source: Ministry of Finance.

(7) The levy used to be computed on the previous end-year deposits and is now computed on the previous end-quarter deposits.

Finally, several expenditure-increasing policy initiatives have been announced by the authorities without ex-ante consultation with the programme partners, e.g. tax breaks for those who have been affected by the bail-in of uninsured deposits, incentives for capital repatriation in the form of income tax relief and tax deductions for the acquisition of fixed assets related to innovation, research, computing, communications and renewable energy. Moreover, the Cypriot authorities have continued in the first half of 2013 to regularly provide substantial amounts of liquidity assistance to one commercial company, which is subject to an on-going state aid investigation. Irrespective of the outcome of this state aid case, further costs for the general government budget can be expected and have been incorporated in the fiscal projection. To minimise the risk of initiatives that could have a material impact on the achievement of programme objectives, the revised MoU foresees that the Cypriot authorities will consult ex-ante with the EC/ECB/IMF on the adoption of such policies. With regard to agreed programme measures, the Cypriot authorities have exhibited awareness of the risks stemming from non-compliance.

The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation and maintain a primary surplus at a high level over the longer-term. Cyprus has taken steps to strengthen its budgetary framework. The annual budget formulation process has already been enacted last April. In compliance with the programme requirements, the government adopted for the first time a Fiscal Strategy Statement (FSS), as a first step in the budget preparation process. The FSS lays out the economic conditions and government's fiscal strategy for the year 2014, incorporates the medium-term budgetary targets and presents reform steps to improve fiscal governance. The draft 2014 Budget Law will be submitted to programme partners for review in mid-September, accompanied by updated expenditure ceilings for the period 2014-2016. A significant reform of the budgetary process and public finance management in a broad sense is in the making, bringing together all facets of fiscal policy-making and budgeting into a single, ambitious umbrella legislation, the Fiscal Responsibility and Budget System Law (FRBSL). This law is currently being developed and is expected to be adopted by December 2013 (see Section 3.3.2).

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Pension and Healthcare Systems

Significant reform measures for the pension system (the general social insurance system (GSIS) and the government employees' pension system (GEPS)) were implemented as on 1 January 2013. These measures were prior actions and they increased retirement ages, introduced penalties for early retirement and reduced the generosity of pension benefits. One outstanding issue where Cyprus has not yet complied is ensuring that total annual public pension benefits for Members of the House of Representatives do not exceed 50% of their annual pensionable salary. Programme partners have reviewed the corresponding draft bill, but this has not yet been approved by the House of Representatives. The MoU also required that, to the extent possible, all measures aimed at the GEPS should also be made applicable to pension schemes in the broader public sector and to pension schemes for hourly paid public employees. This was largely done, but there are number of cases concerning individual retirement funds, which need to be further examined.

The delivery of the actuarial study for the GSIS system was delayed by one month and is now expected by end-August. The European Commission and the authorities agreed on the underlying macroeconomic assumptions for the study. Following its finalisation, the study will be submitted to the Ageing Working Group of the Economic Policy Committee (AWG/EPC) for a peer review in September 2013. In this context, the financing of the non-contributory pension benefits will also be examined. So far, the authorities have separated the non-contributory part from the contributory part of the pension system in accounting terms. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system. If needed, such reforms will be adopted by end-December and enter into force in Q1-2014. All in all, the conclusion of the review is that Cyprus is partially compliant on pension reform issues.

Where the healthcare system is concerned, the conditionality on strengthening the sustainability of the funding structure was met. The measures to this end encompass: i) the revision of criteria for access to free public health care including a compulsory health care contribution for public servants and public servant pensioners; ii) an increase in fees for medical services for non-beneficiaries of free public health care and various financial disincentives for providing unnecessary medical services and products; and iii) the adoption of a restructuring plan for public hospitals to improve quality and optimising costs. As a second step, a concrete action plan was approved by the Council of Ministers by the end-June. This plan was submitted to the programme partners during the first review mission. The implementation of the fiscal measures (as of 1 August 2013) will be monitored, also in view of needed future adaptations of current measures.

The assessment of the risks and benefits of the planned introduction of the National Health System (NHS) was submitted after the deadline of end-June 2013 during the review mission. The results of the study show in the baseline scenario that implementing NHS creates savings in healthcare expenditure for the Cypriot economy as a whole. The implications of the results of the study are that a NHS should be implemented without further delay by end-2015.

The results of the working groups on structural healthcare measures were broadly satisfactory and should be further elaborated before implementation. These measures include: i) the production of prescription protocols for pharmaceuticals and laboratory tests; ii) health-technology assessments to increase the cost-effectiveness of the basket of publicly reimbursed products; iii) the preparation of the implementation of clinical guidelines; and iv) the definition of a basket of publicly reimbursable medical services based on objective, verifiable criteria including on cost-effectiveness criteria. As regards health-technology assessments, this workstream will require substantial progress to be usable as a tool for reviewing the basket of publicly reimbursable medical products and services. Sufficient progress was also made in other measures with deadlines set for Q3 and Q4 later this year, such as the review of income thresholds for access to free public health care, the review of working time in the Health Service and the establishment a system of family doctors acting as gate-keepers for access to further levels of care.

3.3.2. Public Financial Management and Budgetary Framework

The Fiscal Strategy Statement (FSS) provided a first attempt in moving towards better fiscal planning. In compliance with programme conditionality, the House of Representatives adopted the first Fiscal Strategy Statement on 29 May 2013. It presented the general background for fiscal policy, the macroeconomic and budgetary scenario foreseen in the programme, and recent EU reforms of its fiscal governance. Budgetary developments for 2012 were reported and objectives for the period 2014-2016 were set, including targets for the primary balance, current revenue and primary expenditure. A description of future policy actions is provided in the main sectors (health, public sector employment and reforms, education), followed by a summary of guidelines in relation to the preparation of the 2014 budget. The FSS is a positive step towards better annual and multi-annual fiscal planning and contributes to fiscal transparency and accountability. Yet the document leaves some room for improvement, particularly as regards baseline projections, explanations attached to fiscal outcomes and insufficient coverage of non-State entities (Semi-Government Organisations and Local Government).

The authorities opted for a more ambitious, all-encompassing approach taking the form of an umbrella law covering budgetary processes in the broad sense. While the provisions transposing EU requirements in terms of budgetary frameworks had already been enacted through the medium-term budgetary framework (MTBF) law at the end of 2012, the MoU required that the literal transposition featured in the MTBF law should be complemented by further provisions to ensure effectiveness of the enacted provisions by Q2-2013. In the meantime, following recommendations by the IMF as a result of technical assistance, the authorities decided to move to a broader approach that implied bringing together all facets of fiscal policy-making and budgeting into an integrated umbrella legislation – the Fiscal Responsibility and Budget System Law

(FRBSL). Given the clear advantages of such an over-arching framework for fiscal policy-making and the necessary extensive drafting and legal analysis, the deadline for the fulfilment of MoU conditionality has been extended by two quarters.

The adoption of the FRBSL would rescind the MTBF law, but the shift of deadline shift does not jeopardise the fulfilment of EU transposition requirements. The programme partners' acceptance of more time to adopt the FRBSL will allow the transposition of Directive 2011/85/EU and of the Fiscal Compact portion of the TSCG to be anchored in a comprehensive and consistent fiscal framework, which integrates sound practices. It will therefore improve Cyprus' budgetary framework, which had barely changed until very recently, while ensuring compliance with EU requirements by the end of this year.

The FRBSL should also encompass the provisions grounding the Fiscal Council. The integration of a section grounding the Fiscal Council into the FRBSL would ensure the 'wiring' of the provisions applicable to the Fiscal Council with general fiscal framework provisions. This is important given the recently-adopted two-pack Regulation (Reg. (EU) 473/2013) and the Fiscal Compact, which allocates further tasks to independent fiscal institutions. The provisions of the FRBSL should be accompanied by an implementing text specifying further operational elements, including the legal status of the Fiscal Council staff. It is foreseen that the Fiscal Council will be an independent entity in structural terms, with a leadership composed of three members with attached staff.

The review mission identified public financial management elements that are likely to support budget execution. Gaps in the timely recording and reporting of some categories of spending commitments in the accounting system of the State have been identified. Such gaps lead to unwarranted uncertainties for internal control and the overall monitoring of budget execution. While the level of arrears is relatively low, better commitment control would ensure that expenditure remains firmly contained in line with programme requirements.

Regular assessment of potential fiscal risks stemming from the existing stock of debt or any new government debt along with their close monitoring would contribute to more prudent fiscal policy design. In order to ensure a proper risk assessment of these government guarantees amendments to the Public Debt Management Law and allocation of appropriate human resources will be required.

3.3.3. Public Private Partnerships

While the full Public Private Partnerships (PPPs) inventory is not due until Q3 and the legal and institutional frameworks are both being identified, it is of crucial importance to set the PPPs strategy in the right direction as of now. The evaluation and budgeting of projects should fall under the Ministry of Finance, considering the need to manage fiscal risks. By putting in place an adequate legal and institutional framework for public investment including PPPs, the authorities will be in a better position to establish an effective gateway process verifying the fiscal affordability of projects, as well as the assessment and management of fiscal risks. A draft law on PPPs has been submitted but is expected to fall under the umbrella of the FRBSL, envisaged to be adopted by December.

3.3.4. Privatisation and State-Owned Enterprises

A preliminary inventory of State-Owned Enterprises (SOEs) was submitted but still needs including up-to-date valuations of those SOEs with the highest commercial value. The aim of having an inventory is to identify SOEs that could be subject to divestment, restructuring or liquidation, as well as real estate and land assets that may be used as a buffer in the privatisation plan. The full inventory is expected by the end of 2013, including all SOEs, real estate and land owned by the central government and the local authorities. It will be complemented by a report reviewing and assessing the operations and finances of SOEs, and a legal framework regulating the creation and functioning of SOEs. The first part of the exercise is partially compliant for Q2, as fine-tuning of valuations is still needed.

The authorities have initiated work on a privatisation strategy, requesting input from an external consultant yet to be selected. The type of privatisation process to be followed will depend on the nature of the asset and on the economic sector to which it belongs. Specificities and differences of assets will be considered on a case-by-case basis, including the sale of shares/sale of assets ("break-up"), sale of licences or concession agreements. While some progress has been made on drawing up a coherent privatisation strategy, timely and concrete steps are needed for the adoption and implementation of the legal and institutional framework required for the privatisation process by Q4 2013.

The privatisation process has better chances of success if it is centralised and done in conjunction with structural reforms in specific sectors. Although Cyprus has very little experience on privatisation (only three in the last 30 years), the authorities remain committed to be hands-on the privatisation process and to consider the privatisation of important companies in key sectors of the economy, inter alia CyTA (telecom), EAC (electricity) and CPA (commercial activities of ports). This would not only support fiscal consolidation in the programme period, but may also bolster the country's growth potential over the medium to long term.

3.3.5. Revenue Administration

The reform agenda submitted by Cyprus was unsatisfactory, causing a delay in compliance, but the review mission resulted in substantial progress. The reform agenda submitted by the Q2-deadline did not cover, as required, the key recommendations of the diagnostic technical assistance from February 2013 and the reform project suffered from a weak governance structure. Work during the review mission therefore focused on agreeing the main cornerstones of the reform and improving the governance structure. To this end, Cyprus committed to a comprehensive reform revolving around three key elements: i) creating a new function-based revenue department integrating the Inland Revenue Department (IRD) and the VAT Services; ii) developing and implementing a comprehensive compliance management strategy; and iii) establishing full self-assessment system for income taxes. Furthermore, a Large Taxpayer Unit will be created and short-term compliance and efficiency-enhancing measures will be implemented by the end of this year, with a focus on the self-employed and businesses operating outside the tax system. The full reform will be implemented over the course of the programme. First concrete steps will be taken by the end of 2013, including setting up the governance structure of the reform project, elaborating a full reform plan and initiating work on the compliance analysis. A high-level committee will oversee the reforms.

Progress towards meeting the deadlines set for later in 2013 seems overall adequate. Legislative changes are being prepared to strengthen the administration's power to collect taxes and to hold taxpayers responsible for not paying taxes. An independent formal review of discretion granted by law to upper-level management will take place by end-2013. As part of the comprehensive reform, a harmonised independent administrative appeals process will be ensured. In addition, a pilot-run for a new IT system in the IRD began in the second half of July, paving the way for enhanced access to information from relevant government agencies. To monitor the performance of the tax administration, clear performance criteria are being established. In relation to this, Cyprus requested technical assistance on the identification of the tax gap.

3.3.6. Public Administration Reforms

Public administration (PA) reforms are a cornerstone of the MoU, considering its large share of public expenditure. Reforms in the PA are therefore needed, in order to generate savings in the short-term, but more fundamentally in order to provide for a sustainable system in the long-term through the creation of concrete efficiencies. Cyprus sees PA reforms as a priority, as reflected by various speeches given by President Anastasiades and by the appointment of a Special Commissioner for the Reform of the Public Service. As agreed in the April MoU, an independent external review has been commissioned, led in a first phase by the World Bank and the UK public administration.

The Council of Ministers has decided not to request a redirection of ESF funds for the financing of technical assistance (TA) for the PA reforms and to fund the first batch of studies from the government budget. While there is no objection to financing the TA from the government budget, the authorities need to ensure that these expenditures fit within the overall budgetary targets. The rejection of the use of ESF funds for this purpose implies that the responsibility for finding alternative means of funding lies with the Cypriot authorities.

Progress with reducing impediments to staff mobility is broadly satisfactory, but the possibility to reallocate staff and functions seems to not be fully exploited. The amended Public Service Law allows for an increase in staff mobility within and between ministries, as well as within the broader public sector. This means that the Q2 requirement has been fulfilled. Yet, in a number of areas, staff resources are pointed out as a bottleneck for fulfilling the mandate of public sector bodies or implementing MoU requirements. The authorities should make full use of staff mobility provisions to alleviate these concerns.

3.3.7. Reform of the Welfare System

Cyprus did not submit a satisfactory reform plan for its welfare system in due time. Substantial progress was, however, achieved afterwards and the authorities announced on 26 July a major reform to be prepared in stages and enter into force on 1 July 2014. The reform plan aims to better protect the most vulnerable households while ensuring a more efficient use of public funds. Following consultation and review of the draft reform plan with programme partners during the review mission, the reform plan was adopted by the Ministerial Council on 26 July 2013.

This reform plan identifies problems of the existing welfare system which over time has become fragmented, posing several impediments to the equitable protection of vulnerable groups and the efficient use of public resources. The identified weaknesses relate to: i) fragmentation - with benefits addressing the same objectives often under the responsibility of different ministries; ii) duplication - since different entities in the administration serve a single need of the same beneficiary; iii) inequities - with universal benefits being largely insufficiently targeted; and iv) disincentives for taking up work as the public assistance currently excludes the working poor.

Three overarching principles form the basis of the welfare system reform, namely; i) the provision of targeted benefits to citizens who genuinely need assistance; ii) the need for benefits that should not prevent the recipients from entering or re-entering the labour market; and iii) the enhancement of the effectiveness of the social welfare system to protect vulnerable households adversely hit by the on-going economic crisis. To achieve its goals, the reform advocates the consolidation of the existing social benefits by streamlining them and integrating them under one administrative framework; the improvement in targeting of benefit mechanism; and the provision of work incentives to avoid welfare dependency.

At the core of the reformed social welfare system is the existing unemployment benefit combined with a reformed public assistance programme, the Guaranteed Minimum Income (GMI). Clarity on GMI's coverage, composition, and costing, as well as enhanced information on active labour market polices (ALMPs) with reference also to the unemployed youth are provided in the reform plan. A clear sequence of important milestones for the implementation of the reform and information on transitional arrangements are also outlined in the plan. Consultation with relevant stakeholders (organised groups, social partners, etc.) will take place on the adopted reform plan. The relevant legislation is to be submitted before submission to the House of Representatives and is expected to be adopted by the end of May next year.

The authorities' reform plan makes clear that the reformed welfare system must be consistent with the programme's fiscal targets. In a situation where the total spending envelope for social protection may have to be reduced in the coming years, the authorities have decided that priority should be given to protecting the most vulnerable people and that sufficient budgetary means for fundamental social policies should be ensured.

3.3.8. Other fiscal-structural reforms

Progress in the area of international tax cooperation is adequate. Cyprus has abided by deadlines on information exchange established in Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax. In relation to Council Directive 2011/16/EU on administrative cooperation in the field of taxation, the Commission has received complete transposition measures, but the conformity assessment is still pending. A new IT system, for which a pilot was run in July 2013, will improve the administration's capacity to follow up on information received by other countries, inter alia, by helping with the identification of taxpayers. In the long-term, the new integrated administration of direct taxes and VAT will enhance the ability to properly assess the information received.

The ability to serve information requests from foreign authorities and to follow up on such requests has been improved. Cyprus has addressed the majority of shortcomings of the legislative framework that were identified in the Phase 1 report of the OECD Global Forum on Tax Cooperation and Transparency. In particular, book-keeping requirements have been spelled out, while issues of entity transparency and availability of ownership information on all relevant entities and arrangements are being dealt with within the AML action-plan (see Section 3.1.4). In addition, information requests by foreign authorities can now be conformed with even if no double tax treaty exists with Cyprus and appropriate exemptions have been introduced to the requirement of providing the taxpayer with information on the requesting authority.

The government has initiated the immovable property tax (IPT) reform. The implementation of a property price index is a prerequisite for the IPT reform. To this end, the updated values of properties will form the basis for the calculation of the 2014 property tax and for the IPT reform. The authorities have initiated the revaluation of about 1.1-1.3 million land plots and 0.5 million building properties, along with the recording of plot-and building-related characteristics. In full accordance with the MoU requirement, the government extended the reduction of the property transaction fees (the so-called land registry transfer fees) until the end of 2016. However, delays were recorded in the initiation of two studies, one on refining the parameters of the imputed property market value index and the other on simplifying the collection and administration of the property taxes collected at a municipality level. As the studies are essential to refine themodalities of the future IPT, the extension by one quarter for launching the studies was warranted.

3.4. STRUCTURAL REFORMS

3.4.1. Labour market

Progress in the area of real wage adjustment is on-going. The granting of the Cost of Living Allowance (COLA) has been suspended in the public sector for the full duration of the programme, and an agreement was reached with social partners to suspend wage indexation in the private sector until 2014. Where the application of the COLA in the future is concerned, the wage indexation system in the public sector has been reformed as agreed (annual adjustment at 50% of inflation, with an automatic suspension clause in case of recession), and tri-partite negotiations are on-going for extending the reform also to the private sector. For the minimum wage that is applicable to certain professions, no changes are currently foreseen until the end of the programme.

A series of challenges have been identified for the system of active labour market policies. The authorities were not able to conduct a fully appropriate evaluation of the different activation measures, due to the lack of a coherent and homogeneous framework and appropriate data for the continuous monitoring and evaluation of the different schemes. This shortcoming has been identified as one of the challenges pertaining to the system, the other being the difficulties faced by the Public Employment Services in serving an increased number of unemployed people, the need for increased coordination across different ministries and departments of the administration so as to reduce fragmentation, and the absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information. It has been agreed that the Cypriot authorities will prepare by the end of 2013 detailed policy proposals to address the identified shortcomings.

There is a clear strategy to integrate the system of activation policies with the social assistance system. The envisaged reform of the welfare system, which foresees, *inter alia*, the introduction of a GMI scheme, promotes the integration of public assistance with activation policies, making the participation of beneficiaries in active labour market measures compulsory, and ensuring that continued benefit receipt is conditional on fulfilling job search requirements.

Priority will be given to the implementation of measures to tackle youth unemployment. Given the surge in youth unemployment (27.8% in 2012), and the availability of new European funds within the Youth Employment Initiative, the authorities will present a plan for the implementation of activation measures in conformity with the June 2013 European Council conclusions.

3.4.2. Energy

The Cypriot authorities have successfully transposed the Third Energy Package. They must now ensure that the Third Energy Package is fully and correctly implemented, particularly during and after the transformation of the energy sector in the context of the foreseen introduction of natural gas, first through imports and later from the exploitation of the domestic off-shore gas reservoirs. This work includes: providing clarity on the intended use of the available 'isolated market' and 'emergent market' derogations; and indicating the intended duration of the latter derogations.

Although with delays, the government appears to be now well on track in formulating a comprehensive strategy for the rearrangement of the energy sector. In particular, the government has shown awareness of the major risks and of the gaps in their information base and planning. In response, they have commissioned a number of studies and have been requesting technical assistance ([8]) which will provide critical input to the strategy, albeit later than the deadlines foreseen in the April MoU.

Specifically, while the MoU had asked for an outline of the regulatory regime and market organisation for the energy sector and gas exports by Q2, the Cypriot authorities delivered a rather rudimentary outline of the regulatory regime, because of the late delivery of the necessary preparatory studies and also because of capacity constraints within the energy regulator CERA. Discussions with CERA revealed bottlenecks in staffing and resources.

As regards the market organisation of the domestic electricity and gas sector, private consultants had provided a draft outline together with recommendations that are still under discussion. However, this outline does not address the important issue of the extent of competition in the markets in question. Other aspects mentioned in the MoU also need further clarification and/or work, namely; the potential for market entry, for setting up wholesale markets and opening up to non-producing traders; freedom of customers to choose their supplier; the unbundling of network and commercial functions; and the sales framework for the gas exports.

The authorities appear to have advanced more in the development of the infrastructure roll out plan (with a Q3-deadline), since much of the information appears to have become available in their on-going work with the energy companies, in particular that with the license-holder of the Aphrodite field regarding a possible future LNG Plant. However, this also underlines the risk that the strategic outlook is being developed in the slipstream of the on-going chain of planning and implementation decisions, and thus with a less-than-desirable broad outlook. Conversely, crucial decisions also depend on information produced in the actual negotiations with prospective commercial partners, such as is the case with the sales framework for both the domestic and export markets. The latter illustrates the interdependency between the infrastructure roll-out plan and the outline of the regulatory regime and market organisation.

In general, the government's strategy needs to consider more explicitly and more comprehensively the uncertainty concerning the actual size of the domestic commercially-viable natural gas fields and the time at which they will become available as well as developments in the international gas markets. In this context, the authorities should consider more explicitly the uncertainty on the exploration of eventual fields in the blocks/zones other than that of the Aphrodite gas field, and should make use of "alternative world energy scenarios" from an internationally-reputed organisation.

In view of the on-going work, the government agreed with the programme partners on the delivery of a comprehensive intermediate

([8]) Namely on the finance aspects; on the market design and regulatory regime; and on the integration on the electricity grid of the surge in solar and wind power.

outline for the whole energy sector by the end of this year and the delivery of the final outline in Q2 2014; this can be seen as a modest delay compared to the timeline set out in the April MoU.

As regards the management of the public revenues coming from the gas reserves, the Ministry of Finance has now started working on the "resource fund", aligning it with the budgetary framework. In this context, the House of Representatives is expected to adopt the Fiscal Responsibility and Budget Systems Law by December. The law will contain provisions ensuring that all public natural gas revenues, together with all public spending related to these revenues and to the development of the natural gas sector, are channelled through the budget. Discussions during the mission revealed the need to further examine the various types of public revenues, including those received and possibly accumulating in energy entities (partly or fully) owned by the government.

3.4.3. Services and regulated professions

Most amendments aligning the legislation with the principles of the Services Directive have been adopted. In the sector-specific legislation, Cyprus is moving towards the full implementation of the Services Directive, by completing the process in a number of remaining sectors, e.g. building contractors and construction services, tourism, car rental services or employment agencies. As regards the requirements concerning minimum tariffs, which according to article 15(3) of the Services Directive should be eliminated unless they are justified, the Cypriot authorities will provide further information on the rules that refer to the calculation of fees for professional services in technical professions, including those adopted by professional bodies. These rules will be assessed by the Cypriot Commission for the Protection of the Competition (CPC) and by the European Commission before adoption for compliance with internal market and competition principles. As only some of the required legislative amendments were adopted, the Q2-deadline is partially compliant.

Work on the liberalisation of the regulated professions is on-going. Total bans on advertising were amended by the Cyprus Bar Association, bringing it into line with the Code of Conduct of the Council of Bars and Law Societies of Europe. However, there are other specific regulated professions where the elimination is still pending, for which compliance with the Q2 deadline is considered to be partial. On the identification of relevant professions that need full liberalisation, a list of the priority professions was submitted in early August and the related requirements affecting the access and exercise of activity will be reviewed for Q3 compliance.

3.4.4. Housing market and immovable property regulation

The reform of the housing market and immovable property regulation is taking longer than foreseen. The Cypriot authorities presented the draft legislation providing for the mandatory registration of sales contract for immovable property during the review mission, whilst adoption may only take place later in the year. In July 2013, data were published on building and planning permits ([9]) and on title deeds, deed transfers and related mortgage operation. ([10]) This publication, along with an executive commentary, is expected to be done on a quarterly basis. In relation to the electronic access of the title deeds and mortgage registries, the data privacy legislation has been reviewed and the amendments on the procedures for proof of legal interest are still pending. The authorities have committed to abolish any requirements on the proof of legal interest by October 2013.

3.4.5. Tourism

A study on how to improve the tourism sector business model and an update of the Tourism Strategy 2011–2015 were submitted during the review mission. With the current economic outlook, it has become even clearer that tourism represents a driver for future growth and employment, even more considering it contributed to approximately 11% of total GDP in 2012, As some of the targets included in the 2003-2010 Tourism Strategy were not met, a new approach needs to be identified. A concrete action plan due

([9]) http://www.moi.gov.cy/moi/moi.nsf/All/61E2787F312449DEC2257B9F003D0527?OpenDocument

([10]) http://www.moi.gov.cy/moi/dls/dls.nsf/dmldata_en/dmldata_en?OpenDocument in the next quarter should help implementing quantified targets. Procedures that will facilitate condo hotel projects in existing or new hotel developments have been established within the deadline, while mixed-use developments (combined use of land) will be facilitated by the end of 2013. As some of the deliverables were submitted during the first review mission, the implementation of programme commitments can be considered compliant with delay.

As Cyprus suffers a major drawback against its competitors in tourism, a concrete air connectivity strategy and an action plan appear necessary. Cyprus will determine and adapt its external aviation policy, considering the new demands from new markets, but also considering the existing limitations to negotiate bilateral agreements, due primarily to the closure of Turkey's airspace.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

On 25 March, the Eurogroup decided to grant – in principle – external assistance to the Republic of Cyprus of up to EUR 10bn. This envelope was considered adequate to finance debt redemption, fiscal deficits and the recapitalisation of the financial sector – excluding Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC) – until the end of the first quarter of 2016.

Close to EUR 3.1bn were disbursed in the second quarter of 2013 by the ESM and the IMF. Following the approval of the adjustment programme by the ESM Board of Governors the ESM disbursed its first tranche of EUR 3bn in two instalments: EUR 2bn upon adoption of the Financial Assistance Facility Agreement (FFA) by the ESM Board of Directors on 13 May and EUR 1bn on 26 June. The IMF disbursed its first tranche of EUR 86m on 15 May, following the Executive Board's approval of the adjustment programme.

The first disbursement provided the Cypriot authorities with sufficient funds to cover needs for debt service and deficit financing until the next cash disbursement foreseen by the end of the fourth quarter 2013. During the second quarter, funds were used to reimburse in particular the foreign-law bond worth EUR 1.4bn which matured on 7 June and to cover fiscal needs of about EUR 300m. Hence, the government's cash buffer has also increased and will be sufficient to cover estimated third quarter fiscal financing needs of between EUR 600m and EUR 700m.

Following the successful exchange of domestic-law bonds held by residents, which was announced on 27 June and completed on 1 July, the programme remains fully-financed. Cypriot authorities exchanged some EUR 1bn of domestically-held bonds with new bonds maintaining the same coupon rates of about on average 5% and within a maturity range of 6 to 10 years. This operation was fully in line with the Eurogroup statements of 16 and 25 March and ensured that the domestic roll-over target over the entire programme horizon was met at an early stage.

The debt exchange also increased the average maturity of Cyprus' outstanding marketable public debt. Following the redemption of about EUR 1.5bn in June and July (a foreign-law bond worth EUR 1.4bn on 7 June and a domestic-law bond worth around EUR 50m on 4 July subsequent to the debt exchange), the weighted average maturity of total outstanding marketable medium-term and long-term debt increased to almost 8 years. The repayment schedule has also improved somewhat and is spread more evenly with on average about EUR 0.5bn per year, although amortisation humps occur; in 2014, 2015, 2019 and 2020.

In order to avoid high roll-over risks shortly after the end of the programme period, Cypriot authorities have renegotiated the terms of the loan granted by the Russian Federation. Under the original agreement the total reimbursement of a EUR 2.5bn bilateral loan granted by the Russian Federation in 2011 was scheduled for the second quarter of 2016. According to the authorities, Cyprus has succeeded in renegotiating the loan's terms (the completion of the relevant domestic procedures, i.e. ratification of the new agreement by the Russian Duma, is still in progress). Repayment will now take place in eight biannual instalments of slightly more than EUR 300m between 2018 and 2021. The interest rate of 4.5% was reduced to 2.5%.

A successful first programme review would enable the Eurogroup to approve ESM's non-cash disbursement (EUR 1.5bn) for the recapitalisation of the financial sector excluding BoC and CPB – in line with the Eurogroup statement. The precise timing of the injection of capital into the cooperative credit institutions depends on approval of bank restructuring plans by the European Commission under the state aid rules.

The next cash disbursement is currently planned for the end of the fourth quarter 2013, conditional on the timely and full implementation of the programme. As no significant debt redemptions are scheduled for the remainder of this year and fiscal projections remain unchanged vis-à-vis the programme's baseline estimate no cash-disbursements are foreseen until the successful conclusion of the second review, i.e. towards the end of the fourth quarter.

Table 4.1: **Public debt trajectory, 2012-2016**

	2012	2013	2014	2015	2016
Gross debt stock (% of GDP)	85.8	115.0	123.2	126.9	122.5
Δ debt stock	14.7	29.2	8.2	3.6	-4.4
Primary balance (neg = PB in surplus) (1)	3.1	4.2	4.3	2.1	-1.2
Interest payments	3.2	4.1	4.3	4.1	4.2
Deficit/debt adjustment	8.1	13.3	-3.6	0.6	-2.7
Growth impact	1.8	8.2	4.6	-1.3	-2.4
Inflation effect	-1.4	-0.6	-1.3	-1.8	-2.2

(1) Incl. payments for compensation of pension funds.
Source: Commission services.

Taking into account the second ESM and IMF disbursements, around EUR 5.3bn of the overall programme envelope will remain available. Following the first cash disbursement (EUR 3bn) and the cash-less second tranche for the recapitalisation of the financial sector (EUR 1.5bn), the ESM will have disbursed half of its commitment of EUR 9bn, already. The IMF, spreading disbursements equally over the programme horizon and not participating in the recapitalisation of the financial sector, will have disbursed a total of EUR 0.17bn, i.e. about 17% of the funds allocated to the Cypriot economic adjustment programme.

There are no critical changes to the debt sustainability assessment. Debt projections are sensitive to macroeconomic developments, especially deviations in the projected paths of nominal GDP and the fiscal balance. However, there are until now no changes to the key parameters of the macro- and fiscal forecasts which would impact on the debt trajectory. In addition, based on current information, estimated financing needs over the programme horizon still seem appropriate and have not been revised. Consequently, general government debt is expected to peak at around 127% of GDP in 2015 and decline to around 123% of GDP in 2016 (Table 4.1).

5. RISKS TO THE PROGRAMME

Despite the programme's positive kick-off, overall and specific targets are conditioned by the following downside risks:

- potentially stronger contraction of the economy, with further worsening of the labour market outlook and a steeper drop in real estate prices, ultimately leading to a longer period of low confidence;

- protracted period of low confidence in the banking sector resulting from the restructuring and downsizing of the banking sector;

- the relatively large amount of NPLs in the domestic banking system could further tighten credit supply conditions weighing on economic growth and affect the capital situation of the banks;

- worsening of the economic situation in trade-partner economies;

- inability to reach the agreed primary surplus targets established in the programme, due to insufficient policy measures, implementation shortcomings or adverse macroeconomic and financial developments;

- insufficient implementation of fiscal-structural measures underpinning the achievement of continued high primary surpluses;

- lower-than-expected privatisation proceeds;

- insufficient implementation of structural reforms, e.g. in energy, tourism and housing, constrained by adverse macro and financial developments, but also by vested interests; and

- lack of success in regaining market access at a reasonable borrowing cost, once the programme is coming towards its conclusion.

ANNEX 1
Compliance Table

Table A1.1: **Assessment of compliance: monitoring table**

	Actions for the first review (to be completed by end Q2-2013)	**Assessment** - Comment
Financial sector	**REGULATION AND SUPERVISION**	
	Maintaining liquidity in the banking sector	
	1.1 The impact of the (capital) restrictions will be monitored on a daily basis with full information sharing with EC, ECB and IMF. The restrictions on capital movements will be gradually relaxed, in consultation with EC, ECB and IMF and will remain in place no longer than strictly necessary to mitigate serious risks for the stability of the domestic financial system. A Monitoring Board comprising the EC and the Cypriot authorities is established to ensure the monitoring and assessment of the implementation of the temporary capital controls.	**Compliant -** Continuous monitoring, information sharing and Monitoring Board established. Gradual relaxations.
	1.2 The CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.	**Compliant -** Daily flows and liquidity buffer are reported by the banks and are monitored by the CBC.
	1.3 Domestic banks relying on central bank funding or receiving state aid will establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter, starting from June 2013, to the CBC, which will be transmitted to the ECB, the EC, the European Stability Mechanism (ESM) and IMF. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.	**Compliant with delay -** For Bank of Cyprus and the coops, an extension of the deadline, by mid-October and end-September, respectively, was agreed/granted.
	Regulation and supervision for banks and cooperative credit institutions	
.	**1.6** The CBC's guidance on the classification of loans as non-performing will be amended to include all loans past due by more than 90 days. This amendment will be introduced by 30 May 2013. The time series for non-performing loans will be published including historical observations reaching back as far as possible.	**Compliant with delay -** The CBC, after extensive consultation with programme partners, issued the respective Directive on 11 July 2013, with an application date of 1 July 2013.
.	**1.11** The CBC will implement a unified data reporting system for the banks and the cooperative credit institutions by end-June 2013. The publication of the statistical data will be extended to the cooperative credit institutions, for which the CBC will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.	**Compliant with delay -** After a consultation with programme partners, the data template designed by the CBC has been populated and published on 23 July 2013.

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Table (continued)

	1.13 The supervision of cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and integrated into the CBC by end-July 2013, for which legislation will be passed by end-June 2013. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, a time-bound, actionable plan to achieve this by end-June 2013. By end-May 2013 legislation will be introduced to authorise the CBC to instruct the current cooperative credit sector supervisor to intervene also at the level of individual cooperative credit institutions.	**Partially compliant -** The draft bill on instructing the current coops supervisor was amended based on programme partners' comments and is in the process of legal vetting by the Attorney General. As regards the transfer of supervision, draft amending laws were prepared and were sent to the programme partners for comments, but an action plan still needs to be sent.
	Monitoring of corporate and household indebtedness	
	1.15 The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. The Financial Stability Report, to be published on a yearly basis as of December 2013, will include an extended analysis on corporate and household indebtedness. These enhanced monitoring actions will be put in place by end-June 2013.	**Compliant with delay -** The CBC has extended its set of indicators on private sector indebtedness. The internal quarterly "Household and Non-Financial Corporate Indebtedness Report" was sent to the programme partners for comments on 12 July.
	1.16 (a) First, by end-April 2013 a directive will be circulated by the CBC to instruct banks to provide a grace period of 60 days to allow borrowers and banks to restructure loans. (b) Second legislation will be passed, if needed, to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers. (c) Third, by end-June 2013 the Cypriot authorities will develop a framework and issue legislation as needed to address legal, administrative or other impediments affecting the restructuring of viable borrowers, while preserving credit discipline. The approach will be based on market-based voluntary workouts, underpinned by measures to strengthen the legal framework to support debt restructuring. Moreover, amendments will be introduced to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring. (d) Finally, a mediation service between banks and their clients to achieve fair debt restructuring will be established by end-June 2013.	**Partially compliant -** Compliance with respect to (a) and (b). For (c) the CBC has prepared and sent to programme partners a supervisory framework and a draft code of conduct which it will issue to banks. For (d) the existing law on the Financial Ombudsman will be amended to allow the Ombudsman to undertake the mediation role.
	Increasing financial transparency	

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Table (continued)

	1.17 Following the completion of the April 2013 audit, the findings and recommendations contained in the final reports of MONEYVAL and the auditor will be taken into consideration in the action plan envisaged in the programme, and the customer due-diligence and suspicious-transaction reporting procedures will be enhanced following the audit report recommendations by Q2-2013. The Cypriot authorities have committed to an action plan on entity transparency to revise the legal framework and ensure its dutiful implementation, so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters. To this end, the action plan will envisage that the Cypriot authorities will promptly revise relevant pieces of legislation, including, inter alia, the Trust and Company Services Provider law and the Anti-Money Laundering law by Q2-2013. In addition, directives and circulars issued by supervisory authorities (CBC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) will be revised to lay down clear implementing procedures that are in line with relevant legislation and international standards by Q2-2013.	**Compliant with delay -** The AML action plan has been agreed in late July 2013. The required amendments in the Trust and Company Service Provider (TCSP) and the AML laws have been agreed with the programme partners and will be adopted by the HoR (House of Representatives) in early September 2013. The revision of the directives and the circulars by the supervisory authorities has been extended to Q3-2013, since these revisions follow the amendements of the two laws.
	RECAPITALISATION, DUE DILIGENCE, RESOLUTION AND RESTRUCTURING	
	1.18 A Coordination Committee with representatives from the CBC and the Ministry of Finance will be set up to oversee the implementation of the financial sector reform programme and to monitor developments in the banking sector.	**Compliant -** The Coordination Committee has been set up and takes part in the weekly calls with the programme partners with respect to the MoU implementation.
	1.22 The other commercial banks (other than BOC and Laiki) will be instructed by the CBC to take the necessary steps to ensure that they meet regulatory requirements in a stress scenario by end-September 2013. Cooperative credit institutions will be instructed to meet capital regulatory requirements by July 2013.	**Compliant** - Authorities have acted accordingly. Hellenic is in the process of raising capital from private sources. The coops are in the process of applying for state aid.
	Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus	
	1.27 To ensure that the capitalisation targets are met, a more detailed and updated independent valuation of the assets of Bank of Cyprus and Cyprus Popular Bank will be completed, as required by the bank resolution framework, by end June 2013. To this end, no later than mid-April 2013, the terms of reference of the independent valuation exercise will be agreed in consultation with the EC, the ECB, and the IMF.	**Compliant with delay -** KPMG was appointed on 30 May 2013 and delivered the final report on 26 July 2013.

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Table (continued)

	1.28 Finally given the systemic importance of Bank of Cyprus, it is important that the operations of Cyprus Popular Bank are quickly integrated, operational efficiency is improved, the recovery of non-performing loans is optimised with the work-out implemented by the going concern entity and the funding conditions are progressively normalised. (a) In order to achieve these goals and to ensure that Bank of Cyprus can operate with maximum safeguards to preserve stability and continued viability during a transition period, the CBC, following consultation with the Ministry of Finance, will appoint a new Board of Directors and an acting Chief Executive Officer until Bank of Cyprus' new shareholders are organised in a general meeting. (b) The CBC will require the Board of Directors to prepare a restructuring plan defining the bank's business objectives and credit policies by end- September 2013. (c) To ensure that normal business activities are not affected, institutional arrangements will be designed by end-June 2013 in accordance with Cypriot law to insulate Bank of Cyprus from reputational and governance risks.	**Compliant with delay -** The BOD was appointed in late April 2013. An acting CEO was appointed on 28 May 2013. The restructuring plan which is expected to be submitted to the CBC by end-August. The CBC and the MoF consider that the Resolution Authority has sufficient powers to unsulate BoC from potential reputational and governance risks.
	Restructuring and recapitalisation of cooperative credit institutions	
	1.31 With a view to minimising state aid, cooperative credit institutions requiring recapitalisation should seek private sector participation no later than 31 July 2013.	**Compliant -** The Central Cooperative Bank has notified the CBC that no material amount of capital is expected to be raised from the private sector. The CBC notified programme partners and asked for their approval in order for the CCIs (Cooperative Credit Institutions) to proceed directly with the application for state aid for the full amount of recapitalisation needs. Programme partners have provided confirmation.

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	1.32 - 1.34 As regards the cooperative credit institutions, the CBC, assisted by the current supervisor and in consultation with the EC, the ECB and the IMF, will ascertain the viability of individual cooperative credit institutions and design a strategy for restructuring and recapitalising the sector. This strategy, including the possibility of the application of mergers and restructuring, will be submitted to the EC, also informing the ECB and the IMF by end-July 2013 based on an assessment of capital needs and viability to be finalised by June 2013. The terms of reference for this assessment will be finalised in consultation with the EC, the ECB and the IMF by April 2013. The restructuring plans for the cooperatives will be submitted to the EC by September 2013. Cooperative credit institutions in need of aid from the state will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. Implementation of the strategy should be completed by 30 June 2015. Until the overall strategy has been agreed, there will be no change in the structure of the sector, without prior consultation with the EC, the ECB and the IMF. The amounts will be injected following the identification of the capital needs and in accordance with the agreed strategy, after approval of the restructuring plans. A new governance structure will be established, which allocates clear levels of continued accountability and provides for proper incentives to avoid moral hazard, having regard to a two-tier supervisory system applied in other EU Member States.	**Compliant with delay -** The Cypriot authorities have finalised the calculation of the capital needs. The draft strategy for restructuring and mergers has been prepared and sent to the programme partners for comments. Upon agreement, the restructuring plan can be prepared and submitted to programme partners for approval.
Fiscal Policy	**Fiscal Policy in 2013**	
	The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (Annex I of the MoU) and to monitoring the budgetary effect of the measures taken on a monthly basis.	**Compliant -** The adopted bills amounted to consolidation measures of about 7 ½ % of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 4.4% of GDP in 2013, 2.2% of GDP in 2014, and 0.4% of GDP in 2015-2016 based on the macroeconomic projections of the first programme review in July 2013. The CY authorities monitor their effect as part of the regular reporting to the programme partners.
	Revenue Measures	
	2.2 Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.	**Compliant -** Legislation adopted in April 2013.

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	2.3 Increase the statutory corporate income tax rate to 12.5%.	**Compliant -** The law was approved by the HoR in April 2013.
	2.4 Increase the tax rate on interest income to 30%.	**Compliant -** The law was approved by the HoR in April 2013.
	2.5 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11% to 0.15% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.	**Compliant -** The law was approved by the HoR in April 2013.
	2.6 Undertake a reform of the tax system for motor vehicles, based on environmentally-friendly principles, with a view to raising additional revenues, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.	**Compliant with delay -** Submission to the HoR of the draft law for the reform was delayed due to disagreement on the amount of additional revenues to be raised. Agreement has been reached and approval of the reform will be a prior action before the next disbursement.
	2.7 Complete the increase in fees for public services by at least 17% of the current values.	**Compliant -** The relevant bills and the Council of Ministers decisions were adopted prior to the signature of the MoU in April 2013.
	Expenditure Measures	
	Introduce measures to control healthcare expenditure (see 3.2 measures):	
	2.8 3.2 To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted prior to the granting of the first disbursement of financial assistance:	
	2.8 3.2 (a)(i) abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories (except for persons suffering from certain chronic diseases depending on illness severity). Introduction of a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. For families with three or more dependent children, the participation in this health care scheme will be voluntary and, (ii) the measure will be reviewed by Q2 2014 with the programme partners.	**Compliant** The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013 with an implementation clause 3 months after the publication on the gazette. The law entered into force on 1 August 2013. In the law the prices of medical activities have been revised upwards and the increase of utilisation fee for general practitioners' services is lower than that for the utilisation of specialist doctors.
	2.8 3.2 (b) increase fees for medical services for non-beneficiaries by 30%, create a co-payment formula with zero or low admission fees for visiting general practitioners, and increasing fees for using higher levels of care for all patients irrespective of age;	**Compliant -** The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013 with an implementation clause 3 months after the publication on the gazette. The law entered into force on 1 August 2013. A fee for using emmergency care is introduced as a financial disincentive.
	2.8 3.2 (c) introduce effective financial disincentives for using emergency care services in non-urgent situations;	**Compliant -** The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013 with an implementation clause 3 months after the publication on the gazette. The law entered into force on 1 August 2013.

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	2.8 3.2 (d) introduce financial disincentives (co-payment) to minimize the provision of medically unnecessary laboratory test and pharmaceuticals;	**Compliant** - The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013. The law provides for the pre-paid coupons and entered into force on 1 August 2013.
	2.8 3.2(e)(i) adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals improving quality and optimising costs by putting into practice recommendations from the 2009 "Public Hospital Roadmap" and (ii) adopt a new decision by the Council of Ministers for redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".	**Compliant** - A new Council of Ministers decision was adopted prior to the signature of the MoU. An analytical timeline of the subsectors of this reform was presented at the first review mission.
	2.9 Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.	**Compliant** - The Council of Ministers adopted legislation in April 2013 to discontinue the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes, with immediate enforceability.
	2.10 Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.	**Compliant -** The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013 with an implementation clause 3 months after the publication on the gazette. The law entered into force on 1 August 2013.
	2.11 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8%; EUR 2.001-3.000: 1%; EUR 3.001-4.000: 1.5%; above EUR 4001: 2%.	**Compliant -** The law was approved by the HoR in April 2013 and published on the Cyprus official gazette on 30 April 2013 with an implementation clause 3 months after the publication on the gazette. The law entered into force on 1 August.
Fiscal-structural measures	**Pension Reforms**	
	3.1 Separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme by 30 June 2013 . The non-contributory part will be tax financed;	**Compliant -** A study defining and quantifying the contributory and the non-contributory pension schemes was received by programme partners in June 2013. The financing issue will be assessed once the results of the actuarial study on the GSIS will become available.

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	3.1 For the General Social Insurance System (GSIS): (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012) ;	**Compliant -** The draft law was approved by the HoR in December 2012.
	3.1 Ensure that total annual public pension benefits for public sector employees and state officials do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (in place since January 2013);	**Partially Compliant -** A draft law was approved by the HoR in December 2012. However, pensions of the Members of the HoR are dealt with in another law which is still pending and is expected to be approved by the HoR in Autumn 2013.
	3.1 Ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013);	**Compliant -** The draft law was approved by the HoR in December 2012.
	3.1 An actuarial study for the GSIS will be carried out and submitted for peer review in the Ageing Working Group of the Economic Policy Committee by end-July 2013. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.	**Compliant with delay -** The submission of the study is planned for end-August 2013.
	Health care expenditure	
	For measures 3.2 (a - e) see 2.8	
	3.2 (f) assess and publish before parliamentary discussion the potential risks and benefits of the planned introduction of the National Health System (NHS) in an updated actuarial study, taking into account possible proposals for implementing NHS in stages by Q2 2013.	**Compliant -** Subject to agreed changes on sensitivity scenario and transparency of assumptions
	3.2 (g) make the award of the tender for the IT-infrastructure conditional upon the results of the study and the decision for implementing NHS;	**Compliant -** An alternative IT strategy will be elaborated to reduce future expenses on the IT solution.
	3.2 (h) review income thresholds for free public health care in comparison to to the eligibility criteria for social assistance while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures by Q4 2013.	**Compliant -** Working group and roadmap according to progress report established.
	3.2 (i)(i) create protocols for laboratory tests based on thorough scientific evidence.	**Compliant -** Protocols for laboratory tests created.
	3.2 (i)(ii) create protocols for the prescription of pharmaceuticals based on thorough scientific evidence.	**Compliant -** Protocols for the prescription of pharnmaceuticals created.

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	3.2 (k)(i) conduct an assessment of the basket of the top 4 publicly reimbursable healthcare products in terms of annual spending, prepare a report to establish an integrated system for health-technology assessment to increase the cost-effectiveness of the basket of publicly reimbursed products	**Compliant -** Assessment conducted and report prepared.
	3.2 (k)(ii)Prepare the implementation of 10 new clinical guidelines focusing on high annual volume and high cost diseases	**Compliant -** Implementation of 10 clinical guidelines prepared.
	3.2 (n) Define a basket of publicly reimbursable medical services based on objective, verifiable criteria including on cost-effectiveness criteria by Q2 2013	**Partially compliant -** Cost-effectiveness can only be taken in continously with building up competence in health-technology assessment.
	3.2 (o)Furthermore, the Cypriot authorities will consider establishing a system of family doctors acting as gate-keepers for access to further levels of care.	**Compliant** - Progress report has been submitted
	Budgetary Framework	
	3.3 The Cypriot authorities will:	
	3.3 provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures of its governing body and funding arrangements grounded in law by Q2 2013.	**Partially compliant -** Provisions on the establishment of the Fiscal Council, which were initially contained in the MTBF law adopted on 19 December 2012, were insufficiently specified. Enhanced provisions grounding the Fiscal Council are to be included in the Fiscal Responsibility and Budget System Law (FRBSL), an umbrella law covering Cyprus' budgetary processes, expected to be adopted in Q4-2013.
	3.3 complete the adoption of the law transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts ensuring that adopted measures are fully effective by Q2-2013. In particular, integrate the presentation of the existing multi-annual budgetary objectives (MoU fiscal targets and the rolling three-year expenditure ceilings) into a comprehensive Fiscal Strategy Statement in compliance with MTBF requirements in the sense of Directive 2011/85/EU to guide the preparation of the 2014 budget by Q2-2013;	**Partially compliant -** The Fiscal Strategy Document was adopted by Ministerial Council on 29 May 2013. Other requirements are to be met with provisions that are to be included in FRSBL, covering budgeting and fiscal policy to be adopted by Q4-2013
	Public private partnerships (PPPs)	
	State-owned enterprises and privatisation	

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Table (continued)

	3.5 As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets, the Cypriot authorities will establish an inventory of assets, owned by central government, municipalities and regional administrations, including real estate and land. As a first step, priority will be given to assets with the highest commercial value, including at least one third of SOEs by Q2 2013 (and the remaining SOEs by Q3 2013).	**Partially compliant -** The authorities submitted an initial inventory of SOEs within the deadline. However, the valuations of the SOEs with the highest commercial value were not up-to-date.
	Revenue administration, tax compliance and international tax cooperation	
	3.8 The Cypriot authorities will implement reforms, which build on the main recommendations derived from the diagnostic technical assistance mission conducted in February 2013. To this end, the authorities will elaborate a comprehensive reform agenda and consult with the programme partners on this agenda by Q2 2013.	**Compliant with delay -** A reform agenda was submitted to programme partners on time, but did not cover the main recommendations of the diagnostic technical assistance mission. Cornerstones of a reform and first steps towards it were agreed during the mission. The reform plan will be further specified by end-2013.
	Immovable Property Tax Reform	
	3.10 In order to retain a stimulus to property demand and reduce distortions in property prices, provide for an extension of the reduction in property transaction fees until 2016 by Q2 2013.	**Compliant -** Legislation adopted in April 2013
	3.10 In addition, the following studies should be initiated by mid 2013, and their recommendations implemented at the latest from 1 January 2015 onwards: · a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and · a further study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenue from transaction fees and taxes to recurrent taxation by early 2015.	**Partially compliant -** The authorities provided with delay the ToR of the first study, but not of the second one. In addition, preliminary work (i.e. formation of work group) has taken place in relation to the first study. Despite the expected delay in the initiation of the studies, the implementation date of their recommendations has remained unchanged
	Public Administration Reform	
	3.11 The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will undertake the following reform measures: reduce impediments to staff mobility within the public and broader public sector, inter alia, by removing restrictions arising from the Public/Broader Public Service Laws as to the duration and placement of secondments, as well as the need for employee consent by Q2 2013.	**Compliant -** The amended law was submited to the HoR within the deadline.

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	Welfare System (Reforms must be consistent with the fiscal targets defined in this MoU)	
	3.12 The welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), the Cypriot authorities will carry out a reform of the welfare system to be implemented and applied as of 1 January 2014 after review by and consultation with the programme partners.	**Compliant with delay -** A draft refrom plan was submitted to programme partners on 17 July 2013. During the review mission, consultations with programme partners led to a significant revision of the draft plan. A revised draft refrom plan was submitted on 24 July 2013 and the reform plan of the welfare system was adopted by the Ministerial Council on 26 July 2013.
Labour market	**Cost of Living Adjustment (COLA) of wages/salaries**	
	4.1 To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities will reform the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. This reform acts on relevant elements of the indexation system, as follows:	**Compliant -** The 2012 budget law has been amended to reflect the reform of wage indexation.
	4.1 - A lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year; - A mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; - A move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.	**Compliant -** The details of the reform have been specified as agreed.
	4.1 As foreseen in section I.2 of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.	**Compliant -** Wage indexation has been suspended until the end of the programme.
	Minimum wage	
	4.2 With a view to preventing possible adverse competitiveness and employment effects, the Cypriot authorities commit that, over the programme period, any change in the minimum wage covering specific professions and categories of workers should be in line with economic and labour market developments and will take place only after consultation with the programme partners.	**Compliant -** Given the current assessment of the situation in the labour market, no change to the minimum wage is expected to take place until the end of the programme.
	Public assistance and activation of the unemployed	
	The Cypriot authorities will:	

(Continued on the next page)

Table (continued)

	4.3 - ensure that the planned reform of public assistance includes measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt. To this end, the draft reform plan on public assistance will be submitted to the programme partners by Q2-2013 for review and consultation;	**Compliant -** Activation measures are a key component of the agreed reform of the social welfare system.
	4.3 - provide an assessment of current activation policies by Q2-2013;	**Partially compliant -** Due to a lack of consistent data, a proper and comprehensive evaluation of the different activation measures was not possible. At the same time, a series of challenges to the current system of activation policies have been identified.
Goods and services market	**Services Directive: Sector-specific legislation**	
	5.1 The Cypriot authorities will adopt the remaining necessary amendments to the sector-specific legislation in order to fully implement the Services Directive, easing the requirements related to entry and establishment. In addition, requirements concerning minimum tariffs should be eliminated unless they are justified according to article 15(3) of the Services Directive. Amendments will be presented to the HoR by Q2-2013 and minimum tariff requirements without justification will be abolished by Q2-2013.	**Partially compliant -** The authorities have enacted only some of the necessary amendments towards the full implementation of the Services Directive. Further amendments to the sector-specific legislation are necessary. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.
	Reform of Regulated professsions	
	5.2 The authorities will eliminate any existing total bans on the use of a form of commercial communication (advertising) in regulated professions, as required by the Services Directive Q2-2013;	**Partially compliant -** The authorities still need to eliminate some of the existing total bans on advertising in specific regulated professions.
	Competition and sectoral regulatory authorities	
	Housing market and immovable property regulation	
	The Cypriot authorities will	
	5.4 - provide for mandatory registration of sales contracts for immovable property by Q2-2013.	**Non-compliant -** There is still no mandatory registration of immovable property sales contracts.
	5.4 - publish quarterly progress reviews of the issuance of building and planning permits, certificates, and title deeds, as well as title deed transfers and related mortgage operations throughout the duration of the programme;	**Compliant -** The first publication of data was launched in late July 2013.
	5.4 Personal data privacy legislation shall be reviewed and amended to alleviate legal impediments to such electronic access, in particular concerning the procedures for proof of legal interest Q2-2013.	**Partially compliant -** Legislation has been reviewed, while amendments on the procedures for proof of legal interest are still pending.
	Tourism	
	The Cypriot authorities will	

(Continued on the next page)

Table (continued)

	5.5 - carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, increasing occupancy rates of hotels and promoting resident tourism during winter time, developing a multi-dimensional and high quality tourism, inter alia, by defining thematic niches such as sport, cultural and medical tourism, developing individual tourism, promoting professionalism of tourist service providers and ensuring the dissemination of best-practices on upgrading the quality of the services provided, improving the role of tourism-related infrastructure investment. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings by Q2-2013;	**Compliant with delay -** The revised Strategy was submitted within the deadline, while the study was completed by late July 2013.
	5.5 - facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments by Q2-2013.	**Compliant -** The condo hotel projects framework was published within the deadline.
	Energy	
	5.6 Ensure, without delay, that the Third Energy Package has been completely transposed and fully implemented and notify the European Commission that the necessary legislation has been transposed;	**Partially compliant -** The Commission has closed transposition file on the Third Energy Package; compliance has been achieved on transposition and is on-going on implementation.
	5.6.2 An outline of the regulatory regime (CERA) and market organisation for the energy sector and gas exports, which would be conducive to the introduction and proper functioning of open, transparent, competitive energy markets, taking into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions.	**Partially compliant -** A rudimentary outline was delivered. The deadlines for a comprehensive outline were postponed pending the results of on-going studies and further discussion, which will provide important input.

Source: Commission services.

ANNEX 2
Macroeconomic Projections

Table A2.1: **Use and supply of goods and services (volume)**

percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	1.5	0.5	-3.0	-12.4	-5.7	1.6	3.0
2. Government consumption expenditure	1.0	-0.2	-1.7	-8.9	-3.7	-1.7	-1.5
3. Gross fixed capital formation	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.5
4. Domestic demand excl. inventories	0.2	-2.1	-5.9	-13.9	-5.9	1.0	2.1
5. Changes in inventories (contr. to growth)	1.8	0.5	-0.9	0.0	0.0	0.0	0.0
6. Domestic demand incl. inventories	1.9	-1.6	-6.7	-13.9	-5.9	1.0	2.1
7. Exports of goods and services	3.8	4.5	2.3	-5.5	-2.5	1.7	2.7
7a. - of which goods	12.2	22.6	1.0	-1.9	-0.4	1.9	2.8
7b. - of which services	2.4	1.2	2.6	-6.3	-3.0	1.7	2.7
8. Final demand	2.5	0.1	-4.0	-11.2	-4.8	1.3	2.3
9. Imports of goods and services	4.8	-0.7	-7.2	-16.5	-6.8	1.7	3.3
9a. - of which goods	7.3	-4.0	-10.0	-20.0	-8.7	1.6	3.3
9b. - of which services	-0.4	6.8	-1.4	-10.0	-3.5	1.7	3.3
10. GDP at market prices	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
(Contribution to change in GDP)							
11. Final domestic demand	2.0	-1.7	-6.9	-13.8	-5.5	0.9	2.0
12. Changes in inventories	1.8	0.5	-0.9	0.0	0.0	0.0	0.0
13. Net exports	-0.6	2.2	4.4	5.0	1.6	0.2	-0.1

Source: Commission services.

Table A2.2: **Use and supply of goods and services (value)**

percent change unless otherwose stated	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	3.7	3.9	-0.5	-11.6	-4.3	3.2	4.8
2. Government consumption expenditure	2.6	3.5	-0.5	-7.8	-2.4	-0.1	0.2
3. Gross fixed capital formation	-3.7	-11.8	-21.9	-28.7	-10.9	4.0	5.3
4. Domestic demand excl. inventories	2.0	1.0	-3.9	-13.1	-4.6	2.7	4.0
5. Changes in inventories (contr. to growth)	1.8	0.4	-0.8	0.0	0.0	0.0	0.0
6. Domestic demand incl. inventories	3.8	1.4	-4.7	-13.0	-4.6	2.7	40.0
7. Exports of goods and services	6.1	6.6	4.5	-4.0	-1.2	3.2	4.3
7a. - of which goods	13.6	24.1	2.1	-0.2	0.7	3.3	4.3
7b. - of which services	4.8	3.4	5.1	-5.0	-1.6	3.1	4.3
8. Final demand	4.5	2.9	-2.0	-10.2	-3.5	2.9	4.1
9. Imports of goods and services	7.0	2.1	-5.1	-14.5	-4.8	3.5	5.0
9a. - of which goods	9.6	-0.7	-7.9	-17.2	-6.8	3.4	5.0
9b. - of which services	1.6	8.4	0.8	-9.4	-2.0	3.7	4.9
10. Gross national income at market prices	4.4	7.2	-4.8	-5.0	-3.4	1.5	3.0
11. Gross value added at basis prices	3.8	3.9	-0.3	-11.3	-2.6	2.4	3.2
12. Gross domestic product at market prices	3.3	3.3	-0.5	-8.2	-2.9	2.6	3.7

Source: Commission services.

Table A2.3: **Implicit deflators**

percent change	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	2.1	3.4	2.5	0.9	1.4	1.5	1.7
2. Government consumption expenditure	1.6	3.8	1.2	1.0	1.3	1.5	1.6
3. Gross fixed capital formation	1.2	1.4	1.4	1.0	1.2	1.6	1.7
4. Domestic demand incl. inventories	1.9	3.1	2.1	0.9	1.4	1.7	1.8
5. Exports of goods amd services	2.2	2.1	2.2	1.5	1.3	1.3	1.5
6. Final demand	2.0	2.8	2.1	1.1	1.4	1.6	1.7
7. Imports of goods and services	2.1	2.8	2.3	2.5	2.1	1.9	1.7
8. Gross domestic product at market prices	1.9	2.7	2.0	0.6	1.1	1.5	1.8
HICP	2.6	3.5	3.1	1.0	1.2	1.6	1.7

Source: Commission services.

Table A2.4: **Labour market and costs**

Percent change unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity	0.8	0.0	1.0	0.0	0.1	0.0	0.4
2. Compensation per employee	2.6	3.3	1.6	-7.5	-5.0	-1.8	1.3
3. Unit labour costs	1.1	3.2	-0.1	-6.6	-4.7	-1.8	0.6
4. Total population	2.6	2.6	2.7	1.0	1.0	1.0	0.8
5. Population of working age (15-64 years)	2.9	2.9	1.7	1.0	1.0	0.2	0.2
6. Total employment	-0.2	0.4	-4.1	-7.8	-3.7	1.0	1.3
7. Unemployment rate (1)	6.3	7.9	11.9	17.0	19.5	18.7	17.5

(1) Eurostat definition, percent of labour force.
Source: Commission services.

Table A2.5: **External balance**

EUR bn unless otherwise stated	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods (fob)	1.1	1.4	1.4	1.4	1.4	1.5	1.5
2. Imports of goods (fob)	5.8	5.8	5.3	4.3	4.1	4.2	4.4
3. Trade balance (goods, fob/fob) (1-2)	-4.7	-4.3	-3.9	-2.9	-2.6	-2.7	-2.9
3.1 p.m. (3) as % of GDP	-26.8	-24.2	-21.6	-17.8	-16.4	-16.6	-16.9
4. Exports of services	6.2	6.4	6.7	6.4	6.3	6.5	6.8
5. Imports of services	2.6	2.8	2.8	2.6	2.6	2.7	2.8
6. Service balance (4-5)	3.6	3.6	3.9	3.8	3.7	3.8	4.0
6.1 p.m. 6 as % of GDP	20.6	19.9	21.6	23.0	23.3	23.3	23.4
7. External balance of goods and services (3+6)	-1.1	-0.8	0.0	0.9	1.1	1.1	1.1
7.1 p.m. 7 as % of GDP	-6.2	-4.3	0.1	5.2	6.8	6.6	6.4
8. Balance of primary incomes and current transfer	-0.5	-0.2	-2.1	-1.2	-1.2	-1.2	-1.3
8.1. - of of which, balance of primary income	-0.6	0.1	-0.7	-1.3	-1.3	-1.5	-1.7
8.2 - of which, net current transfers	0.0	-0.2	-0.1	0.1	0.2	0.3	0.4
8.3 p.m. 8 as % of GDP	-2.9	-1.3	-11.8	-7.2	-7.3	-7.5	-7.4
9. Current external balance (7+8)	-1.6	-1.0	-2.1	-0.3	-0.1	-0.1	-0.2
9.1 p.m. 9 as % of GDP	-9.2	-5.6	-11.7	-2.0	0.6	-0.9	-1.0
10. Net capital transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11. Net lending (+)/net borrowing (-) (9+10)	-1.6	-1.0	-2.1	-0.3	-0.1	-0.1	-0.2
11.1 p.m. 11 as % of GDP	-9.0	-5.4	-11.8	-2.1	-0.6	-0.8	-0.9

Source: Commission services.

Table A2.6: **Fiscal accounts**

	2010	2011	2012	2013	2014	2015	2016
			levels, EUR m				
Taxes on production and imports	2,679	2,612	2,640	2,315	2,269	2,289	2,445
Taxes on income and wealth	1,926	2,098	1,981	1,847	1,711	1,766	1,842
Social contributions	1,552	1,566	1,634	1,385	1,394	1,259	1,298
Other current resources	948	851	885	1,116	886	1,124	1,325
Total current revenue	7,106	7,127	7,139	6,663	6,260	6,439	6,910
Capital transfers received	10	12	11	11	10	11	11
Total government revenue	7,116	7,139	7,150	6,674	6,270	6,450	6,921
Compensation of employees	2,758	2,875	2,820	2,613	2,544	2,380	2,283
Intermediate consumption	978	945	907	857	831	976	1,075
Social transfers	2,500	2,630	2,701	2,573	2,665	2,590	2,551
Interest payments	391	426	564	669	653	679	707
Subsidies	62	85	95	100	102	96	93
Other current expenditure	436	500	476	361	302	244	197
Total current expenditure	7,125	7,461	7,562	7,173	7,097	6,965	6,906
Total capital expenditure	911	811	715	565	505	515	512
Total expenditure	8,036	8,272	8,278	7,738	7,602	7,480	7,419
General government balance, EDP (1)	-920	-1,132	-1,127	-1,064	-1,332	-1,030	-498
			% of GDP				
Taxes on production and imports	15.4	14.5	14.8	14.1	14.2	14.0	14.4
Taxes on income and wealth	11.1	11.7	11.1	11.2	10.7	10.8	10.9
Social contributions	8.9	8.7	9.1	8.4	8.7	7.7	7.7
Other current resources	5.4	4.7	4.9	6.8	5.6	6.9	7.8
Total current revenue	40.8	39.6	39.9	40.6	39.2	39.4	40.7
Capital transfers received	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total government revenue	40.9	39.7	40.0	40.6	39.3	39.4	40.8
Compensation of employees	15.8	16.0	15.8	15.9	15.9	14.5	13.5
Intermediate consumption	5.6	5.3	5.1	5.2	5.2	6.0	6.3
Social transfers	14.4	14.6	15.1	15.7	16.7	15.8	15.0
Interest payments	2.2	2.4	3.2	4.1	4.1	4.1	4.2
Subsidies	0.4	0.5	0.5	0.6	0.6	0.6	0.5
Other current expenditure	2.5	2.8	2.7	2.2	1.9	1.5	1.2
Total current expenditure	40.9	41.5	42.3	43.7	44.5	42.6	40.7
Total capital expenditure	5.2	4.5	4.0	3.4	3.2	3.1	3.0
Total expenditure	46.2	46.0	46.3	47.1	47.7	45.7	43.7
General government balance, EDP (1)	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
Nominal GDP	17.4	18.0	17.9	16.4	16.0	16.4	17.0

(1) Excl. compensation of pension funds, estimated to amount to 1.8% of GDP in 2013 (accruals).
Source: Commission services.

Table A2.7: **Debt developments**

	2010	2011	2012	2013	2014	2015	2016
EDP deficit (% of GDP)	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
EDP gross debt (% of GDP)	61.3	71.1	85.8	115.0	123.2	126.9	122.5
			levels, EUR bn				
EDP deficit	-0.9	-1.1	-1.1	-1.1	-1.3	-1.0	-0.5
Gross debt	10.7	12.8	15.3	18.9	19.7	20.9	21.0
Change in gross debt	0.8	2.1	-2.6	-2.6	-1.8	-1.1	-0.1
Nominal GDP	17.4	18.0	17.9	16.4	16.0	16.4	17.0
Real GDP	15.1	15.2	14.8	13.5	13.0	13.1	13.4
Real GDP growth (% change)	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
			% of GDP				
Gross debt ratio	61.3	71.1	85.8	115.0	123.2	126.9	122.5
Change in gross debt ratio	2.8	9.7	14.7	29.2	8.2	3.6	-4.4
			Contribution to change in gross debt				
Primary balance (1)	3.0	3.9	3.1	4.2	4.3	2.1	-1.2
Snow-ball effect	0.4	0.4	3.6	11.7	7.6	1.0	-0.5
of which							
Interest expenditure	2.3	2.4	3.2	4.1	4.3	4.1	4.2
Real growth effect	-0.8	-0.3	1.8	8.2	4.6	-1.3	-2.4
Inflation effect	-1.1	-1.7	-1.4	-0.6	-1.3	-1.8	-2.2
Stock-flow adjustments	-0.6	5.4	8.1	13.3	-3.6	0.6	-2.7

(1) Incl. payments for compensation of pension funds.
Source: Commission services.

Table A3.1: **Estimated financing needs for the period 2013-2020**

cash data unless states otherwise	2013				2014				2015				2016	Programme period (2013Q2-2016Q1)	2013	2014	2015	2016	2017	2018	2019	2020
million euros, negative = surplus / revenue	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1									
Amortisation of existing market debt excl. short-term	8.5	1,440.9	132.0	33.5	252.3	108.8	556.9	97.7	147.5	65.6	73.3	910.5	338.2	4,157.1	1,606.4	1,015.6	1,196.9	662.031	421.0	791.9	1,486.1	1,808.3
of which:																						
domestic- (GRDS) & foreign-law (EMTN) bonds	0.0	1,416.9	47.6	1.0	244.0	90.0	500.0	55.3	141.3	44.3	17.6	873.8	332.4	3,764.0	1,465.4	889.3	1,076.9	332.4	287.4	19.6	703.1	1,032.5
loans	0.0	17.9	76.1	24.2	0.0	10.5	48.6	34.2	0.0	15.0	49.4	30.5	0.0	306.6	118.2	93.4	95.0	103.3	113.6	752.3	763.0	755.8
Amortisation of new market debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	218.5	0.0	0.0	0.0
Amortisation of offical lenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.2	57.4	114.8	165.0
ESM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.2	57.4	114.8	165.0
Financial sector recapitalisation	0.0	0.0	1,500.0	0.0	0.0	300.0	0.0	300.0	0.0	200.0	0.0	200.0	0.0	2,500.0	1,500.0	600.0	400.0	0.0	0.0	0.0	0.0	0.0
of which contingency buffer	0.0	0.0	0.0	0.0	0.0	300.0	0.0	300.0	0.0	200.0	0.0	200.0	0.0	1,000.0	0.0	600.0	400.0	0.0	0.0	0.0	0.0	0.0
Fiscal financing needs	-0.1	257.4	616.7	326.1	38.9	609.1	270.1	600.9	21.8	453.5	6.9	336.3	-250.5	3,287.3	1,200.1	1,519.0	818.6	-137.4	-355.9	-144.3	-123.5	-92.9
of which:																						
primary balance	-182.0	115.0	469.0	147.0	47.5	320.7	-85.8	396.1	-83.5	334.5	-160.3	253.2	-238.8	1,514.6	731.0	678.5	343.9	-203.8	-530.8	-736.8	-764.8	-793.8
interest (in ESA terms)	148.1	207.9	208.0	104.2	151.8	80.7	320.3	121.2	159.1	89.7	285.9	131.4	172.7	2,032.8	520.0	674.0	666.1	693.9	701.1	725.8	778.0	841.5
programme financing needs	8.4	1,698.3	2,248.7	359.5	291.2	1,017.9	827.0	998.6	169.3	719.1	80.2	1,446.9	87.7	9,944.4	4,306.5	3,134.7	2,415.5	87.7	290.7	705.1	1,477.4	1,880.4
memo: total annual financing needs															4,315.0	3,134.7	2,445.5	524.6	0.0	0.0	0.0	0.0

Source: Commission services.

ANNEX 4

Programme Documents

Memorandum of Understanding on Specific Economic Policy Conditionality

The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus. The key programme objectives are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls;

- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and

- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the sector's problems are home-grown and relate to overexpansion in the property market as a consequence of the poor risk management practices of banks. Furthermore, the financial sector was vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector would benefit from a considerable restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress since April

Work continued to address the challenges, in particular the downsizing of the banking sector and regulatory reform, as well as the restructuring of the banking sector. First, Bank of Cyprus has been taken out of resolution upon the finalisation of its asset valuation . Second, the authorities have designed a strategy to restructure the cooperative credit institutions. Third, Hellenic bank has launched a capital raising plan. Fourth, administrative restrictions and capital controls have gradually been relaxed.

While the implemention of the restructuring of the banking sector has met with some delays, considerable progress has been achieved on supervision and regulation. The new classification on non-performing loans is in effect since 1 July. A unified data reporting system for both commercial and cooperative banks has been implemented and on 23 July the financial stability indicators in the new framework were available on the website of the Central Bank of Cyprus (CBC). The integration of the supervison of the cooperative credit institutions is being finalised. Monitoring of private sector indebtedness is stepped up with the presentation of the first (internal) quarterly report on 12 July. Concerning dealing with troubled borrowers, a CBC circular was issued end-April to grant a grace period of 60 days and legislation/regulation is in preparation to better manage arrears and to set up an mediation service. The amendments to anti-money laundering legislation have been submitted to Parliament and changes to the trust register to improve the information on the beneficial owner is in the process of legal vetting.

A. Regulation and supervision

Maintaining liquidity in the banking sector

1.1. As bank liquidity was under pressure after the two largest domestic Cypriot banks have been put under resolution, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of credit institutions. Temporary restrictive measures for cash withdrawals and exports of cash, card payments, credit transfers, the cashing of cheques and account opening were introduced. These measures were designed to minimise disruptions in the payment systems and to ensure the execution of transactions essential for the functioning of the economy. The Government has introduced and implemented the restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions has since been monitored on a daily basis by the Cypriot authorities with full information sharing with the European Commission (EC), the European Central Bank (ECB), the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). A Monitoring Board has been established by the EC and the Cypriot authorities, with the ECB, the IMF, ESM and the EBA participating as observers, in order to ensure monitoring, assessment and timely relaxation of the implemented temporary restrictive measures. A number of restrictions have already been relaxed or lifted, following a gradual approach, after consultation with the Monitoring Board. The remaining restrictive measures will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system.

1.2. The Cypriot authorities have developed a roadmap which identifies a series of milestones for the gradual relaxation of the remaining measures, also taking into account indicators of investor confidence in the banking system and financial stability indicators, including the liquidity situation of credit institutions. To enhance transparency and predictability of policies, the roadmap was published **on 8 August 2013**. The roadmap foresees two major stages of relaxation: the first pertains to measures within the Republic and the second relates to cross-border movements of capital.

1.3. Furthermore, the CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector. The CBC will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules. In this respect, the Cypriot authorities stand ready to consider the issuance of additional government guarantees, if needed.

1.4. The authorities will request domestic banks relying on central bank funding or that are to receive State aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter to the CBC, which will be transmitted to the ECB, the EC, the ESM and the IMF. The Cooperative Central Bank and the Bank of Cyprus will submit their first plan **by end-September 2013 and mid-October 2013 respectively**. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central bank, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.

1.5. The lack of concentration limits in the liquidity framework for euro-denominated assets allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the CBC will update the liquidity regulations **by December 2014**, after consultation with the ECB, the EC and the IMF and informing the ESM.

Regulation and supervision of banks and cooperative credit institutions

1.6. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on a report commissioned to an independent expert, the necessary legislative changes will be submitted to the House of Representatives **by mid-2014** and implemented **by end-2014**, macroeconomic conditions permitting.

1.7. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. A new definition of non-performing loanshas entered into force on 1 July 2013. The time series for non-performing loans will be published including historical observations reaching as far back as possible.

1.8. The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. The legal framework for the credit register will be set up **by end-September 2013** and the central credit register will be operational **by end-September 2014**.

1.9. After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC will review, **by end-October 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.

1.10. Legislation will be passed **by end-September 2013** to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members whose existing debts to their banks are non-performing in accordance with the new definition adopted by the CBC, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.11. The CBC will submit draft legislation to Parliament **by end-December 2013** to introduce mandatory supervisory action based on capitalisation levels, drawing upon technical assistance and international best practices, becoming effective **by end-March 2014**

1.12. The CBC will issue **by end-October 2013** mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their operations. Starting **end-December 2013**, banks under restructuring plans will be required to publish quarterly reports describing main developments. To enhance their credibility, the reports will be accompanied by independent assessments made by the banks’ external auditors on the basis of agreed procedure with the CBC.

1.13. Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed in accordance with the timeline to be set in the framework of the Single Supervisory Mechanism.

1.14. Cooperative credit institutions have played a significant role in the domestic economy and an important objective of the programme is to strengthen the regulation and supervision of the cooperative sector. To complete the alignment of the regulation and supervision of cooperative credit institutions to that of commercial banks, the Cypriot authorities will integrate the supervision of cooperative credit institutions into the CBC, for which legislation will be passed as a **prior action**. Subsequently, the CBC will finalise **by end-September 2013** a detailed action plan to effectively exercise the supervision of the cooperative sector. This action plan should include steps to recruit experienced staff, and to apply the CBC supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational **by end-March 2014**.

1.15. The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF while informing the ESM will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution. The pro forma consolidated accounts of the cooperative credit institutions will be published beginning from 2013 annual accounts.

1.16. The CBC should have sufficient staff to fulfill its responsibilities and tasks. Legal obstacles to the CBC's ability to employ and retain the necessary and qualified staff should be removed without delay. To further strengthen the regulatory and supervisory framework in line with international best practices, the authorities will also request a stand alone assessment against the "Basel Core Principles for Effective Banking Supervision", to be completed **by end-2015**.

Monitoring of corporate and household indebtedness

1.17. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. The first quarterly monitoring report has been received in the beginning of July 2013 and its scope and content will be further enhanced.

1.18. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs.

- Several steps have already been taken and the Cypriot authorities need now to finalise the banks' Code of Conduct for dealing with troubled borrowers and framework for the management of arrears **by end-August 2013**. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented
- **By end-September 2013** banks will be asked to submit to the CBC a strategy to implement the framework for the management of arrears. Banks will need to include in the strategy a diagnostic of areas that require strengthening and an action plan to ensure full implementation.
- **By end-October 2013**, banks will submit to the CBC their plan to implement the restructuring framework within their organization. They will also be required to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).

- Building on recent work to identify and address impediments for private debt restructuring, **by end-October 2013** the authorities will perform a legal review of the relevant legislation with technical assistance as needed.

- On this basis, legislation will be passed to expand the role of the mediation service between banks and their clients to achieve fair debt restructuring **by end-November 2013,** while ensuring adequate resources for the service given the expected case load.

Increasing financial transparency

1.19. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the April 2013 audit undertaken by MONEYVAL and an independent auditor identified specific shortcomings. The Cypriot authorities are committed to further enhancing the AML framework and to ensuring its implementation, under the timetable set out in the agreed AML Action Plan (see Annex 2) and in particular by taking the following measures:

- Strengthen preventive measures of obliged entities with regard to customer due diligence, use of introduced business and reporting of suspicious transactions (Action Plan – sections 1, 2 and 3).
- Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the Cypriot authorities' commitment to establish trust registers with the supervisory authorities (Action Plan – section 4.3.1)
- The supervisory competent authorities will review their off-site and on-site supervisory procedures and further implement a risk-based approach to AML supervision for financial and non-financial (lawyers, accountants and TCSPs) institutions (Action Plan – sections 5 and 6).
- On a quarterly basis, in the context of the programme review starting **Q4 2013**, the supervisory competent authorities will, on a confidential basis, share anonymised information with the programme partners, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

Moreover, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to revise the legal framework so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters:

- To this end, the Cypriot authorities will promptly, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, adopt revisions to the Trust and Company Services Provider law.

- In addition, **by 11 September 2013** and in any event prior to the release of the second tranche of financial assistance, the authorities will amend the Anti-Money Laundering Law in order to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.

- In addition, the authorities will ensure that directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) are revised to lay down clear implementing procedures, in line with relevant legislation and international standards **by Q3 2013**.

B. Recapitalisation, resolution and restructuring

Restoring adequate capital buffers

1.20. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by end-December 2013**.

Restructuring and resolution of Bank of Cyprus

1.21. A transitory Board of Directors of Bank of Cyprus, appointed on 26 April 2013, has been mandated by the CBC to ensure the bank's stability once it has exited resolution The transitory Board of Directos has called a General Meeting of the shareholders to be held, no later than **12 September 2013** to appoint a new Board of Directors. The CBC will require the Board to prepare a restructuring plan defining the bank's business objectives and credit policies, including measures to enhance viability and profitability, **by mid-October 2013**. The plan, to be reviewed and approved by the CBC, should specify quarterly goals.

Restructuring and recapitalisation of other commercial banks

1.22. Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. Capital should, to the largest extent possible, be raised from private sources including asset disposals and liability management exercises. To this end, **by end-September 2013**, the necessary steps will have been launched. In case, **by end-October 2013**, private sector participation was not successful, State aid can be granted. Any public support granted, must be in line with State aid rules. The banks need to be fully capitalised **by end-December 2013** without burdening depositors.

Restructuring and recapitalisation of cooperative credit institutions

1.23. The CBC assessed the capital needs of individual cooperative credit institutions, indicating a total capital shortfall of EUR 1.5 billion. The CBC has finalised by **July 2013** a strategy for restructuring and recapitalising the sector, including a plan to merge individual cooperative credit institutions into a maximum of 18 entities **by March 2014**. These mergers are designed to achieve viability, efficiency and profitability.

1.24. Within that strategy the CBC will introduce a minimum capital requirement for the core tier 1 ratio of 4% for the individual affiliated cooperative credit institutions. That requirement will enter into force **by end-December 2013**, but the capital will be only injected by the Central Cooperative Bank into individual cooperative credit institutions as mergers are completed. At the consolidated level, the sector is still subject to the general minimum core tier 1 capital requirement of 9%.

1.25. The restructuring plan for the cooperative sector will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before the restructuring plan has been formally approved under state-aid rules. The terms and remuneration of the public support will comply with the EU State-aid rules with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process, which will be scrutinised by an external monitoring trustee. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

1.26. 1.26. The legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector will be established, as a **prior action** for the review. The framework will allocate clear levels of continued accountability and will define the role of the State as the main Central Cooperative Bank shareholder. On this basis, a relationship framework between the State and the Central Cooperative Bank will be established and fully operationalized **by end-October 2013**, to ensure that the Central Cooperative Bank adopts sound policies and restructuring measures to enhance the viability of the cooperative sector, but without interfering in commercial business decisions. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the fulfilment of the prior action, as mentioned above, and will be deposited in a securities account with the CBC to boost confidence in the system. EUR 1.5 billion of state funds will be injected in the Central Cooperative Bank in exchange for common shares on the basis of capital needs identified in the PIMCO exercise and in line with state aid rules, **by end-October 2013**.

2. Fiscal policy

Key objectives

Putting public finances on a sustainable path is of overriding importance in order to stabilise the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term economic prospects of Cyprus.

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; (3) to this end, to fully implement the fiscal consolidation measures for 2013, listed in Annex 1 and below; (4) to correct the excessive general government deficit by 2016; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to monitoring the budgetary effect of the measures taken on a monthly basis. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[11] will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Sound fiscal policy and expenditure prioritisation should contribute to preserving the good implementation of Structural and other EU funds, in respect with the programme's budgetary targets. In the light of Cyprus' economic challenges, EU funds will be targeted to those areas that deliver the most important economic and social impact, in accordance with the priorities to be set in the relevant EU regulatory framework. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-20 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.

[11] Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3.

In accordance with Regulation 472/2013, Cyprus shall provide all the information that the programme partners consider to be necessary for the monitoring of the implementation of the economic adjustment programme. The Cypriot authorities will consult ex-ante with the European Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a general government primary deficit of no more than EUR 395 million (2.4% of GDP) in 2013. The 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank (see 2.3). Over 2013, the Cypriot authorities will rigorously implement the 2013 Budget Law (as amended), including the additional permanent measures adopted prior to the granting of the first disbursement of financial assistance (see Annex 1), which should amount to at least EUR 351 million (2.1% of GDP).

The following measures will be adopted after review by and consultation with the programme partners prior to the granting of the second disbursement of financial assistance:

2.2. A reform of the tax system for motor vehicles with effect **from budget year 2014**, based on environmentally-friendly principles, with a view to raising additional revenues in the medium-term, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

2.3. A compensation scheme for provident and retirement funds in Cyprus Popular Bank. The scheme should meet the following criteria: (i) ensure comparable treatment with such funds in Bank of Cyprus, (ii) take into account the cash-flow and actuarial position of each fund in determining timing by which the compensation will take place, (iii) minimise the impact on the general government deficit and ensuring its one-off nature. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will earmark an amount of up to EUR 299 million out of the state budget, for such compensation, of which up to a maximum of EUR 154 million can be released, before the second review of the adjustment programme.

Fiscal policy in 2014

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014. To this end, Cyprus should fully implement permanent measures for 2014, amounting to at least EUR 270 million in 2014 (Annex 1). The total amount of fiscal policy measures to underpin the 2014 budgetary targets, will be agreed in the context of the 2014 Budget Law consultation.

After review by and consultation with the programme partners **by mid-September 2013**, the 2014 Budget Law will be adopted **by December 2013**. The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document. The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided to the programme partners.

Ensure additional expenditure savings, including by revising the formula for calculating overtime compensation on weekdays and in weekends for state officers and apply the revision pro rata in the case of hourly paid employees.

Fiscal policy in 2015-16

The Cypriot authorities will achieve a deficit in the 2015 general government primary balance of no more than EUR 344 million (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204 million (1.2% of GDP).

After review by and consultation with the programme partners the 2015 and 2016 Budget Laws will be adopted, respectively, **by December 2014** and **December 2015**.

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document. Any deviation from the budgetary objectives contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided to the programme partners. In **Q2-2016**, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While taking note that the Cypriot authorities have recently introduced significant reforms (as noted in Annex 1), the implementation of further reforms of the pension system to address the high projected increase in pension spending may be necessary in order to put the pension system on a sustainable path. The overarching objectives of the reforms are: i) to reduce the increase in pension spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

In view of this, the Cypriot authorities have implemented/agreed to implement the following measures:

- separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme (in place **since July 2013**). The non-contributory part will be tax financed;
- measures have been adopted to ensure that total annual public pension benefits do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (except for pension benefits for Members of the House of Representatives, for whom the measures will be adopted **by mid-October 2013** and enter into force by **1 January 2014**); and
- ensure that all of the measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

An actuarial study for the GSIS will be submitted **by end-August 2013,** for peer review in the Ageing Working Group of the Economic Policy Committee. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.

The actuarial study should project the scheme’s finances on a cash basis. Given the financial sustainability focus, on the revenues side, the study should not take into account any government subsidy (i.e. contribution that is currently at 4.3% of the payroll and the return on the accumulated notional reserves as at the start of the projection period) with the exception of credited contributions and the contributions made by the government as an employer on behalf of its employees. On the expenditures side, the study should only take into account benefits related to contributions paid and credited contributions, i.e. excluding the costs related to the top-up for the minimum pension (which is considered to be tax financed). The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs.

After review by and consultation with the programme partners, if needed, a comprehensive reform with the aim of establishing the long-run viability of the system, will be carried out; and, this reform will be adopted **by end-December 2013** and enter into force **in Q1-2014**.

Health care expenditure

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted:

a) preserve and implement all fiscal measures relating to compulsory health-care contribution for public servants and public servant pensioners to be reviewed by **Q2-2014** with the programme partners and all co-payments for using public health care services;

b) restructure public hospitals according to the action plan as approved by the Council of Ministers at end-June 2013 and aim at full implementation by **Q2-2015;**

c) taking into account the results of the updated actuarial study and after consultation with the programme partners, implement without further delay a National Health System (NHS), to be in place by **end-2015**, ensuring its financial sustainability while providing universal coverage and considering the possibility of implementation in stages by **end-2015**;

d) secure adoption by the Council of Ministers of a binding set of contingency measures (e.g. revision of the basket of publicly reimbursable medical services and products, cuts in tariffs for medical products and providers of medical services, limits to the volume of reimbursable products and services) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded**;**

e) to complete the IT-infrastructure necessary for implementing the NHS, explore all options for improving the IT-infrastructure via the most cost-effective web-based applications as an alternative to the currently-defined IT tender by **Q4-2013**;

f) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance, while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures by **Q4-2013**;

g) continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment. Periodic reviews of the basket of publicly-reimbursable medical services will be conducted, based on objective, verifiable, criteria, including cost-effectiveness criteria (health technology assessment will contribute when feasible); prepare quarterly reports on the results of the respective workstreams;

h) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;

i) continue to code inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**; and,

j) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.10) **by Q1-2014**.

Furthermore, the Cypriot authorities will consider establishing a system of family doctors acting as gate-keepers for access to further levels of care.

<u>Budgetary framework and public financial management</u>

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in the high-level Fiscal Responsibility and Budget System Law (FRBSL), which will be adopted **by Q4-2013** (including an implementing text pertaining to Fiscal Council staff and a draft MoU on exchange of information between the Fiscal Council and the Ministry of Finance);
- Enact a FRBSL applicable to the entire general government sector. The umbrella law will encompass, inter alia, macro-fiscal policy-making, and budget formulation, approval and execution. It will take on-board and deepen existing provisions transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and implementing the Two-Pack EU Regulation 473/2013 and the Fiscal Compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts (on budget documentation and statistics) ensuring that adopted measures are fully effective **by Q4-2013**.

As regards expenditure controls in the state budget, which shall avert the risk of overspending against existing appropriations and/or accumulating arrears, the Cypriot authorities, **by Q4-2013**, will:

- Remove the risk of overspending by making sure all spending commitments are timely and properly recorded and reported in the accounting system.
- Improve the monitoring of government guarantess through a risk assessment analysis. To this end, amend the Public Debt Management Law, **by end-December 2013**, in order to ensure a proper risk assessment of the outstanding stock of government guarantees and ensure appropriate human resources to that end.

<u>Public private partnerships (PPPs)</u>

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. **As of 2014**, the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to the annual financial report;

- put in place an adequate legal and institutional framework for public investment projects, including PPPs, to assess fiscal risks and to monitor their execution through: (i) establishing an effective gateway process that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Minister of Finance and his services (i.e. the Ministry, Planning Bureau and Treasury) in reviewing and approving public investment projects and in particular PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of public investment project and PPP related obligations. The legal basis for managing public investment and specifically PPPs will be included in the FRBSL, which will be drafted **by Q3-2013** and implemented **by Q4-2013**; and
- commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any project having reached commercial close by end-October 2012.

State-owned enterprises and privatisation

3.5. As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets, the Cypriot authorities will:

- establish an inventory of assets, owned by central government and local authorities, including real estate and land. The inventory shall include all SOEs, reflecting up-to-date valuations of those with the highest commercial value **by Q3-2013**. The inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets (those of market value exceeding EUR 1 million) will be ready **by Q3-2013**. The full inventory of all assets (SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;
- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.10) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfil this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and
- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**.

3.6. The Cypriot authorities will initiate a privatisation plan to help improving economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability:

- This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (commercial activities of ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules;
- The privatisation plan will be based on the report reviewing and assessing the operations and finances of SOEs (3.5), as well as the inventory of assets. The privatisation plan will be finalised after consultation with programme partners, including asset-specific timelines and intermediate steps **by November-2013**;
- In parallel, the specific legal and institutional framework for the privatisation process will be implemented **by Q4-2013**, after consultation with programme partners; and
- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion **by the end of the programme period** and an additional EUR 400 million **by 2018 at the latest**.

<u>Revenue administration, tax compliance, and international tax cooperation</u>

3.7. The Cypriot authorities will reform the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion, with a view to increasing fiscal revenue. The reform will comprise of a programme of short-term measures to enhance compliance, efficiency and effectiveness as well as a comprehensive long-term reform covering risk management and the establishment of a new integrated function-based tax administration structure, integrating the existing IRD and VAT services. The short-term programme will be implemented by **Q4-2013** and include the following sets of measures:

Enact legislative changes to enhance tax collection and voluntary compliance by

- attributing personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company and to the responsible manager for fraudulent filing of company taxes;
- harmonising the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and ensure tax fraud is prosecuted as a criminal offense; and
- strengthening powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer.

Improve efficiency and effectiveness of the administration by,

- ensuring staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- optimising the use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities and with other relevant authorities, taking into account legal provisions for data protection; and (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers);
- enacting the necessary legislation to establish self-assessment for all income taxpayers by changing from a pre-assessment verification of income tax returns to post assessment audits selected on the basis of risk;
- deciding on a joint audit programme for large taxpayers, to be conducted **in 2014;**
- developing a joint work programme for conducting targeted audits and enhancing voluntary compliance of known high-risk groups; and
- conduct an independent formal review to recommend changes to legislation to determine the appropriate level of discretion available to the tax administration management and how it is exercised.

The long-term reform will include the following sets of measures:

- A comprehensive compliance strategy that will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis and on an evaluation of different risk treatment strategies. Work for the risk identification and analysis will begin **in Q4-2013**.
- The full integration of the two tax departments will be completed in several phases and will be accompanied by a set of flanking reform measures, such as the development of a common tax procedure code. As a first step, the authorities will,
    1. establish the project management, including a high-level governmental steering committee chaired by the Minister of Finance and an executive technical committee, which manages the development and implementation of the reform plan and which will be chaired by the Permanent Secretary of the Ministry of Finance **by Q3-2013**;
    2. develop a reform plan that reflects the recommendations of the TA received in February 2013. The reform plan will be agreed with program partners and approved by the government **by Q4-2013**; and
    3. reinforce the tax unit in the Ministry of Finance that is responsible for tax policy formulation and for monitoring the implementation of tax policy and the revenue performance (including by measuring the tax gap) **by Q2-2014**.

3.8. The Cypriot authorities will safeguard the timely and effective exchange of information in regard to tax matters, fully ensuring the applicability of laws and standards governing international exchange of tax information. In this respect, the Cypriot authorities will enhance the practice of timely delivery of relevant and accessible tax information to other EU Member States. The authorities will:

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[12] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States;
- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and
- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending **on 31 December 2013**, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD. **In 2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits conducted in 2014. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country.

Immovable property tax reform

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

[12] The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.

3.9. In view of this, the Cypriot authorities have agreed to:

- implement a property price index that establishes the average market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each cadastral plot **by Q2-2014**, in time for the immovable property tax collection in 2014. The index shall vary according to location and zoning as well as other tangible building- and plot-related characteristics. Moreover, the authorities will implement a methodology for annual updates of such imputed market valuations;
- implement the recurrent immovable property tax based on such imputed market valuations **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent authority **by Q3-2014**;

In addition, the following studies should be initiated **by Q3-2013**, and their recommendations implemented at the latest **by 1 January 2015**:

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- a study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenues from transaction fees and taxes to recurrent taxation.

Public administration reform

3.10. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population, the Cypriot authorities will:

- as a first step, starting on **1 September 2013**, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00);
- as a second step, further reductions of overtime and related costs to the public sector wage bill are foreseen, by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict

controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) by **Q1-2014**.

In addition, the Cypriot authorities are commissioning an independent external review of possible further reforms of the public administration. The review will include a horizontal and a sectoral element.

The horizontal element will be undertaken by the World Bank and the UK public administration and will include the review of:

- the appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and
- the introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The results of the horizontal review will be presented **by Q3-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it **by Q4-2014**.

The sectoral element will cover:

- an examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- an examination of the possibility of abolishing or merging/consolidating non-profit organisations/companies and state-owned enterprises; and
- the re-organisation/re-structuring of local government,

and will comprise two batches:

- the first batch will be undertaken by the World Bank and the UK public administration and will cover the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies and Official Receiver. The results of the first batch will be presented by **Q1-2014.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with programme partners, submit it to the House of Representatives for approval and implement it by **Q2-2014**.
- the second batch will cover all remaining Ministries (Labour and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defense, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Planning Bureau being covered under the PFM. It will also include all SOEs (subject to the decisions taken under the provision of 3.5 regarding privatisation, restructuring or liquidation). Finally, it will cover the President's Office and the Council of Ministers, as well as the Constitutional and Independent Services (see Annex 3 for a detailed list). The results of the second batch will be presented by **Q4-2015.** Based on the findings of this review, the Cypriot authorities will agree on a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement it by **Q1-2016.**

Welfare system

3.11. The existing welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), and enhancing the protection of vulnerable households, the Cypriot authorities will implement the reform plan of the welfare system, as of **1 July 2014**.

The Cypriot authorities will ensure that the reform will be achieved through:

- consolidating the existing social benefits by streamlining, and, inter alia by merging some benefits and phasing out others, and integrating them under the Ministry of Labour and Social Insurance.
- improving the targeting of benefits; and
- providing work incentives to avoid welfare dependency.

To this end, the Cypriot authorities will take the following steps:

- first, define the minimum consumption basket in terms of composition and weights **(Q3-2013)**;
- thereafter, refine the costing and the coverage of the new guaranteed minimum income scheme (GMI) which will replace the existing public assistance scheme **(end-October 2013)**;
- refine the means testing mechanism by introducing a common definition of income sources, financial assets and movable and immovable property, so as to ensure the consistency of eligibility criteria, across different benefit schemes **(Q4-2013)**;
- ensure that a comprehensive database and the necessary IT requirements are in place to support the administration of the reformed welfare system (**by May 2014**); and
- transfer all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Insurance, which should be appropriately equipped in terms of financial and human resources, the latter being reassigned from other departments of the public administration **by April-2014**, except the benefits to be provided by the Ministry of Education and Culture (education benefits) and the Ministry of Interior (benefits to displaced people), (see 3.10).

The reformed welfare system must be consistent with the fiscal targets defined in this MoU. Draft legislation will be submitted for review to the programme partners before submission to the House of Representatives. The law will be adopted by **end-May 2014**.

4. Labour market

Key objectives

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustment (COLA) of wages and salaries

4.1. To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities are reforming the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. This reform acts on relevant elements of the indexation system, as follows:

- a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;
- a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and
- a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

As foreseen in section I.2 (Annex 1) of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by end-2013**. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.

Minimum wage

4.2. With a view to preventing possible adverse competitiveness and employment effects, the Cypriot authorities commit that, over the programme period, any change in the minimum wage covering specific professions and categories of workers should be in line with economic and labour market developments and will take place only after consultation with the programme partners.

Activating the unemployed and combating youth unemployment

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.11.

4.4. In their assessment of current activation policies, the Cypriot authorities have identified a series of challenges pertaining to the system. These include: the difficulties faced by the Public Employment Services in serving an increased number of unemployed people; the lack of a coherent and homogeneous framework for the continuous monitoring and evaluation of the different schemes, which impedes the proper evaluation of the activation system as a whole; the need for increased coordination across different ministries and departments of the administration and the need to reduce fragmentation; and the absence of a data warehouse, which impedes an automatic and immediate processing and exchange of information.

Therefore, the Cypriot authorities willprepare detailed policy proposals to address the identified shortcomings and weaknesses, to be submitted to the programme partners **by end-2013** for review and consultation. These will include:

- the development of a coherent methodology for the continuous monitoring and evaluation of activation programmes, to be applied consistently across the different schemes, thereby enabling the assessment of their performance and effectiveness;
- the development of the appropriate IT infrastructure so as to automatize better and more comprehensive collection (see 3.11), processing and exchange of data across the various schemes as well as with the administration of social welfare services;
- ensuring an effective integration of the different schemes by centralising the administration of all activation programmes and by enhancing the coordination across the different departments responsible for the various programmes;
- enhancing staff mobility to support the administrative capacity of the public employment services so as to enable them to better respond to the increased demand for their services; and
- reviewing and enhancing the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

4.5. With one of the steepest increases in the youth unemployment rate in the EU and with the rapid rise of young people not in employment, education or training (NEETs), Cyprus needs to take swift action to create opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will present by **Q4-2013** a draft action plan for the implementation of measures envisaged for support under the Youth Employment Initiative, in line with the conclusions of the European Council of June 2013. The design, management and implementation of these measures targeted to youth shall be well integrated within the broader system of activation policies (section 4.3) and be coherent with the reform of the social welfare system (section 3.11) and the agreed budgetary targets.

5. Goods and services markets

Key objectives

Addressing issues of a structural nature is critical for rebalancing the Cypriot economy, restoring its growth potential and improving competitiveness. Removing unjustified obstacles in services markets can have a significant impact on growth, in particular for the services-intensive Cypriot economy. In addition, improving the quality and reducing the cost of regulated professional services can play an important role for the business environment and for Cyprus' competitive position. Since tourism is one of Cyprus' largest sectors and an important potential driver of future growth, a reinvigoration of the competitiveness of this sector is warranted. Improving the regulation of administration related to the real estate sector will contribute to the overall functioning of the housing market and help to foster foreign demand at a time when the prospects of this sector are affected by downside risks. Finally, the exploitation of the domestic offshore natural gas potential offers the medium- to long term prospect for reducing Cyprus' energy import dependency and the security and sustainability of energy supply. This would help to address Cyprus' sustained current account deficit and high public debt. However, these positive effects will accrue only after overcoming the challenges of financing and planning the infrastructure investments, designing efficient energy markets and an adequate regulatory regime.

Services directive: Sector-specific legislation

5.1. The Cypriot authorities will adopt any remaining necessary amendments to the sector-specific legislation (e.g. construction, tourism, car rental services, employment agencies), in order to fully implement the Services Directive, easing the requirements related to provision of services and establishment. Amendments will be adopted **by Q3-2013**. Rules that refer to the calculation of fees for professional services (including those adopted by professional bodies) need to be assessed before adoption for compliance with internal market and competition principles, except as otherwise agreed with programme partners. To this end, the opinion of the Cypriot Commission for the Protection of the Competition (CPC) and of programme partners is required.

Reform of regulated professions

5.2. The Cypriot authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in specific regulated professions, such as veterinarians, as required by the Services Directive **by Q3-2013**; and
- further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the access and exercise of activity. This review will be completed **by Q3-2013** for a list of priority professions, to be agreed with programme partners before mid-August 2013, and **by Q4-2013** for the rest of regulated professions. Following completion of the review, the requirements that are not justified or proportional will be eliminated **by Q1-2014**.

Competition and sectoral regulatory authorities

5.3. The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:

- guaranteeing sufficient and stable financial means and qualified personnel to ensure its effective and sustained operation **by Q4-2013;**
- enhancing the effectiveness of competition law enforcement by adopting the necessary amendments to the legislation on mergers and antitrust, including the power to conduct sector enquiries **by Q4-2013**;
- promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition **by Q4-2013**;

The Cypriot authorities will increase competition by ensuring that powers and independence of the National Regulatory Authorities (NRAs) remain effective, by enabling them to have the necessary resources in line with their duties and in accordance with the EU Regulatory Framework. Any legislative amendments that may be necessary to reach these objectives will be adopted **by Q4-2013**.

Housing market and immovable property regulation

5.4. Action is required to ensure property market clearing, efficient seizure of collateral, and restoring demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- enact legislation for mandatory registration of sales contracts for immovable property **by Q3-2013** and implement guaranteed timeframes for the issuance of building certificates and title deeds **by Q1-2014**; ensure that the title deed issuance backlog drops to less than 2,000 cases of immovable property units with title deed issuance pending for more than one year **by Q4-2014** (backlog refers to (i) applications, (ii) units that are eligible for the "ex officio" issuance of title deeds, required certificates and permits); take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property **by Q4-2014**;

- every three months, publish quarterly progress reviews, including executive commentaries on developments related to the issuance of building and planning permits, certificates, title deeds, title deed transfers and related mortgage operations, starting end-July 2013;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the monetary financial institutions and for all government services **by Q4-2014**. Any requirements on the proof of legal interest for access to these data by these bodies shall be abolished **by October 2013**;
- amend the procedure on the forced sale of mortgaged property (see 1.6) to allow for private auctions by amending the relevant legislation and rules in relation to the forced sales of mortgaged property either by adopting similar principles of the rules for immovable property recovery in bankruptcy regulations or by enacting new legislation **by Q4-2013**; and
- improve the pace of court case handling, in order to eliminate court backlogs by **Q1-2016** and provide for specialized judges by **Q4-2013,** with instructions for the expeditious processing of cases under commercial and immovable property laws.

<u>Tourism</u>

5.5. Since tourism is one of Cyprus' largest economic sectors and a potential driver of future growth and employment, a reinvigoration of its competitiveness is necessary. To that end, the Cypriot authorities will:

- provide a concrete action plan leading to the implementation of the quantified targets identified, inter alia in the recently revised Tourism Strategy 2011-2015 **by Q3-2013**;
- present a progress report on the implementation of the action plan twice per year, starting **in Q4-2013,** including an assessment of its implementation based on performance indicators.
- amend the current hotel and and other relevant legislation (eg. the immovable property law and town planning policies), in order to facilitate mixed-use developments, **by Q4-2013**;
- provide a report on the analysis and assessment of concrete needs based on the existing and the future air services agreements **by Q4-2013**. This report will provide the basis for an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, while ensuring sufficient air connectivity. This strategy accompanied with a concrete action plan will be launched **by Q1-2014**. The implementation of the action plan will be reviewed annually by the Cypriot authorities, starting **in Q1-2015**.

<u>Energy</u>

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented particularly during and after the transformation of the sector; and provide clarity on the intended use of the available 'isolated market' and 'emergent market' derogations and indicate their intended duration of the latter derogations;

- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, constitutes a living document to be developed under the full authority of the Cypriot Government. It should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:

    1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible technical and commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related ownership structure; related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;

    2. *a comprehensive outline of the regulatory regime (CERA) and market organisation* for the restructured energy sector and gas exports, with a view to introducing open, transparent, competitive energy markets, and taking explicitly into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: a description of the envisaged institutional framework (the various government and private actors with their respective functions); the type and scope of the regulatory instruments; the different forms of government ownership and involvement; the sequence and envisaged timing of the major actions and changes; the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues; by **Q4 2013,** with a view to a final outline **by Q2 2014**; and

    3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage various types of public revenues from offshore gas exploitation and sales (direct revenues, fees, dividends etc). The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. As a first step, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, coupled with clear accounting rules regarding dividend and fees from government entities and stakes in the energy sector. These will be anchored in the FRBSL (see 3.3) which will be adopted **by Q4-2013**.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time. In addition, the strategy should take into account the current uncertainty over the actual size of domestic, offshore, commercially-viable, natural gas fields and possible changes in international gas prices and demand. As regards the later, appropriate data should be firmly based on *alternative world energy scenarios* from an internationally-reputed organisation. The plan will be based on an appropriate level of technical assistance on technical aspects in this context.

6. Technical assistance

6.1. Given the nature of the structural challenges Cyprus is facing, including a lack of specific skills in some areas and scarcity of resources, the Cypriot authorities will provide a request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-September 2013**. This request will identify and specify the areas of technical assistance or advisory services, which the Cypriot authorities consider essential for the implementation of the MoU and where they intend to seek such technical assistance services, in coordination with the programme partners. All technical assistance provided by the European Commission, other than technical assistance provided directly under the Structural and other EU funds, will be coordinated by the Support Group for Cyprus.

Annex 1

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0%; EUR 1001-1500: 6.5%; EUR 1501-2000: 8.5%; EUR 2001-3000: 9.5%; EUR 3001-4000: 11.5%; above EUR 4001: 12.5%.

I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see 4.1).

I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.10); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

Revenue measures

I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% to 0.11% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

Fiscal measures with effect in 2013

Expenditure measures

I.9 Ensure a reduction in total outlays for social transfers by at least EUR 113 million through: (a) the abolition of a number of redundant and overlapping schemes such as the mothers allowance, other family allowances and educational allowances; and (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

I.10 Ensure a reduction of at least EUR 29 million in the total outlays of allowances for employees in the public and broader public sector by:

i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;

ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15%; and

iii. reducing the daily overseas subsistence allowance for business trips by 15%. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50% (20% - 45% of overseas subsistence allowance instead of 40% - 90% currently paid).

I.11 Reduce certain benefits and privileges for state officials and senior government officials, in particular by:

i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;

ii. abolishing the right to duty free vehicles for employed and retired senior public sector officials; and

iii. extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on the pensionable earnings of these individuals.

I.12 Implement the following measures regarding the Government Pension Scheme (GEPS):

i. freeze public sector pensions;

ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;

vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4% to 6.8%; and

vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.

viii. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;ix. introduce a change of indexation of all benefits from wages to prices; and

x. pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013).

I.13 Implement further reform steps under the General Social Insurance Scheme by:

i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5% per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;

ii. freezing pensions under the Social Security Fund for the period 2013-2016;

iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.

iv. increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age;

v. introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

vi. introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018;

vii gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012); and

viii. ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013).

I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.

I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.

I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

The additional permanent expenditure measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.17 Introduce the following measures to control healthcare expenditure:.

a. abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

b. increase fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

c. introduce effective financial disincentives for using emergency care services in non-urgent situations;

d. introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

e. adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

I.18 Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.

I.19 Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.

I.20 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8%; EUR 2.001-3.000: 1%; EUR 3.001-4.000: 1.5%; above EUR 4001: 2.0 %.

Revenue measures

I.21 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.22 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.23 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.24 Increase the standard VAT rate from 17% to 18%.

I.25 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.26 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

The additional permanent revenue measures for 2013, which were adopted by Cyprus **prior to the granting** of the first disbursement of financial assistance:

I.27 Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.

I.28 Increase the statutory corporate income tax rate to 12.5%.

I.29 Increase the tax rate on interest income to 30%.

I.30 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11% to 0.15% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.31 Complete the increase in fees for public services by at least 17% of the current values

<u>Fiscal measures with effect in 2014</u>

Expenditure measures

I.32 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.33 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.34 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

I.35 Introduce as of the budget year 2014 structural reform measures in the educational system, notably, a reduction of the number of teachers seconded to the Ministry of Education and Culture, the removal of 1:1.5 teaching time ratio from evening schools of general and technical and vocational education, the elimination of teaching time concession to teachers for being placed in two or more educational districts, the elimination of mentoring components for pre-service and in-service training for newly appointed teachers and the reduction of the cost of afternoon and evening programmes.

Revenue measures

I.36 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

I.37 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.38 Increase the reduced VAT rate from 8% to 9%.

I.39 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.40 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

Annex 2

The AML Action Plan by Cyprus on customer due diligence and entity transparency

	Heading/Deficiency	*Action*	*Timeline*
1	**Customer Due Diligence**		
1.1	**Business profile**		
	Business profiles not always properly established.	1.1.1 CBC to provide guidance to ensure that obliged entities engage in adequate training of all staff involved in establishing customer business relationships and opening accounts, so that business profiles are properly determined and assigned.	Q4 - 2013
1.2	**Customer risk profile**		
	Lack of understanding of cumulative risks in complex ownership structures / introduced business.	1.2.1 CBC to provide sufficient guidance to ensure that obliged entities have sound and effective risk management systems in place to identify and understand ML/TF risks within their customers, products and services, geographical locations/areas, and delivery channels. Risk management systems should include an overall policy for identifying and understanding, measuring, controlling, and monitoring ML/TF risks. The risk management policies, procedures and measures should be submitted to the board for approval on an annual basis, or as required by changes in the business model.	Q4 - 2013 Q1-2014
	New legislative measures.	1.2.2 CBC and other supervisory authorities to issue guidance to obliged entities in order to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences.	Q4 - 2013
	Particular issues relating to PEPs.	1.2.3 CBC to issue additional guidance to obliged entities to adequately identify and establish the source of wealth for PEPs or for customers that become PEPs after the business relationship has been accepted.	Q4 – 2013
1.3	**Ongoing CDD**		
	Higher risk customers/changes in risk not dealt with appropriately on an ongoing basis. Particular issues relating to PEPs.	1.3.1 CBC to issue additional guidance to ensure that financial institutions have sound and effective systems and measures in place to demonstrate enhanced ongoing monitoring for higher risk clients, including PEPs. 1.3.2. CBC to ensure that financial institutions have sound and effective systems and measures including updated CDD measures.	Q4-2013 Q2-2014

2	**Reliance/introduced business**		
	Use of introducers allowed by CY legislation and is widespread.	2.1 CBC to review, strengthen, and amend as needed the regulatory framework and the relevant requirements relating to the use of introducers/third parties to ensure compliance by obliged entities establishing business relationships and/or opening accounts through third parties.	Q4 – 2013
	Training/awareness in institutions.	2.2 CBC to reiterate and clarify the obligation under the CBC directive that obliged entities are required to establish adequate AML/CFT training programs for all staff responsible for establishing business relationships and/or opening customer accounts and updating customer information. CBC to ensure that training programs are implemented and include information on current ML and TF techniques, methods and trends, and clear explanations of all aspects of the AML/CFT laws, regulations. In particular, this should include requirements concerning CDD, suspicious transaction reporting and sanctions for non-compliance.	Ongoing
	Mechanisms for coordination with supervisors of introducers	2.3 CBC to establish co-operation mechanisms with CySEC, the Cyprus Bar Association and ICPAC (for accountants) for exchanging information and ensuring supervisory coordination.	Q3 – 2013
3	**Suspicious Transaction Reporting**		
	Changes in the legal framework.	3.1 MOKAS to reiterate and clarify through further training the requirements to report STRs, including the new duty to report issues relating to tax crimes as of December 2012, in coordination with relevant supervisory authorities.	Q1 - 2014
4	**Transparency of beneficial ownership**		
4.1	**Access to information**		
	Ensure that transparency and availability of beneficial ownership information is in line with international standards and best practice.	4.1.1 Revision of Trust and Company Services Providers Law as appropriate and AML Law to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to the domestic competent authorities and their foreign counterparts; and revise the directives and circulars issued by supervisory authorities (CBC, CySEC, Cyprus Bar Association, ICPAC). 4.1.2. In the case of nominees, either a) require nominee directors[3] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee	Q3 – 2013 Q3-2013

[3] Under Cyprus law, there is no legal concept of "nominee director", but it is used with reference to professionals who provide director services.

		directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).	
4.2	**Company Registry**		
	Efficiency of Companies' Registrar as an important aid to CDD.	4.2.1 Carry out a third party review of the functioning of the Companies' Registrar and communicate results to the programme partners, and ensure the department of the registrar is appropriately resourced.	End 2013
4.3	**Register of Trusts**		
	Enhance the transparency of trusts in line with international standards and best practice.	4.3.1 CY to establish trust registries with the supervisory authorities for all express trusts established under CY law, where the name of the trust and the name and address of the trustee will be contained therein. The trust registers will be accessible by the supervisory authorities in order to facilitate them in their supervisory duties.	Q3 - 2013
5	**Supervision of financial institutions**		
5.1	**Revise the AML/CFT supervisory structure within the CBC, ensuring it is adequately resourced**	5.1.1 Revise and/or establish organisation structure and management within the CBC's Banking Supervision and Regulation Department (BSRD) to address AML/CFT matters,[4] in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Q4 – 2013
		5.1.2 CBC to ensure adequate human resources and technical capacity to undertake effective AML/CFT supervision. The level of resources should be commensurate with the size, complexity, and risk profiles of the financial institutions operating in the system.[5] To meet this objective, if deemed necessary by the CBC, hire AML/CFT experts with the necessary professional skills and experience (e.g. foreign supervisors retired or on leave) – subject to necessary confidentiality restrictions.[6]	Q4 - 2013

[4] in accordance with BCP 2 and FATF 26-27
[5] FATF Immediate Outcome (IO) 3
[6] See BCP 2.6c

5.2	**Develop risk-based supervisory tool(s) for offsite surveillance/monitoring activities prior to implementation**	5.2.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a risk assessment methodology and tool(s) that provides for: - a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,[7] and delivery channels; - an assessment of the internal control environment that should be in place to mitigate and/or control the inherent ML/TF risks, as identified and measured; - institutional risk profiles; - specific AML/CFT supervisory strategies (adapted to institutional risk profiles).	Q4 - 2013
5.3	**Develop risk-based supervisory tool(s) for onsite inspections prior to implementation**	5.3.1 Design, develop, adopt and pilot, for a selected group of financial institutions, a methodology for onsite activities, including the necessary examination/verification procedures for onsite inspections. Examination procedures, should include, at a minimum: -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program.	Q1 – 2014
5.4	**Establish Formal AML/CFT Training Program**	5.4.1 Establish a formal AML/CFT training program for CBC staff to ensure adequate implementation of the offsite and onsite tools. Develop and deliver customised AML/CFT training to supervisory staff in topics including, but not limited to: - newly developed offsite and onsite risk-based tools; - customer acceptance policies; - customer due diligence (CDD); - monitoring of transactions; - identification and reporting of STR; - funds transfers; - correspondent banking; - recordkeeping; - compliance function; - internal controls; - audit functions; - corporate governance;	Q2 – 2014

[7] The off-site supervisory tool will include monthly reporting by obliged entities on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies to be carried out in accordance to paragraph 3.11 will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

i. Ministry of Labour and Social Insurance
ii. Ministry of Communications and Works
iii. Ministry of Energy, Commerce, Industry and Tourism (excluding the Companies Registrar and Official Receiver, to be covered in the first batch of studies)
iv. Ministry of Interior
v. Ministry of Defense (excluding the National Guard and Cyprus Army)
vi. Ministry of Justice and Public Order
vii. Ministry of Foreign Affairs

Note: Ministry of Finance, including Treasury and Planning Bureau, will be reviewed under the PFM.

Constitutional Powers /Services

i. President's Office and Council of Ministers
ii. Law Office
iii. Audit Office
iv. Public Service Commission

Independent Services/Authorities

i. Educational Service Commission
ii. Internal Audit Service
iii. Office of the Commissioner for Administration (Ombudsman)
iv. Office for the Commissioner of Personal Character Data Protection
v. Tender Review Body
vi. Refugee's Review Body

Independent Services/Authorities to be excluded from the external review and justified in the Notes below

i. Office for the Commissioner of State Aid Control [13]
ii. Authority for the Supervision of Cooperative Societies [14]
iii. Competition Protection Commission[15]

[13] It functions according to *acquis communautaire* prescriptions and itemploys only a limited number of people (4 persons).
[14] The relevant organisation is dealt within the context of the financial sector part of the MoU.
[15] CPC is currently under review by PAPD and should be finalised by Q4 2013, as part of MoU paragraph 5.3. Once the review is finalised, programme partners will assess whether an independent review for the CPC will be needed.

Cyprus: Letter of Intent

Nicosia, August 29, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Ms. Lagarde:

In the attached update of the Memorandum of Economic and Financial Policies (MEFP) of April 29, 2013 we describe progress and policy steps towards meeting the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Our policy implementation under the program has remained on track:

- Fiscal performance through end-June has exceeded expectations, as demonstrated by our meeting of all fiscal quantitative performance criteria (PCs). This reflects prudent budgetary execution, especially with regard to primary spending, in the context of macroeconomic developments that have remained in line with our conservative baseline. We have also facilitated government financing by meeting our structural benchmark on the exchange of €1 billion of domestic debt maturing during the program period and the rollover of the €1.9 billion Laiki recapitalization bond.

- On financial sector policies, despite some initial delays associated to the complexity of the challenges in front of us, we have made substantial progress toward stabilizing the financial system:

    - We have fully recapitalized Bank of Cyprus (BoC) and taken it out of resolution following completion, albeit with some time lag, of the structural benchmark requirement on an independent fair valuation of BoC and Laiki balance sheets.

    - The administrative restrictions imposed at end-March to preserve financial stability have been gradually relaxed, and we have thus fully met the continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple currency practices.

    - We have also fully met our structural benchmark to develop a strategy to recapitalize and restructure the cooperative sector on the basis of completion with a minor delay of the structural benchmark requirement to assess capital needs and viability of all individual cooperative credit institutions (CCIs). As prior actions for this review, we will amend legislation to strengthen its supervision and establish a legal framework to facilitate the recapitalization and restructuring of the sector.

Looking forward, our main priority continues to be the restoration of confidence in and soundness of our banking system. In this regard, in line with Eurosystem rules, we will aim to strengthen BoC's liquidity position as needed, as it adapts its governance and business structure to the new environment. We will also proceed with ensuring adequate capitalization and restructuring of other banks and the CCI sector, while strengthening their supervision and regulation. These will be key milestones in our newly developed strategy to relax administrative restrictions in an orderly and predictable way. Finally, we will revamp our private debt-restructuring framework and take action to strengthen AML implementation.

We will also embark on a significant modernization of our fiscal structural institutions to support our ongoing fiscal consolidation efforts so as to achieve sustainable public finances. We are committed to a substantial overhaul of our revenue administration, anchored by the integration of the internal revenue department and the value added tax services. At the same time, to protect revenue collection during the downturn, we will intensify our efforts to fight tax evasion. In addition, to ensure adequate and effective social protection for those most in need during the difficult adjustment period ahead of us, we will undertake a fundamental reform of our social welfare system, based on the introduction of a guaranteed minimum income program and consolidating overlapping benefits.

Financing of our program remains adequate. The recent debt exchange and rollover of the Laiki recapitalization bond have facilitated our cash flow management. We also expect to complete the restructuring of the Russian loan maturing in 2016 in line with program assumptions, and remain committed to finalizing the assessment of state assets and the privatization plan in line with our program's objectives.

On this basis, we request the following:

- Completion of the first review under the extended arrangement and the second purchase under this arrangement in the equivalent of SDR74.25 million;

- Modification of the end-September PCs on: (i) the general government primary balance, general government primary expenditure, and the stock of general government debt to accommodate budgetary compensation ensuring comparable treatment between pension funds with deposits in BoC and Laiki; and (ii) the accumulation of government guarantees, to ensure adequate liquidity buffers for BoC (Table 1);

- Establishment of new quantitative performance criteria for end-December 2013 (Table 1);

- In addition, we propose new or modified structural benchmarks on the following (Table 3): (i) offer for voluntary recapitalization of Hellenic Bank; (ii) completion of the recapitalization of Hellenic Bank; (iii) restructuring, business and funding plans to be prepared by BoC and assessed by CBC; (iv) merger of CCIs; (iv) adoption by Parliament of our fiscal responsibility and budget systems law; and (v) implementation of measures to fight tax evasion.

We are fully committed to the policies set forth in the letter of intent of April 29, 2013 and in the attached update to the MEFP, which we believe are adequate to achieve the objectives under the program. We stand ready to take any measures that may become appropriate for this purpose as circumstances change. We will consult with the Fund on the adoption of any such actions in advance of revisions to the policies contained in this letter and the MEFP, in accordance with the Fund's policies on such consultations.

Sincerely,

/s/	/s/
__________________	______________________________
Harris Georgiades	Panicos Demetriades
Minister of Finance	Governor of the Central Bank of Cyprus

Cyprus: Memorandum of Economic and Financial Policies

A. Strategy, Recent Developments, and Outlook

1. **Macroeconomic conditions have deteriorated, but remained broadly in line with the program assumptions.** Since March, economic conditions have become more difficult, with activity severely affected by the high uncertainty related to the state of the banking system and the effects of the administrative restrictions. This is reflected in the very high unemployment rate. However, confidence indicators have rebounded somewhat from their lows reached in April. Falling domestic demand resulted in a substantial adjustment of the external sector, primarily through a contraction of imports. But it also led to a drop in inflation in the second quarter, which can help to improve Cyprus's competitiveness. Given the significant uncertainty surrounding the outlook, our program will continue to remain guided by the macroeconomic baseline developed in April. The economy is expected to contract this year and next, but with firm program implementation, expected to lead to a recovery of confidence, we anticipate growth to resume in 2015. Our strong service sector, in particular professional services and tourism, is expected to drive long-run growth.

2. **In this context, full and timely implementation of our adjustment program is critical to restoring financial stability, ensuring fiscal sustainability, and returning to sustainable growth.** Our program's main objectives are to restore the health of the financial sector and put public finances on a sustainable path through fiscal consolidation and structural reforms. Given the urgent need to restore confidence following the deep banking crisis in March, the first review of the program focuses on stabilizing our financial sector: we aim to ensure that the new Bank of Cyprus (BoC) will be able to adapt to the new circumstances, set a clear roadmap to restructure and recapitalize the rest of the financial sector, and put in place a strategy to gradually lift capital and administrative controls. In the fiscal area, the review aims to set in motion significant institutional reforms of our revenue administration and welfare system, while also defining short-term structural measures to protect vulnerable groups and fight tax evasion.

B. Financial Sector Policies

3. **Our key priority is to stabilize our financial sector and ensure its return to health.** We have already taken important steps to build confidence and restore the viability of our credit institutions. First, we have completed the independent valuation of BoC and Laiki balance sheets on July 26, on which basis we have fully recapitalized the new BoC and taken it out of resolution. Second, we have finalized a strategy to recapitalize other banks in an adequate and timely fashion and without any depositor involvement. Third, we have assessed the capital needs and viability of our cooperative credit institutions (CCIs), which has allowed us to develop a comprehensive strategy for their recapitalization and restructuring. Looking forward, we will build on these steps to ensure that our financial sector is well capitalized and can support our economy.

Recapitalizing and restructuring financial institutions

4. **We have taken the necessary steps for BoC to exit resolution as an adequately capitalized institution:**

- The capital needs of BoC have been confirmed through an independent fair value assessment. On July 26, KPMG completed its assessment of both BoC and Laiki assets and liabilities, on the basis of internationally accepted valuation methodologies and our program's macroeconomic baseline. This assessment was done in accordance with our resolution law, so as to enable adequate and fair compensation for the respective shareholders of new BoC. On the basis of this assessment, the Resolution Authority identified an additional capital shortfall in the new BoC necessary to achieve an adequate capitalization now and in the future, so as to preserve the bank's viability and the financial system's stability.

- The new BoC has been fully recapitalized on this basis. Given the systemic nature of the bank, and in the context of low depositor confidence, the bank's CT1 capital was brought to about 12 percent of risk-weighted assets with the contribution of its uninsured depositors. This has helped to restore BoC's solvency and viability such that it can maintain a CT1 ratio of 9 percent throughout the entire program period.

5. **We will work to strengthen BoC's liquidity position, in line with Eurosystem rules.** We stand ready to consider the issuance of additional government guarantees up to €2.9 billion in line with state aid rules and in compliance with the provisions of our Public Debt Management Law, to be used to enhance BoC's pool of Eurosystem eligible collateral, if needed to safeguard financial stability. To further safeguard the bank's liquidity position, we have rescheduled the maturity of the remaining uninsured deposits over a 12 month period, which can be extended up to a 24 month period if needed, while allowing depositors to use such funds to repay loans from BoC. The Central Bank of Cyprus (CBC), in consultation with the ECB, will continue to monitor the liquidity situation of all banks and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

6. **We will also make the necessary arrangements to ensure that BoC swiftly adapts its governance structure and business plan to the new circumstances.** To this end:

- The CBC appointed a transitory Board of Directors, with a view to rapidly establishing a permanent governance structure. The transitory board, appointed on April 26, has been mandated by the CBC to ensure BoC's stability once it has exited resolution. The transitory board has called an Annual General Meeting of the shareholders to be held no later than September 12, 2013, to appoint a new Board of Directors.

- The CBC has instructed the bank to prepare restructuring, business, capital and funding plans, and will prepare an assessment of these by end-October 2013 (modified **structural benchmark**). The plans will need to define the bank's business objectives and credit policies, include measures to enhance its profitability and liquidity, and specify quarterly goals.

7. **We are also taking steps to facilitate the recapitalization of the remaining domestic financial institutions. In particular:**

- Hellenic Bank (HB) will be recapitalized by end-December 2013 (**structural benchmark**). We have instructed HB to take steps to raise capital (in line with the capital needs identified by the PIMCO exercise) using private sources, including new equity issuance or voluntary liability management. While this represents a slight delay with respect to the original recapitalization strategy for the bank, it can allow it to remain under private ownership. HB will be instructed to launch the offer for private participation in the bank's capital by end-September (**structural benchmark**). If private negotiations do not result in a successful and adequate capitalization of HB by end-October, to the extent that public support is needed, it will be in line with state aid rules, so as to fully recapitalize the bank by end-December 2013.

- We have developed a comprehensive strategy to restructure the CCI sector and ensure its long-run viability. The strategy encompasses the following steps:

    - We have assessed the capital needs of all individual CCIs, on which basis we have revised our estimate of capital needs to €1.5 billion, based on PIMCO's assessment and methodology. As the CCIs have reported that private funds are not available, they will be recapitalized with public funds.
    - As prior action for the review, we will establish the legal framework for an appropriate ownership and governance structure to manage the state's majority stake in the CCI sector. On this basis, by end-October 2013, we will establish and fully operationalize a relationship framework between the state and the Cooperative Central Bank (CCB) to ensure that the latter adopts sound policies and restructuring measures to enhance the viability of the CCI sector, but without undue political interference in its business decisions. Also by end-October the Central Bank will issue a circular to define a 4 and 9 percent CT1 capital requirement at the individual and consolidated level, respectively.
    - Immediately following adoption of the legislative amendments, we will deposit €1.5 billion in public funds in a securities account with the CBC as evidence of our full commitment to fully recapitalize the sector without burdening depositors.
    - By end-October 2013, we will inject the state funds in the CCB in exchange for common shares, in line with state aid rules.
    - We will merge the CCIs into maximum 18 institutions by end-March 2014 (**structural benchmark**), with the aim to ensure the profitability, efficiency, and considering the asset quality, of the individual institutions, which will be recapitalized to fulfill the capital requirements under the law. Going forward, we will review the new structure and require CCIs that become unviable to be merged with viable ones.

8. **We will transfer the supervision and regulation of the CCIs to the CBC.** To ensure that the CCIs will maintain prudent levels of risk going forward, we will include in the amendment to the cooperative and banking laws provisions to establish the CBC as the single supervisor of the CCI sector, also as prior action. Subsequently, the CBC will finalize by end-September 2013 a detailed action plan to exercise the supervision of the cooperative credit sector. This plan will include steps to recruit

experienced staff and apply the CBC's supervisory and regulatory model for the effective monitoring of the entire cooperative credit sector, to be fully operational by end-March 2014.

9. **We will continue to improve our regulatory and supervisory framework to stabilize the financial system and prevent the buildup of new vulnerabilities.** To this end:

- We will submit by end-December 2013 draft legislation to Parliament to introduce early corrective measures to enhance supervisory powers to address capitalization issues, to enter into force by end-March 2014. This will allow for prompt supervisory remedial action at any financial institution upon deterioration of its capitalization (such as suspension of dividend payments, etc.).

- The CBC will issue by end-October 2013 mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their operations. Starting with end-December 2013, banks under restructuring will be required to publish quarterly reports describing main developments regarding their restructuring. To enhance their credibility, the reports will be accompanied by independent assessments made by the banks' external auditors on the basis of agreed procedures with the CBC.

- To ensure conservative implementation of accounting standards on loan provisioning, by end-October 2013, the CBC will complete a review of banks' practices regarding loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning.

- We will strengthen the CBC's supervisory capacity by ensuring it has sufficient staff. To further enhance our regulatory and supervisory framework in line with international best practices, we will also request a standalone assessment against the "Basel Core Principles for Effective Banking Supervision," to be completed by end-2015.

10. **We have developed a milestone-based roadmap to ease administrative restrictions and capital controls as soon as possible while preserving financial stability**. Removal of these measures is important to support the economic recovery, but acting prematurely could endanger financial stability. Accordingly, the lifting of restrictions will be based on reaching specific milestones pertaining to our bank recapitalization and restructuring strategy, while retaining some flexibility to adapt to significant new developments. To enhance transparency and predictability of policies, the roadmap was published on August 9, 2013. The roadmap will be guided by a number of key principles: (i) domestic restrictions will be removed before lifting controls on cross border transfers; (ii) the relaxation of restrictions will be based on key milestones, including: completing BoC's recapitalization and resolution, approval of the restructuring strategy of BoC, recapitalization of HB, and the restructuring strategy and disbursement of the funds for the recapitalization of CCIs; (iii) relaxations will also take into account the prevailing level of confidence in the banking system and financial stability-related indicators, including the liquidity situation of credit institutions. On this basis, we request extension of the approval from the Fund on measures falling under Article VIII.

11. **We are taking steps to revamp our corporate and household debt-restructuring framework**. By end-August, we will publish a Code of Conduct to guide negotiations between troubled

borrowers and banks and establish debt restructuring options and an appeals process. Also by then, we will publish a Framework for Arrears Management to ensure that banks adopt minimum standards and procedures to restructure problematic loans on the basis of best international practices. Next steps include:

- By end-September 2013, banks will be asked to submit to the CBC a strategy to implement the framework for arrears management. The strategy will need to include a diagnostic of areas that require strengthening and an implementation roadmap.

- By end-October 2013, the CBC will require banks to submit a detailed implementation plan for arrears management and to report on restructuring progress along specific performance indicators (e.g. number of loans restructured, cash collections, etc.).

- Building on our recent work to identify and address impediments for private debt restructuring, by end-October 2013 we will perform a legal review of the relevant legislation with technical assistance as needed and prepare a report on impediments in the framework and measures to address them.

- Subject to the findings of the review and report, by end-November 2013 we will pass legislation to expand the role of the financial Ombudsman to assist in restructuring disputes in a way that respects the rights of lenders and borrowers alike, while ensuring that it has adequate resources.

12. **We are committed to implement corrective actions to address shortcomings identified with the help of the recent independent AML audits.** Two independent audits of implementation of the AML framework by the banks were completed at end-April. On this basis, we have developed an action plan and will take steps to strengthen AML implementation, as follows:

- In implementing the AML legal framework and as supervisor, the CBC will follow up on possible breach of compliance with AML requirements by banks identified by the auditor (e.g. misclassification of customer risk, unreported suspicious transactions). It will apply appropriate supervisory enforcement actions with regard to any breaches of compliance, including sanctions, if applicable, by end-September 2013;

- The CBC will review its own AML/CFT supervisory structure on the basis of relevant Basel Core Principle and FATF standards with help from technical assistance, if required, and, on this basis, establish an effective and adequately resourced structure by end-December 2013;

- The Ministry of Finance (MOF) will commission a third party assessment of the functioning of the Registrar of Companies, which will be completed by end-December 2013. Also by then, the companies' department of the Registrar will be appropriately resourced. Further, to increase transparency, the Registrar will revise its pricing policy on access to basic information on all companies incorporated in Cyprus by end-June 2014, in order to make available basic information free of charge while ensuring budget neutrality.

- The CBC (with help from technical assistance) and relevant AML supervisors will develop and implement the necessary risk-based tools for off- and onsite AML supervision of financial institutions (by end-June 2014), lawyers and accountants (by end-September 2014), and trust and company service providers (by end-December 2014).

C. Fiscal Policy

13. **We remain committed to achieving the necessary budgetary savings required to restore the sustainability of our public finances.** We have comfortably met our end-June fiscal targets, given the ambitious fiscal consolidation undertaken at end-2012 and in April 2013. The primary balance for the first half of the year was €289 million (1.8 percent of GDP) better than programmed, and our primary spending was below target by €74 million (0.5 percent of GDP), respectively. We will continue to maintain a prudent budget execution to ensure the program fiscal targets for 2013 are met, including by tightly controlling discretionary spending given high revenue uncertainty.

14. **We will ensure adequate compensation of pension funds with deposits in Laiki bank for resolution-related losses.** These funds' deposits in Laiki have been fully converted into equity following the bank's resolution, while the deposits of pension funds in BoC have been partially converted into equity. To ensure comparable treatment between pension funds in the two banks, the funds with deposits in Laiki will be compensated following the conversion of deposits into equity (based on the total balance of deposits held in Laiki as of March 26 and the remaining balance of deposits in BoC after conversion into equity). Under these terms, compensation will not exceed €300 million. Out of this amount, we will release up to €154 million by the time of the second review of the program.

D. Structural Fiscal Reforms

Social Welfare System and Social Insurance

15. **We will reform our social welfare system to better protect vulnerable groups.** Our existing system does not in all cases provide benefits to those who are most in need, including the working poor, and its administration has shortcomings. To address these shortcomings and ensure adequate social protection during this economic downturn and beyond, we have developed a comprehensive reform plan to introduce a guaranteed minimum income (GMI) scheme while eliminating 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. Basic needs will be defined by a minimum consumption basket, which will be reviewed by end-September 2013. On this basis, we will estimate the cost of the GMI scheme in line with the program's macroeconomic framework by end-October 2013 and refine the means testing mechanism by end-December 2013. In addition to the GMI, other benefits may continue to be granted while overlapping benefits will be consolidated. The legal framework for the new social welfare system will be adopted by end-May 2014. The new system will be implemented by end-June 2014 (modified **structural benchmark**).

16. **We will continue to reform our pension system.** Building on earlier reforms, by end-August, we will complete an actuarial study of our general insurance pension scheme (GSIS) to determine options to ensure the system's long-run viability. Reforms resulting from this analysis will be adopted by end-December 2013 and enter into force by end-March 2014.

Revenue Administration

17. **We will also reform our revenue administration to increase its efficiency and bring it in line with best practice.** Tax administration is complicated by differing systems and procedures that have become outdated and burdensome for the taxpayer, affecting tax revenues. Our aims are to (i) increase revenues through better compliance management, (ii) improve efficiency and effectiveness of tax administration and reduce costs through economies of scale, and (iii) improve taxpayer services by reducing the administrative burden. To this end, we will put in place a new function-based tax administration integrating the existing Internal Revenue Department and VAT Service. As a first step in our reform agenda, we will establish by end-September 2013 a steering committee and a project team tasked to develop a reform plan. The reform plan will be agreed with program partners and approved by the government by end-December 2013. The Ministry of Finance would seek technical assistance, as appropriate.

18. **To support revenue collection in the short run, we will take a number of measures to fight tax evasion (end-December 2013 structural benchmark).** We will use information from databases across government agencies to identify non-compliant taxpayers in high-risk professions and industries for audit. Building on these efforts, we will develop a work program for conducting targeted joint audits through end-December 2014. We will also amend relevant legislation to establish self-assessment for all income taxpayers to expedite the tax filing process and allow focus on post-assessment audits selected on the basis of risk. Finally, we will pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act of and assistance to tax evasion into a criminal offense.

Public Financial Management

19. **We are continuing to take steps to strengthen our public financial management.** In particular:

- We have accelerated the preparation of our new Fiscal Responsibility and Budget Systems Law (FRBSL) so that a Fiscal Council can be established as of January 1. For this reason, the draft law will be submitted to Parliament by end-October 2013, and adopted by end-December (modified **structural benchmark**).

- To avoid budget overruns, which are a higher risk at a time when budget resources are tight, we will address gaps in our commitment control systems by introducing pre-invoicing controls. To this effect, we will modify our systems and procedures and publish a circular to announce that government orders are subject to pre-commitment validation by end-March 2014. This will help to minimize the risk of over committing public funds and thus of overspending or accumulating arrears.

• To help monitor fiscal developments in a timely manner so as to identify potential problems early on, starting with September data, the Treasury department will provide monthly reports on key indicators (on revenue, expenditure and borrowing) for the general government level to the MOF Budget Directorate.

• Finally, to allow more regular assessment of the risks stemming from government guarantees, given an already very high level of public debt, we will change the Public Debt Management Law by end-December 2013 to assign responsibility for monitoring the stock of guarantees to the Public Debt Management Office, while ensuring adequate staffing. This will allow closer monitoring of developments related to guarantees on a continuous basis.

20. **We are committed to managing our hydrocarbon resources in a transparent and efficient manner and in line with international best practice.** To this end, we are developing the legal basis for the transparent management of natural resource revenues through the budgetary framework. To ensure that all natural resource revenues and any public spending related to these revenues and the development of the natural gas sector are channeled through the budget provisions to this end will be included in the FRBSL. In due time, we will also develop, in consultation with program partners, the legal framework for a natural resource fund, which will be established in line with international best practice.

21. **We are moving ahead with developing and implementing a legal and institutional framework for public investment, including public-private partnerships (PPPs).** Currently we do not have a clear legal and institutional framework for public investment budgeting and for managing public investment projects. In this regard, we will include in our new FRBSL provisions that ensure that public investment projects are integrated in the budget process. The law will formalize the role of the Minister of Finance and his Services in reviewing and approving public investment projects, including PPPs.

Privatization

22. **We are also making progress with the preparation of a plan and a legal framework for privatization.** We have already prepared an inventory of the assets with the highest commercial value. While the valuation of the assets needs to be refined, a first assessment provides an indication that the target for privatization proceeds by end-2018 (€1.4 billion) is achievable. To prepare for the actual privatization process, we will appoint an external consultant to develop by end-November 2013 a privatization plan and a draft legal framework. The legal and institutional framework will be implemented by end-December 2013.

E. Program Financing and Monitoring

23. **In line with our earlier commitments, we have taken several measures to reduce program financing needs.** We have successfully completed the exchange of €1 billion domestic debt falling due

during the program period into new debt at 6–10 year maturities and keeping the interest rate unchanged. Similarly, we have rolled over the €1.9 billion Laiki recapitalization bond at original terms. We are making progress on the restructuring of the €2.5 billion Russian bond falling due in 2016 and we expect this will take place at the terms envisaged in March. We will plan for an allocation of central bank profits of €0.4 billion (in line with CBC duties under the Treaties and the Statute) to be distributed in 2014. Moreover, an asset swap will be decided by the CBC in accordance with its rules and the Treaty so as to contribute approximately €1 billion to the reduction of our public debt by end-June 2014.

24. **Implementation of policies under our program will continue to be monitored through quarterly reviews.** Our program includes continuous performance criteria, indicative targets, and structural benchmarks, which are defined in the attached Technical Memorandum of Understanding (TMU). As is standard in IMF arrangements, there is a continuous performance criterion on the non-accumulation of external payment arrears. We also include in our program a continuous performance criterion on non-intensification of restrictions of payments and transfers for current international transactions or to introduce multiple practices.

25. **We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.**

Table 1. Cyprus: Quantitative Conditionality 1/
(In millions of euros)

	Performance criteria					Indicative targets	
	Jun-13			Sep-13	Dec-13	Mar-14	Jun-14
	Target	Adjusted target	Actual				
Floor on the general government primary balance 2/	-222		67	-402	-549	-47	-367
Ceiling on the general government primary expenditure 2/	3,230		3,156	5,065	7,223	1,581	3,196
Ceiling on the stock of general government debt	17,153	17,083 5/	16,930	18,521	18,744	18,728	18,498
Ceiling on the accumulation of new general government guarantees 3/	145.3		9.9	145.3	145.3	0	0
Ceiling on the accumulation of external arrears 3/ 4/	0		0	0	0	0	0
Ceiling on the accumulation of domestic arrears 3/	0		0	0	0	0	0
Ceiling on the accumulation of VAT refund arrears by the general government 3/	10		-0.9	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since the beginning of the corresponding year.
3/ For 2013, cumulative since March. For 2014, cumulative since the beginning of the year.
4/ Continuous performance criterion.
5/ The target was adjusted downward by the size of the revision of the stock of debt at end-2012, in line with the TMU.

Table 2. Cyprus: Structural Conditionality for the First Review

Measures	Timing	Status	Remarks
Prior actions			
Establish the legal framework for an appropriate ownership and governance structure to manage the government's majority stake in the CCI sector	Before Board meeting		
Amend the cooperative and banking laws provisions to establish the CBC as the single supervisor of CCI sector	Before Board meeting		
Performance criterion			
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous	Met	
Structural benchmarks			
Complete the due diligence valuation of CPB and BoC assets as described in the resolution law in accordance with the terms of reference agreed with the EC/ECB/IMF	End-June 2013	Partially met	The valuation study was completed on July 26
For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability in accordance with terms of reference prepared in consultation with EC/ECB/IMF	End-June 2013	Partially met	Capital needs of individual CCIs have been assessed on time but the viability assessment was completed on July 19.
Develop a strategy to recapitalize and restructure the CCI sector with public money as needed	End-July 2013	Met	
Roll over and extend the maturity of at least €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and roll over the €1.9 billion recapitalization bond of CPB	End-June 2013	Completed on July 1	The closing date for the exchange was set on July 1, as the deadline of June 30 fell on a weekend.

Table 3. Cyprus: Existing and New Structural Conditionality

Measures	Timing
Existing Structural benchmarks	
CBC to prepare an assessment of BoC's restructuring, business, funding and capital plans 1/	End-October 2013
Adopt the legal framework for a central credit register (TMU ¶18)	End-September 2013
Revise the anti-money laundering legal framework (TMU ¶16)	End-September 2013
Adopt a law on fiscal responsibility and budget systems (TMU ¶19) 2/	End-December 2013
Implement a new social welfare system to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs 3/	End-June 2014
New Structural benchmarks	
CBC to instruct Hellenic Bank to launch an offer for private participation in the bank's capital	End-September 2013
Recapitalize Hellenic Bank in line with the capital needs identified by the PIMCO exercise	End-December 2013
Adopt measures to fight tax evasion (TMU ¶20)	End-December 2013
Merge the credit cooperative sector into a maximum of 18 institutions which will be recapitalized to fulfill the capital requirements under the law	End-March 2014

1/ The content of this benchmark has been modified and the deadline moved from end-September to end-October.
2/ The original benchmark referred to submission to Parliament.
3/ The original deadline was end-December 2013.

Cyprus: Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the Fund on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

2. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those that prevailed on April 15. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.308099 dollar, €1 = 129.0309 Japanese yen, €1.15222= 1 SDR.

3. For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the Fund.

A. Quantitative Performance Criteria and Indicative Targets

Floor on the General Government Primary Cash Balance (performance criterion)

4. For the purposes of the program, the general government includes the institutions listed under this category according to ESA 95 for Excessive Deficit Procedure (EDP) reporting purposes. In particular, the general government includes:

- *The central government.* Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi-government organizations.

- *The local governments.* Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.

- *The social security funds.* These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.

- *Any newly created institution defined as general government under ESA 95.* This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

5. The performance criteria are set on the general government cash primary balance (GGPCB), defined as the general government cash balance (GGCB) minus general government interest receipts plus general government interest payments. In turn, GGCB is defined as total revenue (tax revenue, social security contributions, grants and other revenue) minus total expenditure. The payment of called guarantees will be recorded as cash expenditures. Privatization receipts, as defined below, and the proceeds from the sale of land and buildings, will be excluded from revenue. The floor on the GGPCB in each year will be measured cumulatively from the start of that calendar year.

- Privatization receipts are those receipts associated with the disposal to private owners by a government unit of the controlling equity of a public corporation or quasi-corporation.

- The floor on the GGPCB will be adjusted downwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF staff.

6. The floor on the GGPCB of end-December 2013 will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki up to €146 million.

Ceiling on the General Government Primary Expenditure (performance criterion)

7. General government primary expenditure (GGPE) includes compensation of employees, goods and services, subsidies, social benefits, other recurrent expenditure, and capital expenditure.

- The ceiling on the GGPE will be adjusted upwards by the payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF staff.

8. The ceiling on the GGPE of end-December 2013 will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €146 million.

Ceiling on the stock of General Government Debt (performance criterion)

9. The general government debt constitutes total outstanding gross liabilities as defined by ESA95. This includes the debt of all institutions included in the general government as defined above and other ESA 95 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.

10. The ceiling on the general government debt will be adjusted:

- Upward (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upwards, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF staff.

Ceiling on the Accumulation of new General Government Guarantees (performance criterion)

11. The ceiling on new general government sector guarantees shall include domestic and external guarantees granted during the test period, as well as guarantees for which the maturity is being extended beyond the initial contractual provisions. The ceiling shall exclude guarantees granted under a risk sharing instrument of the EU structural funds (see COM (2011) 655 final) that do not create contingent liabilities for the Cypriot State. Government entities outside of the general government (e.g. state owned enterprises) but within the non financial public sector are not permitted to grant guarantees. The stock of guarantees at end March 2013 was €3.1 billion. This excludes €3.8 billion of temporary government guarantees issued on March 25 to facilitate the sale of Laiki's Greek branch and which were cancelled on June 27.

12. The ceiling on the accumulation of new general government guarantees will be adjusted upwards for the issuance of government guaranteed bonds to be used in monetary policy operations to boost BoC's liquidity up to €2.9 billion.

Ceiling on the Accumulation of External Arrears (continuous performance criterion)

13. External payment arrears are defined as payments on debt to non-residents contracted or guaranteed by the general government, which have not been made within seven days after falling due. The stock of external payment arrears as of end-March 2013 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

14. Domestic expenditure arrears are defined as unpaid invoices that have passed the due date by 90 days. In case no due date is specified on the supplier contract, an unpaid commitment is considered to be in arrears 90 days after the initiation of the invoice. The stock of domestic expenditure arrears as of end March 2013 was €0.

Ceiling on the Accumulation of VAT Refund Arrears by the General Government (performance criterion)

15. VAT refund arrears consist of unpaid VAT refunds that have past the due date for payment established in the tax legislation and/or the corresponding regulations. The stock of VAT refund arrears as of end March 2013 was €140 million.

B. Monitoring of Structural Benchmarks

16. **Revision of the anti-money laundering legal framework (end-September 2013).**

Specification. The adopted legal framework will provide for the following:

- Ensure that the financial intelligence unit can exchange adequate information with foreign counterparts on money laundering, associated predicate offenses and terrorist financing, in the context of its analytical function, without having to secure a court order;
- Ensure that all trustees of trusts created under and governed by Cyprus law are regulated or otherwise registered. Registers will be kept by the relevant supervisory authorities in order to enable them to carry out their duties and will contain adequate, accurate and current information on the name of a trust and the name and address of its trustee(s);
- Ensure that adequate, accurate and up-to-date information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities, along the following lines:
    - The company secretary is the holder of beneficial ownership information and is accountable for providing adequate, accurate and current beneficial ownership information to competent authorities
    - The company secretary is i) a regulated professional supervised by a Cypriot authority, or ii) if the company is excluded from the scope of the TCSP Law, a natural person resident in Cyprus;
- Ensure that the use of "nominee" directors (i.e. professionals who provide director services) or "nominee" shareholders does not create any obstacle to the authorities' timely access to adequate, accurate and up-to-date information on the beneficial ownership, and control of companies by having a mechanism in place consistent with the FATF standards. To this end, the authorities will require that all nominee directors and nominee shareholders be authorized or otherwise regulated (i.e. as lawyers, accountants

or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).

17. AML supervision's implementation: On a quarterly basis, in the context of the program review starting in the fourth quarter of 2013, the supervisory competent authorities will, on a confidential and anonymized basis, share information with Fund staff, by granting access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.

18. Adopt the legal framework for a central credit register (end-September 2013)

Specification. The adopted legal framework shall include provisions to:

- Establish a framework that allows credit institutions to keep in a centralized manner critical information on household and corporate borrowers (including their consolidated debt exposure, past due and performing loans, collateral, etc.), while sensitive and/or confidential information shall be safeguarded;

- Ensure adequate access by credit institutions and exchange of consumers' data among credit institutions to enhance credit underwriting policies.

19. Adopt a law on fiscal responsibility and budget systems (end-December 2013).

Specification. The adopted legal framework will contain the following elements:

- It will provide a comprehensive coverage of the general government sector and the government's financial relationships with state enterprises and other public entities that are outside the boundary of the general government sector.

- It will incorporate provisions (i) on fiscal transparency and accountability requiring the government to articulate a comprehensive, legally based and independently monitored fiscal strategy consistent with EU requirements and (ii) for the development over time of a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down approach to budget preparation that is closely linked to the process of fiscal policy-making, and providing more flexibility to ministries and semi-governmental organizations.

20. Adopt measures to fight tax evasion (end-December 2013)

Specification. The adopted measures will include the following:

- Develop a work program for conducting targeted joint audits through end-December 2014;

- Amend relevant legislation to establish self-assessment for all income taxpayers;

- Pass legislation to harmonize and increase collection enforcement powers of the revenue administration, including by providing the authority to seize assets, or prohibit the alienation or use of assets, including property and bank accounts, and turning the act and assistance of to tax evasion into a criminal offense.

C. Reporting Requirements

21. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance, Cystat, and the Central Bank of Cyprus. The authorities will transmit to the IMF staff any data revisions in a timely manner. Table 1 describes the supporting data needed for monitoring of the quantitative targets, the required frequency of the data, the institution/department responsible for providing the data, and the timing for provision of the data.

Table 1. Cyprus: Reporting Requirements			
Information required	**Data Frequency**	**Institution/Department responsible for providing information**	**Maximum time lag for submission after the end of the reporting period**
Detailed execution of revenues, expenditure and financing provided in EDP reporting format	Monthly	MOF. Budget Department/Cystat Government Financial Statistics.	25 days after the end of the month, except end-December data which will be provided30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident). Details on any financial balance sheet transactions	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Central Government Debt stock by type of debt instrument, maturity, currency, type of debt holder. Interest bill for each type of debt instrument on a monthly basis for the current year and the next year, and annual for each year thereafter until 2020	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure and VAT refund arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Customs & Excise Department, VAT Service	15 days after the end of the month
Stock of government guarantees and their monthly flows by institution.	Quarterly	MOF. Treasury Department.	25 days after the end of the month
Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the domestic operations of the banking system – aggregate monetary balance sheet of credit institutions by institutional category	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the banking system (consolidated, including foreign operations), aggregate	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period

balance monetary balance sheet of credit institutions by institutional category			
Table 1. Cyprus: Reporting Requirements (Concluded)			
Individual operational balance sheet of the domestic operations of the largest banks and coops with detailed information on deposits (by maturity, currency, and type of depositor), central bank funding, interbank funding, debt securities, loans provided to the public and the private sector, 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Details for the largest banks and coops on liquid assets (cash and securities), liquidity position (i.e. the pool of assets eligible for ELA but not already encumbered), other assets and liabilities 1/	Daily	Central Bank of Cyprus	Next working day
Deposits by institution, currency, and residency and end-of-day liquidity buffers	Daily	Central Bank of Cyprus	Next working day
Financial soundness indicators—core set, deposits, NPLs, capital adequacy ratios	Quarterly	Central Bank of Cyprus	60 days after the end of the month

1/ Reporting requirements for cooperative banks will be revisited after the CBC becomes their supervisor.

ANNEX 5

Assessment of Effective Action in accordance with Council Recommendation under Art. 126(7)

A5.1. INTRODUCTION

On 13 July 2010, the Council decided in accordance with Article 126(6) of the Treaty of the Functioning of the European Union (TFEU) that an excessive deficit existed in Cyprus and issued a recommendation to Cyprus in accordance with Article 126(7) of the TFEU with a view to bringing an end to the situation of an excessive government deficit by 2012. ([16])

Cyprus' general government deficit remained at high levels in recent years, despite a sizeable consolidation effort. In 2011 and 2012, the headline balance reached 6.3% of GDP, compared to 5.3% of GDP in 2010, the year of the initial EDP Council recommendation. In 2012, less tax-rich growth, reduced revenue elasticities and a one-off expenditure kept the deficit at high levels.

On 25 April 2013, the Council addressed a decision to Cyprus on specific measures to restore financial stability and sustainable growth ('the programme').

In parallel the European Stability Mechanism (ESM) granted a financial assistance facility to Cyprus. In this context, a Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) was signed on 26 April 2013 by the Cypriot authorities and the Commission, acting on behalf of the ESM.

On 16 May 2013, the Council concluded that effective action over the years 2011-2012 had been taken, and that an extension of the deadline by four years for the correction of the excessive deficit procedure was justified. The average annual improvement of the structural budget balance over 2011-2012, after correction for the effects of revised potential output growth and less tax-rich growth was estimated to be 2.4% of GDP. This was above the minimum average annual fiscal effort of at least 1½% of GDP required by the Council recommendation, indicating that Cyprus could be considered to have taken effective action in line with the Council recommendations.

This was supported by a careful analysis ([17]) that shows that Cyprus adopted sizeable consolidation measures over 2011-12, with an estimated direct deficit-reducing impact of around 1½% of GDP in 2011 and around 4¼% of GDP in 2012, based on a bottom-up assessment.

Subsequently, the Council recommended that "Cyprus should put an end to the present excessive budget deficit situation by 2016. In order to bring the headline government deficit below the 3% of GDP reference value by 2016, Cyprus should achieve the headline general government deficit targets of 6.5% of GDP in 2013, 8.4% of GDP in 2014, 6.3% of GDP in 2015, and 2.9% of GDP in 2016. To this end, Cyprus should rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which should amount to at least EUR 351mn in 2013. Cyprus should fully implement the fiscal measures for 2014 that were adopted in December 2012, amounting to at least 270mn EUR in 2014. Cyprus should monitor the budgetary effect of consolidation measures taken on a monthly basis and stand ready to preserve fiscal targets by taking additional measures in the event of underperformance of revenues or higher social spending, taking into account macroeconomic circumstances. Cyprus should maintain fiscal consolidation over the medium term, converging towards its medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures."

In its recommendations, the Council established a deadline of 3 months for the Cypriot authorities to take effective action, in accordance with Article 3(4) of Council Regulation (EC) No 1467/97.

This document provides an assessment of whether Cyprus has undertaken effective action towards the correction of its excessive general

([16]) Official Journal, L186/30, 20/07/2010. EDP-related documents for Cyprus can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/cyprus_en.htm

([17]) COMMISSION STAFF WORKING DOCUMENT accompanying the Recommendation for a COUNCIL RECOMMENDATION with a view to bringing an end to the situation of an excessive government deficit in Cyprus, SWD (2013) 176 final, 7.5.2013.

Table A5.1: **Macroeconomic developments and outlook**

	2012	2013		2014		2015		2016	
	Outturn	PF April	PF July	PF April	PF July	PF April	PF July	PF April	PF July
Real GDP (% change)	-2.4	-8.7	-8.7	-3.9	-3.9	1.1	1.1	1.9	1.9
Contributions to real GDP growth (pp.):									
Final domestic demand	-6.1	-13.7	-13.8	-5.5	-5.5	0.9	0.9	2.0	2.0
Changes in inventories	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	4.4	5.0	5.0	1.6	1.6	0.2	0.2	-0.1	-0.1
Employment (% change)	-4.1	-6.6	-7.8	-3.1	-3.7	1.1	1.1	1.3	1.3
GDP deflator (% change)	2.0	0.6	0.6	1.1	1.1	1.5	1.5	1.8	1.8
Output gap (% of potential GDP)	0.1	-6.2	-5.8	-7.6	-6.6	-4.3	-3.0	-0.9	0.8
Potential output growth	-1.4	-2.6	-3.0	-2.5	-3.1	-2.3	-2.7	-1.6	-2.0

Programme Forecast (PF) April: Commission Spring Forecast; PF July Commission most recent forecast underlying the revised MoU from July 2013.
Source: Commission staff estimates.

government deficit in the 3 months following the 16 May 2013 Council Recommendation. In particular, it examines the budgetary developments since the May 2013 Council Recommendation.

A5.2. RECENT MACROECONOMIC DEVELOPMENTS

In 2012, economic activity in Cyprus significantly weakened, with real GDP decreasing by 2.4%. The deterioration was driven by the unwinding of Cyprus' unsustainable economic imbalances, which led to a widespread loss of confidence among economic agents. Domestic demand contracted markedly against the background of falling domestic consumption and private investment. The largest fall in economic activity took place in construction and in the broad industrial sector, while growing financial stability concerns led to weakening activity in financial services. The unemployment rate rose sharply, reaching nearly 12%.

In the first quarter of 2013, real GDP declined by 4.7% y-o-y, accelerating from -3.5% y-o-y in the fourth quarter of 2012. Private and, particularly, public consumption continued its downward movement, and the underlying growth momentum of gross fixed capital formation remained weak. The weak domestic demand resulted in a significant decline in imports of goods and services. With export of goods and services displaying a small increase compared to the first quarter of 2012, net exports provided a significant positive contribution to GDP growth.

Activity in the second quarter of this year was down 5.2% y-o-y ([18]). Large uncertainty in the composition of growth persists, particularly, due to the restructuring of the banking sector and the imposition of administrative measures on financial transactions to safeguard financial stability. However, short term indicators suggest a continuation of the underlying weak trend in both the household sector as well as the corporate sector. The spill-overs from financial sector instability to the real economy are likely to have imposed a significant drag on economic activity in the second quarter of 2013, mainly via concerns over financial sector stability in the short and medium terms. Amid declining lending, deposits were gradually finding their way out of the banking sector, rendering efficient financial intermediation even more difficult. Foreign investors were adopting a wait-and-see attitude, as future prospects remained uncertain. International transactions were hampered by restrictions on capital flows.

Real GDP is expected to decline drastically by 8.7% in 2013 as a whole, unchanged compared to the Commission 2013 Spring Forecast (see Table A5.1). The envisaged contraction is driven by the immediate restructuring of the banking sector and its impact on net credit growth, the longer-lasting deleveraging of corporate and household balance sheets, the fiscal consolidation

([18]) On 14 August, a Q2 GDP flash estimate was released by ESTAT. Since it was published after the finalisation of the macroeconomic forecast by the programme partners and due to its flash nature, this preliminary figure has not been taken into account. The programme projection will be reviewed and updated, if needed in the context of the second review mission.

pursued, and the high degree of economic uncertainty which will strain domestic demand and investment. In addition, the temporary imposition of capital controls and withdrawal restrictions combined with the related uncertainty are expected to hamper international capital flows and to reduce business volumes in both domestic and internationally-oriented companies. The bail-in of uninsured depositors is expected to cause a loss of wealth, which will also affect private consumption and investment.

Compared to the Commission 2013 Spring Forecast (which is identical to the programme scenario of April 2013), the macroeconomic projection remains broadly unchanged. Overall activity is unchanged, however, private consumption has been revised slightly down as the unemployment rate is projected to increase faster than previously envisaged; this is reflected also in the downward revision of imports.

Macroeconomic risks remains important and tilted to the downside. Downside risks relate to the tighter domestic credit conditions and a further deterioration of confidence in the banking system, a further worsening of labour market conditions and a non-negligible risk of household and corporate defaults propagating further through the economy. Also, the deep restructuring of the Cypriot economy, and its banking sector in particular, could cause stronger negative spill-overs on related professional business services and financial services' exports. More generally, the transition to a more varied growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and whose absorption will require flexible factor and product markets. Upside risks for the Cypriot economy relate mainly to possible improvements in the external outlook and, in the outer years, investments in the energy sector and a more competitive tourist sector could contribute increasingly to economic growth.

A5.3. ASSESSMENT OF EFFECTIVE ACTION

Following the expiry of the deadline established for taking effective action in a recommendation under Article 126(7), the Commission shall assess whether the Member State concerned has acted in compliance with the recommendation. This assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council. A Member State should be considered to have taken effective action if it has acted in compliance with the recommendation, regarding both the implementation of the measures required therein and budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council and the underlying improvement in the structural balance. Where relevant, a careful analysis should take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented.

Budgetary implementation in 2013

Despite the adverse macroeconomic environment and the faster-than-expected decline in employment, the general government headline budget deficit for the first half of 2013 amounted to 1.2% of GDP. This is significantly better than the authorities' half-year target for 2013 (by 2.3% of GDP), which has been established as an intermediary target in accordance with programme conditionality.([19]) It is also a significantly better outcome than in the respective period in 2012 (by 2.2% of GDP). Similarly, the primary balance exceeded the end-Q2 value targeted by the authorities by 1.6% of GDP.

Total revenue for the first 2 quarters of the year was in accordance with what has been targeted by the authorities, albeit around 1% of GDP lower than the same period in 2012. The outcome in the first half of 2013 benefited from extraordinary high non-tax revenues. These one-off revenues mainly comprised, inter alia, higher dividends due to exceptional profits by the Central Bank of Cyprus. Due to these one-off effects, one has to be cautious about overall revenue trends, since there are risks to the future performance of

([19]) CYSTAT publishes accrual data (ESA95) for the General Government on a quarterly basis. For monitoring purposes, the Ministry of Finance establishes quarterly targets in ESA95 terms which are in accordance with the annual EDP targets.

key revenue items. Overall, the end-year projection of total revenues remains in line with the projection underpinning the Commission 2013 Spring Forecast.

Revenues from both taxes on income and wealth and social contributions, in the first half of the year, performed somewhat better than expected. The developments were driven by the increased collection of taxes on interest and (deemed) dividends, which mitigated the negative impact of falling wages, employment and profits on income tax collection. In light of the large fall in banking sector deposits, the decrease in deposit rates as well as negative employment trends eventually showing up in the collection of social security contributions, this positive performance is, however, not expected to persist.

Revenues from taxes on production and imports at the end of the second quarter showed signs of weakness. This was in particular due to a significant drop in Land and Survey fees collections, associated with the continued contraction in the real estate market, as well as a significant decline in excise duties collected. The latter can be explained by cyclical conditions, a stronger-than-expected behavioural change in the demand for tobacco products and a steep decline of new motor vehicle purchases. Conversely, in spite of the shrinking tax base, VAT collection turned out better than expected, most likely driven by the hikes in the VAT rate of 2 pp. and 1 pp. in March 2012 and January 2013, respectively.

Total expenditure has been kept under strict control and has been restrained for key spending categories. Consequently, total primary expenditure was in the first half of the year significantly lower (by 1.7% GDP) than projected by the authorities. Primary expenditure was also significantly lower than in the respective period in 2012 (by 3.3% of GDP). Programme conditionality for total primary expenditure (in cash terms) was over-achieved.

Expenditure targets have been met. Current expenditure was lower than projected, mainly due to expenditure restraint in the categories of current transfers, goods and services and wages and salaries. On the contrary, social transfers other than in kind equalled the authorities' projection for the first half of the year, but grew at a faster pace than expected in the second quarter of 2013. This trend bears witness to the increasingly difficult labour market conditions. Capital expenditure receded over the first six months of the year, driven largely by the treatment of signing fees for gas exploitation as disposal of non-produced assets and an administrative delay of land annexation compensations during the first half of 2013. Interest payments for 2013 are on track, based on the outcome of the first half of the year.

Overall, Cyprus has executed the 2013 Budget effectively in the first half of the year. The measures taken by the authorities with regard to direct taxes are expected to counteract the negative impact to this tax category of wage cuts in both the private and the broader public sector. The projection of indirect tax revenue is broadly unchanged, balanced between relatively resilient VAT collection and other indirect taxes that appear more sensitive to adverse macroeconomic circumstances over the coming quarters. On the expenditure side, the cautious execution of expenditure measures is expected to continue compensating for higher social payments driven by the increasingly difficult labour market conditions.

Against the background of these developments in the first two quarters of 2013, an updated projection of the fiscal accounts confirms that the underlying budgetary trends in the first half of 2013 remain in line with the adjustment path established in the EDP recommendation. However, taking into account the compensation for provident and retirement funds in Cyprus Popular Bank (CPB) to ensure equal treatment with such funds in Bank of Cyprus (BoC) following the conversion of deposits into equity, the 2013 deficit is likely to be substantially higher than the government deficit of 6.5% of GDP recommended by the Council (see Table A5.2) ([20]).

([20]) In the Memorandum of Understanding on Specific Economic Policy Conditionality for Cyprus' adjustment programme (as approved on 24 April 2013 by the ESM Board of Governors) was explicitly mentioned that "the 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity". It was moreover agreed that "given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation". For this purpose, indicative financing of close to 2.5% of GDP was

Table A5.2: **Composition of the budgetary adjustment**

% of GDP unless otherwise stated	2012	2013		2014	
	Outturn	PF April*	PF July*	PF April	PF July
Revenue	40.0	39.6 (40.6)*	39.6 (40.6)*	39.1	39.3
of which:					
- Taxes on production and imports	14.8	14.1	14.1	13.8	14.2
- Current taxes on income, wealth, etc.	11.1	10.9	11.2	10.8	10.7
- Social contributions	9.1	8.5	8.4	8.0	8.7
- Other (residual)	4.9	6.1 (7.1)*	5.9 (6.9)*	6.4	5.6
Expenditure	46.3	46.1 (47.1)*	47.9 (46.1)*	47.5	47.6
of which:					
- Primary expenditure	43.1	42.1 (43.1)*	43.8 (44.8)*	43.4	43.6
of which:					
- Compensation of employees	15.8	15.8	15.9	15.4	15.9
- Intermediate consumption	3.2	5.3	5.2	5.7	5.2
- Social payments	15.0	15.8	15.7	16.4	16.7
- Subsidies	0.5	0.6	0.6	0.6	0.6
- Capital expenditure	4.0	2.4 (3.4)*	2.4 (3.4)*	3.3	3.2
- Other (residual)	4.6	2.2	4.0**	1.9	2.0
- Interest expenditure	3.2	4.1	4.1	4.1	4.0
General government balance (GGB)	-6.3	-6.5	-8.3	-8.4	-8.3
GGB excl. compensation of pension funds	-6.3	-6.5	-6.5	-8.4	-8.3
Primary balance (PB)	-3.1	-2.4	-2.4	-4.3	-4.3
PB excl. compensation of pension funds	-3.1	-2.4	-2.4	-4.3	-4.3
One-off and other temporary measures	0.4	1.5	-0.2**	0.0	0.0
Cyclically-adjusted balance	-6.3	-3.8	-5.8	-5.1	-5.4
Structural balance	-6.7	-5.4	-5.6	-5.1	-5.4
Change in structural balance	-0.1	1.3	1.2	0.3	0.1
Real GDP growth (% change)	-2.4	-8.7	-8.7	-3.9	-3.9
GDP deflator (% change)	2.0	0.6	0.6	1.1	1.1
Nominal GDP (EUR bn)	17.9	16.4	16.4	16.0	16.0

PF April: Commission 2013 Spring Forecast; PF July: Commission most recent forecast underlying the revised MoU from July 2013. *: In April PF it was assumed that the signing fees for gas exploitation of EUR 174.8mn (1.1% of GDP) are recorded as sales revenue under Other (residual) but in July PF it has been reclassified as negative expenditure in ESA 95 terms (disposal of non-produced assets); for ease of comparison the table reports April PF numbers at face value (figures in brackets) and numbers corrected for this reclassification. **: This includes the compensation of pension funds amounting to 1.8% of GDP.
Source: Commission staff estimates.

The first review mission under the programme established that the rate of compensation will be no larger than 52.5% of the total deposit balance held in CPB, based on a rate of conversion of 47.5% of deposits into equity in BoC. This implies that the total budgetary costs of compensation would amount to around 1.8% of GDP, of which about half can be released by the time of the second review of the adjustment programme. Based on the currently available information, it is expected that the budgetary commitment can be fully accounted for in 2013. In this case, the corresponding 2013 primary balance deficit would amount to around 4¼% of GDP and the headline deficit would amount to around 8½% of GDP, thus exceeding the 2013 target set in the 16 May Council Recommendation. The Cypriot authorities have committed to adopt the modalities of this scheme before the release of the second tranche of assistance, after review by and consultation of the programme partners. Due to its extraordinary one-off nature, the compensation for provident and retirement funds would not impact on the budgetary outcomes in the outer years, and the headline deficit for 2014 is projected to meet the EDP target of 8.4% of GDP. Further, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

earmarked for the third quarter of 2013 in the assessment of Cyprus' financing needs (note to the ESM pursuant to Art. 13.1 of the ESM Treaty). At the time of adopting the Council recommendation, the budgetary impact of this compensation could, however, not be established with precision, since it would depend on the conversion rate to be determined for deposits in BoC. The primary and headline balance deficit targets for 2013 were therefore set without explicitly taking into account the budgetary impact of this compensation.

The 16 May Council Recommendation focused on the headline balance targets and the bottom-

up effort, given the exceptional situation of highly uncertain macroeconomic environment in Cyprus at that time, with structural balance estimates being more uncertain and subject to variation over time than under more stable macroeconomic conditions. Since Cyprus can be expected not to meet the 2013 target for the headline balance recommended by the Council, due to the budgetary impact of the compensation of pension funds, a careful analysis should be conducted in order to assess whether expenditure targets have been met and the planned discretionary measures have been implemented.

An in-depth bottom-up assessment of the implemented fiscal measures is of particular relevance in the case of Cyprus, since the Council Recommendation of 16 May 2013 explicitly specifies also the recommended amount of discretionary consolidation measures. An assessment of the consolidation measures that have a fiscal impact in the years 2013 and 2014 is therefore required to assess if Cyprus has taken effective action.

Cyprus has implemented fiscal consolidation measures in three different rounds. A first set of measures was implemented in December 2012, including immediate cuts in public sector wages and pensions. A second set of measures was adopted via the 2013 Budget Law in December 2012. After the MoU negotiations were finalised in April 2013, a third round of measures was adopted. These measures were prior actions and were implemented before the granting of the first disbursement of financial assistance.

Including the effect of two additional measures that were not prior actions and that are expected to be implemented by end-2013, consolidation measures with an estimated direct deficit-reducing impact amounting to around 4.5% of GDP in 2013 and 2.2% in 2014 (see Table A5.3) will have been implemented. In both years, the figures include a negative impact of -0.1% of GDP related to an extraordinary dividend from a semi-government organisation, which is expected to be successively reduced in 2013 and 2014. Table A5.4 gives an overview of the main measures with budgetary impact in 2013 and 2014.

For 2013 the majority of consolidation measures are on the expenditure side. The 2.6% of GDP of expenditure measures notably refer to sizeable reductions in social transfers, public sector wage and pension cuts and reduced transfers to state-owned enterprises and other semi-governmental organisations. On the revenue side, the effort in 2013 amounts to close to 2% of GDP and comprised of increases in both indirect taxes (VAT and excise duties on energy, alcohol and tobacco) and direct taxes (e.g., tax on interest income, corporate income tax and property tax).

Table A5.3: **Fiscal consolidation measures, 2012-2014**

% of GDP	2012	2013	2014	2013-2014
Total measures	0.3	4.5	2.2	6.7
Revenue measures	0.2	2.0	1.6	3.6
Expenditure measures	0.1	2.6	0.6	3.2

Source: Commission staff estimates.

For 2013, the Council recommended that the agreed consolidation measures should amount to at least EUR 351mn (2.1% of GDP). These measures comprise first and foremost an increase in the statutory corporate income tax rate to 12.5% (expected to yield EUR 88mn), an increase in the tax rate applied to interest income to 30% (EUR 97mn), and an increase in the bank levy to 0.15% (EUR 8mn). As part of the prior actions, the immovable property tax was increased substantially (expected to yield EUR 53mn), further wage and pension cuts were implemented (EUR 8mn), social transfers to pensioners and for housing purposes were reduced (EUR 47mn) and measures to control healthcare expenditure were introduced (EUR 16mn). Furthermore, the government streamlined social transfers by more than the EUR 113mn required (additional EUR 78mn). While these additional savings from social transfers were already included in the 2013 Budget Law, they were not taken into account for the fiscal projection underpinning the Council Recommendation of 16 May 2013. Hence, the agreed measures implemented amount to more than EUR 351mn for 2013.

For 2014, the estimated direct deficit-reducing impact of the consolidation measures amounts to 2.2% of GDP. On the expenditure side, the biggest impact comes from a further cut of public sector wages and measures to contain the growth in social transfers and health care expenditures. However, most of the effort comes from the revenue side (1.6% of GDP) with further increases

Table A5.4: **Main discretionary measures with budgetary impact in 2013 and 2014**

2013 (% of GDP)	Expenditure	Revenue
December 2012	• Public sector wage and pension cuts (-0.9%)	
2013 Budget law	• Reduction in outlays for social transfers (-1.0%) • Reduction in transfers to SOEs and in budgetary appropriations to semi-governmental organisations (-0.3%) • Reduction of allowances to public sector employees (-0.1%) • Freezing pensions under the General Social Insurance Scheme (-0.1%)	• Increases in excise duties on energy, tobacco and alcohol products (0.3%) • Increase in the standard VAT rate (0.2%)
April 2013 prior actions (expenditure)	• Reduction in outlays for social transfers (-0.3%) • Measures to control health care expenditure (-0.1%)	• Increase in the tax rate on interest income (0.6%) • Increase in the corporate income tax rate (0.5%) • Increase in property tax (0.3%)
2014 (% of GDP)		
	• Public sector wage and pension cuts (-0.4%) • Reduction in outlays for social transfers (-0.2%)	• Increases in the standard and reduced VAT rates (0.4%) • Increase in excise duties on energy products (0.2%) • Extension of the temporary contribution on wages and pensions (0.4%) • Increase in the contribution to the General Social Insurance Scheme (0.4%)
April 2013 prior actions	• Measures to control health care expenditure (-0.1%)	• Increase in the tax rate on interest income (0.1%) • Increase in the corporate income tax rate (-0.2%) • Increase in property tax (0.1%)

A positive sign implies that revenue / expenditure increases.
Only measures yielding more than 0.1% of GDP are listed, which explains discrepancies with Table A5.3.
The loss in tax income due to public sector wage and pension cuts and increases in contributions is not accounted for in the numbers. In total, the loss amounts to 0.3% of GDP for 2013 and another 0.3% for 2014.
Source: Commission staff estimates.

in indirect taxes (VAT and excise duties on energy) and increases in contributions on wages and pensions. The increases in 2013 in property tax, the tax on interest income and VAT reach their full-year effects only in 2014, contributing to the revenue-bias of the fiscal effort in that year.

Under the updated fiscal and macroeconomic projections, Cyprus would achieve a budgetary impact for 2014 of more than the EUR 270mn recommended by the Council by fully implementing the agreed fiscal measures. Public sector wages and pensions will be cut by another 3% (expected to yield EUR 53mn) and social transfers will be further streamlined (EUR 29mn). The scaled temporary contribution of up to 3.5% on wages and pensions will be extended until the end of 2016 with the introduction of a new band at the lower end (EUR 58mn), and the contribution to the General Social Insurance Scheme will increase by 0.5 pps for both employers and employees (EUR 43mn). Further hikes of the standard and reduced-rate VAT and the full year effect of the 2013 VAT increase are estimated to contribute a sizeable amount (EUR 67mn), and so does another increase in the excise duties on petrol and gasoil by 5ct/litre (EUR 30mn). Finally, savings are expected from the increase in the bank levy to 0.15% reaching its full-year effect (EUR 9mn) and from the introduction of a fee on monthly transportation cards for students and pensioners (EUR 10mn).

In spite of their implementation, some measures on the revenue side are expected to underperform. For example, a shortfall will likely occur for the withholding tax for interest income, where for constitutional reasons, the increase was

Table A5.5: **Change in the structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls**

Uncorrected fiscal effort		Fiscal effort corrected for α		Fiscal effort corrected for α and β		Average implicit fiscal effort recommended (2013-2014)	Deadline for correction
2013	2014	2013	2014	2013	2014		
1.2	0.1	1.3	0.4	0.9	0.7	0.8	2016

Source: Commission services.

enacted only as of 29 April 2013 instead of 1 January 2013. Also the yield of the increase in the bank levy (paid by credit institutions) has been revised downwards, due to a change in legislation, which effectively reduced the tax base for 2013 in order to avoid financial institutions paying levy on a deposit base substantially higher than the current amount of deposits. With regard to the motor vehicle tax reform, generating additional revenues turned out more difficult than anticipated due to Cyprus' steeply deteriorating motor vehicle market, but it was agreed to cover the shortfall by compensatory measures.

Summing up, expenditure targets have been met, the discretionary measures on the revenue side have been implemented and the agreed consolidation measures are currently assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014. Thus, the in-depth bottom-up assessment of measures that have a fiscal impact in 2013 and 2014 suggests that Cyprus has taken effective action with regard to the 16 May Council recommendation.

The exceptional situation of highly uncertain macroeconomic environment in Cyprus makes it difficult to accurately estimate the fiscal effort in structural terms. Moreover, as noted in the analysis of the Commission services ([21]), swings in potential growth estimates are quite strong in the case of Cyprus, and the variation over successive forecasts in the contributions to potential growth from total labour, capital accumulation, and productivity (TFP) has been large. These shifts in estimated potential output and the highly uncertain macroeconomic conditions imply a corresponding impact on the estimated structural effort, even when no changes occur to the budgetary execution or the implementation of individual consolidation measures.

Nevertheless, the recommended headline balance targets under the April Programme Forecast implied an estimated structural fiscal effort of 1.3% of GDP in 2013 and of 0.3% in 2014. Under the updated July Programme Forecast a worse labour market projection impacts negatively on potential output which was revised downwards by 0.4 pp. in 2013 and 0.6 pp. in 2014. ([22]) This, in turn, reduces the estimated output gap in both years. As a result, given the unchanged projection of real GDP growth, the cyclical component is estimated as less negative than in the April Programme Forecast. Thus, the structural improvement for 2013 and 2014 ("Uncorrected fiscal effort") is slightly lower than implied in the 16 May Council Recommendation (see Table A5.5). Correcting for the revision of potential output growth ("α"), the fiscal effort improves to 1.3% and 0.4% for 2013 and 2014. ([23])

In contrast, tax revenue elasticities appear slightly lower in 2013 and slightly higher in 2014, compared to the April Programme Forecast, which leads to a reduction of the corrected fiscal effort in 2013 of 0.4% and an increase in 2014 of 0.3%. The assessment of the yield of certain revenue measures has been revised down for 2013. This includes those revenue measures, where the implementation was delayed (see above) and where the full-year effect therefore materialises only in 2014. Hence, while the agreed amount of total discretionary measures have been implemented by the Cypriot authorities, the downwards adjustment of the effect of

([21]) COMMISSION STAFF WORKING DOCUMENT accompanying the document Recommendation for a COUNCIL RECOMMENDATION with a view to bringing an end to the situation of an excessive government deficit in Cyprus, SWD (2013) 176 final, 7.5.2013.

([22]) The revision of the labour market forecast is driven both by a larger fall in employment and a significant upward revision of unemployment.

([23]) For an explanation of the methodology of calculating the corrected structural fiscal effort, please consult http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op151_en.htm discretionary revenue measures is predominantly driven by a shift in timing of revenue collection as several revenues foreseen for 2013 in the April Programme Forecast were shifted to 2014 in the July Programme Forecast.

Correcting for both of these effects ("α" and "β"), the fiscal effort amounts to 0.9% and 0.7% in 2013 and 2014. On average, the corrected fiscal effort for 2013-2014 is therefore in line with the implicitly recommended effort.

Budgetary prospects for 2014-16

An ambitious but achievable fiscal adjustment path over the medium-term is essential to make Cyprus' public debt sustainable. For this reason, a key objective of the fiscal strategy and the agreed consolidation measures is to achieve a strengthening of the primary balance over the programme period and a further strengthening in the years that follow. The authorities are bound to stand ready to preserve the programme objectives by taking additional measures in the event of fiscal underperformance, taking into account adverse macroeconomic effects.

On the revenue side, fiscal performance in the programme years is expected to reflect broadly the macroeconomic developments. Specifically, revenues from taxes on production and imports are expected to be in line with trends in nominal private consumption, with a sizeable drop in 2014 followed by a steady rebound in 2015 and 2016. Similarly, the collection of direct taxes is expected to initially follow a decreasing trend. Social contributions are expected to be on a downwards trend in 2014 and 2015 and start increasing again in 2016, reflecting the developments in employment and wages.

On the expenditure side, total expenditure is expected to be kept tight, despite the increased unemployment. Specifically, the compensation of employees is projected to decline throughout the programme period, both due to the reduction of employees and the reduction of wages and allowances. Moreover, the reform of the welfare system is expected to contain the growth in social transfers. Public investment is expected to be reduced even further in 2014, but then to increase again in 2015 and 2016, along with the amelioration of the overall macroeconomic conditions. Lastly, only minor fluctuations in interest payments are expected throughout the programme period.

All in all, the annual targets established in the Council recommendation are projected to be met, leading to a correction of the excessive deficit by 2016.

Budgetary framework and fiscal structural measures

The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation over the longer-term, leading to a primary balance surplus of 3% of GDP in 2017 and 4% of GDP in 2018, which should be maintained at such level thereafter.

Moreover, the implementation of the fiscal-structural measures specified in Decision 2013/236/EU will support the achievement of long-term sustainability of public finances. The fiscal-structural measures are far-ranging and comprise, inter alia, establishing a medium-term budgetary framework, undertaking reforms of the pension, health care and welfare system as well as the revenue administration, and ensuring improvements to the public finance management and the functioning of the public sector.

Significant pension reform measures were implemented as of 1 January 2013. An actuarial study is underway to help decisions on further reforms to ensure the long-run viability of the national pension system.

For healthcare reform, an updated actuarial study of the National Health System (NHS) has now been completed, leading to the implementation of a financially sustainable NHS by end-2015. In the meantime, co-payments for using public healthcare services have been introduced, expected to raise revenues and to control demand, while eligibility for free public healthcare has been constrained, particularly through the introduction of a compulsory health care income-based contribution for public sector employees and pensioners. Also, efficiency increasing structural measures have been initiated; these include the re-organisation of hospitals, the introduction of protocols and clinical guidelines and the introduction of an IT-infrastructure.

A reform plan was announced by the government that will form the basis for a comprehensive reform of the welfare system, to be prepared in stages and enter into force on 1 July 2014. The reform aims to provide better protection of vulnerable groups, to ensure efficient use of public funds within the welfare system, while at the same time ensure balance between welfare benefits and incentives to take up work. The authorities' reform plan makes clear that the reformed welfare system must be consistent with the programme's fiscal targets. In a situation where the total spending envelope for social protection may have to be reduced in the coming years, the authorities have decided that priority should be given to protecting the most vulnerable people and that sufficient budgetary means for fundamental social policies should be ensured. The core of the reform is therefore the introduction of a guaranteed minimum income (GMI) scheme together with the elimination of duplicate benefits.

In public finance management, the Fiscal Strategy Statement adopted for the first time in May 2013 was a step forward in better fiscal planning. Meanwhile, the authorities decided to adopt an umbrella law covering budgetary processes in the broad sense, which would rescind the MTBF law and would also encompass the provisions grounding the Fiscal Council. To improve the effectiveness and efficiency of the revenue administration, the Cypriot authorities agreed to implement a comprehensive reform. Under the reform, a new integrated tax department covering direct and indirect taxes will be established and a compliance management strategy will be implemented. Lastly, work on public administration reform has been initiated with the reduction of impediments to staff mobility and the change of working hours. An independent external review has been commissioned, to identify further areas of public administration reform.

Public Debt

Public debt rose by almost 10 pp. in 2011 and in 2012, reaching almost 71.1% of GDP in 2011 and 85.8% of GDP in 2012, mostly driven by higher stock-flow adjustments related to the government's participation in the recapitalisation of one commercial bank in June 2012. In addition, higher-than-expected deficit outcomes in the past, partly arising from higher borrowing costs due to Cyprus' difficulty in accessing international markets, as well as the slowdown in the nominal GDP (through the denominator effect) also increased the debt-to-GDP ratio.

The general government's gross debt stock remained broadly stable over the four first months of 2013, reflecting favourable fiscal developments. The Cypriot authorities announced on 27 June an exchange of some EUR 1bn of domestic-law bonds held by residents (higher than foreseen in April) with new bonds maintaining the same coupon rates. This exchange was completed on 1 July 2013. Further, the first disbursement of programme money by the ESM and the IMF took place in May and June 2013, amounting to EUR 2.1bn and EUR 1bn, respectively as was foreseen in April. In the absence of significant long-term debt maturities, debt redemption in the first half of 2013 was linked almost exclusively to short-term obligations. The first disbursement provided the Cypriot authorities with sufficient funds to cover needs for debt service and deficit financing until the next cash disbursement foreseen by the end of the fourth quarter 2013. During the second quarter, funds were used to reimburse in particular the foreign-law bond worth EUR 1.4bn which matured on 7 June and to cover fiscal needs of about EUR 300m. Hence, the government's cash buffer has also increased and will be sufficient to cover estimated third quarter fiscal financing needs of between EUR 600 and 700m.

Table A5.6: **Public debt trajectory 2013-2016 under the updated Programme Forecast**

	2012	2013	2014	2015	2016
Gross debt ratio (% of GDP)	**85.8**	**115.0**	**123.2**	**126.9**	**122.5**
Changes in the ratio (pp.)	*14.7*	*29.2*	*8.2*	*3.6*	*-4.4*
of which					
(1) Primary balance (pp.)	**3.1**	**4.2**	**4.3**	**2.1**	**-1.2**
(2) Snowball effect (pp.)	**3.6**	**11.7**	**7.6**	**1.0**	**-0.5**
Interest expenditure (pp.)	*3.2*	*4.1*	*4.3*	*4.1*	*4.2*
Growth effect (pp.)	*1.8*	*8.2*	*4.6*	*-1.3*	*-2.4*
Inflation effect (pp.)	*-1.4*	*-0.6*	*-1.3*	*-1.8*	*-2.2*
(3) Stock flow adjustment (pp.)	**8.1**	**13.3**	**-3.6**	**0.6**	**-2.7**

Source: Commission staff estimates.

The fiscal consolidation implies that the improvement in the primary balance over 2013-16 will eventually contribute to reducing the debt ratio, in spite of the rather strong debt-increasing effects from interest expenditure and the projected recession (see Table A5.6). Provided that the budget execution remains on

Table A5.7: **Baseline scenario (Commission 2013 Spring Forecast)**

% of GDP unless indicated otherwise	2012p	2013f	2014f	2015f	2016f
Revenues	40.0	40.6	39.1	39.4	40.8
Current revenues	39.9	40.6	39.0	39.4	40.7
Discretionary measures with impact on current revenue (EUR bn)	0.362	0.631	0.167	-0.021	-0.027
Expenditure	46.3	47.1	47.5	45.7	43.7
Nominal GDP (EUR bn)	17.9	16.4	16.0	16.4	17.0
Nominal GDP growth	-0.5	-8.2	-2.9	2.6	3.7
Real GDP growth	-2.4	-8.7	-3.9	1.1	1.9
Potential GDP growth	-1.3	-2.6	-2.5	-2.3	-1.6
Structural balance	-6.7	-5.4	-5.1	-4.4	-2.5
Primary balance	-3.1	-2.4	-4.3	-2.1	1.2
General government balance	-6.3	-6.5	-8.4	-6.3	-2.9
p.m CAB methodology revenue elasticity	1.0	1.0	1.0	1.0	1.0
p.m Apparent revenue elasticity	9.5	1.9	1.4	1.3	2.0
p.m Output gap (% of potential output)	0.0	-6.2	-7.6	-4.3	-0.9

f: forecasted data.
Source: Commission staff estimates.

track, the debt-to-GDP ratio can be expected to reach 115% at the end of 2013 and to around 127% of GDP in 2015. Thereafter, on the back of solid primary surpluses and the projected return to positive GDP growth rates, the debt-to-GDP ratio is set to start falling to around 123% of GDP in 2016. This is in line with the April Programme Forecast and the debt sustainability assessment presented.

A5.4. FISCAL ADJUSTMENT PATH

The Council Recommendation of 16th May 2013 was based on the Commission 2013 Spring Forecast. The updated fiscal and macroeconomic projections in the context of the July review of Cyprus' programme are largely unchanged compared to the Commission 2013 Spring Forecast.

Given that the deviation from the headline target set in the 16 May Council Recommendation is explained by the extraordinary one-off compensation of provident and pension funds in CPB, no additional measures appear needed at this stage.

At present, Cyprus continues to rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which at this point in time are assessed to amount to slightly more than the required EUR 351mn in 2013 and at least 270mn EUR in 2014. The situation will have to be monitored closely and further corrective action would have to be taken early on if deviations from budgetary plans were to materialise. The total amount of fiscal policy measures required to underpin the 2014 budgetary targets will be assessed in the context of the 2014 Budget Law consultation. For 2015-2016, Cyprus should achieve a deficit in the 2015 general government primary balance of no more than EUR 344mn (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204mn (1.2% of GDP), which under the updated programme forecast will require further measures to be specified in the outer years.

Table A5.8: **Updated Programme Forecast, July 2013**

		2012	2013	2014	2015	2016
Potential Growth (annual % change)	**PF April**	-1.3	-2.6	-2.5	-2.3	-1.6
	PF July	-1.4	-3.0	-3.0	-2.6	-1.8
Actual Growth (annual % change)	**PF April** / **PF July**	-2.4	-8.7	-3.9	1.1	1.9
Output gap (% of potential GDP)	**PF April**	0.0	-6.2	-7.6	-4.3	-0.9
	PF July	0.1	-5.8	-6.7	-3.2	0.5

PF April: Commission 2013 Spring Forecast; PF July: Commission's most recent forecast underlying the revised MoU from July 2013.
Source: Commission staff estimates.

A5.5. CONCLUSION

Based on currently available information, it appears that Cyprus remains on track towards correcting the excessive deficit by 2016 as recommended by the Council on 16 May 2013.

The current forecast suggests that, due to the compensation of provident and pension funds in Cyprus Popular Bank, the headline deficit target for 2013 will not be achieved. However, the underlying budgetary trends and the execution of the 2013 budget remain in line with the adjustment path established in the EDP recommendation. Given the extraordinary nature of the pension funds compensation, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

Further, an in-depth bottom-up analysis shows that Cyprus has adopted sizeable consolidation measures with a direct deficit-reducing impact in 2013 of around 4.5% of GDP and around 2.2% of GDP in 2014. In line with the Council Recommendation, Cyprus continues to rigorously implement the 2013 Budget Law, has met expenditure targets and implemented the agreed discretionary consolidation measures, which are assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014.

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