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Cyprus—2011 Article IV Consultation Concluding Statement of the Mission[1]

October 12, 2011

Introduction

The Cypriot economy faces strong headwinds and substantial downside risks that are likely to persist. In part, these risks reflect developments outside Cyprus – including financial turbulence across the euro area, exposure of the large banking system to developments in Greece, and darkening prospects for growth globally. But they also reflect imbalances that have developed in Cyprus in recent years, including the rapid deterioration of public finances. As a result, the government has lost access to international capital markets. Adverse feedback loops between fiscal imbalances and banking vulnerabilities pose a significant risk going forward.

The situation demands a strong and immediate policy response. Decisive and credible measures to reverse the fiscal slippage and put the public debt ratio on a declining path are essential to restore access to capital markets, safeguard the confidence of investors that underpins Cyprus' role as an international financial center, and protect the competitiveness of the economy. In the financial sector, the authorities should remain vigilant to detect liquidity pressures at an early stage, engage in rigorous stress testing and contingency planning, and ensure that appropriate legal powers are in place to address potential problems.

Bold corrective actions can set the stage for resumption of economic growth, based on the underlying strengths of the Cypriot economy. These include a successful international services sector built on the foundation of a highly educated workforce and entrepreneurial spirit. The country's long history of steady growth and low unemployment testifies to the underlying dynamism of the economy.

Economic outlook

After a modest recovery in 2010, headwinds to growth have stiffened. Financial conditions have tightened throughout the euro area, including Cyprus. The growth outlook for Cyprus' trading partners has deteriorated and global trade is slowing, which will weigh on services exports. A climate of tight credit and uncertainty is likely to dampen both consumption and investment, while the construction sector is still retrenching from its past excesses. Fiscal consolidation, while necessary to restore sound public finances and lay the foundations for durable growth, may dampen demand in the short term. Reflecting these forces, the economy is expected to show little if any growth this year, and to register a small contraction in 2012.

Fiscal policy

Reversing the large deterioration in public finances is an urgent priority. Reducing the deficit of some 7 percent of GDP in 2011 is needed to halt the rapid increase in public debt that has taken place in the past three years and to put the public debt ratio on a downward trajectory. The pace of adjustment must be fast to restore confidence and regain access to capital markets. Measures to achieve fiscal savings should focus mostly on expenditure reductions, which experience has shown to provide more durable savings than tax increases. Moreover, the large increases in public expenditure in the past three years, in particular in public sector wages and benefits and in untargeted social transfers, indicate that there is ample room to contain spending. Fiscal savings must be based on conservative assumptions and be implemented without slippage. This is a precondition for regaining credibility and restoring confidence.

The government has set ambitious targets that would deliver a large reduction in the deficit in 2012 and a balanced budget within three years. This timeframe strikes an appropriate balance, providing for large up-front savings while avoiding an excessive contraction in demand in the near term. The measures passed in August were an encouraging first step towards achieving the government's fiscal targets, in particular the introduction of contributions by public sector employees towards their pensions. Additional measures are being considered by the government. In order to achieve the needed adjustment, these measures should comprise actions to contain public sector wages and benefits, such as a freeze of the cost of living allowance; targeting of social transfers, while protecting the social safety net for the most vulnerable; and an increase in the value-added tax rate to 17 percent, which is still be well below the EU median level of 20 percent.

To restore confidence, the government should now move quickly to pass into legislation specific measures in the context of a credible multi-year consolidation plan for

2012-14. It should ensure that the magnitude of the measures is fully sufficient to achieve the target of fiscal balance by 2014, and stand ready to take additional measures if needed in the period ahead. In the event that economic growth recovers more quickly than expected and revenues exceed projections, this should lead to a faster pace of deficit reduction without relaxation of expenditure restraint.

Financial sector

Cyprus' large banking sector, with assets of over eight times GDP, is a pillar of the economy, directly generating a high share of jobs and income, and indirectly supporting other business services. Cypriot banks have a number of strengths, including limited exposure to securitized assets and predominant reliance on deposits rather than wholesale market funding. Nevertheless, the financial turbulence in the euro area and the large exposure of Cypriot banks to Greece have had a negative impact on asset performance, profitability, and capital and liquidity buffers.

In view of unsettled external conditions, utmost vigilance and careful contingency planning are required. The authorities should be prepared for the possibility of further negative shocks. They should undertake rigorous stress tests to identify potential capital and liquidity shortfalls under adverse scenarios, and require banks to strengthen buffers accordingly where needed. It is important to continue monitoring bank liquidity on a high frequency basis and coordinate closely with supervisors in other countries and with EU authorities to enable a coordinated response to problems that may arise. The authorities should enhance their legal and regulatory powers to ensure they are fully equipped to take prompt action to recapitalize or resolve banks, if necessary. In this context, passage of the framework law and amendments to the banking act should be an immediate priority.

Cooperative credit institutions require careful oversight and should be subject to stress testing and contingency planning similar to the banks. Their regulatory regime should be fully harmonized with the regime for banks. In this regard, the recent adoption of common definitions of non-performing loans is welcome. Cooperatives should improve their transparency through regular publication of data on a comparable basis to banks. Finally, as in the past, we recommend that supervision of banks and cooperatives should be unified to ensure consistency in treatment.

Structural reform

The foremost priority in the area of structural reform is to bolster the underlying strength of a well-qualified private sector labor force in order to improve prospects for growth and employment. Containment of public sector wages and benefits, sustained reduction in the size of public employment, and significant reform of the automatic cost of living adjustment, will make a major contribution towards this end by increasing wage flexibility and augmenting the flow of highly qualified workers into the private sector. Initiatives to improve training and education to create a better match with employers' needs and to promote wider use of information and communication technology by businesses is also important.

Reform of the national pension system is key to address long-term fiscal challenges. Cyprus is expected to have one of the largest increases in pension expenditures in the euro area over the longer term. Although the fiscal burden of the pension system is presently limited, the system will become unsustainable as it matures and the population ages. Moreover, the reserves held by the social security fund represent obligations of future taxpayers and thus do not constitute a true financial buffer. Now is the time to initiate reform of the system to ensure its financial equilibrium over the long term. If reforms are agreed soon, they can be phased in gradually over time, avoiding the disruption that would occur if they were delayed until the mounting costs of the system demand immediate action.

Reforms to fiscal institutions are needed to improve accountability, transparency, and efficiency of public finances.

- Cyprus has taken initial steps towards budgetary reform, but further actions are necessary to support the introduction of a multi-year budgetary framework. More accurate revenue and expenditure estimates and fewer budget rigidities will reduce the need for supplementary budgets. Reorganization of the revenue administration to combine separate departments that administer different taxes with limited exchange of information, will improve efficiency. Reforms in these areas will help the government succeed in its fiscal consolidation efforts. Finally, the new EU directive that mandates the introduction of fiscal rules in national legislation, including a national expenditure rule, should be expeditiously implemented to lock in sound management of public finances.
- The framework for Public-Private Partnerships (PPPs) needs to be reformed to protect the budget from insufficiently evaluated financial risks. It is essential to conduct systematic cost-benefit analysis and put in place procedures that enable the Minister of Finance to prevent PPP projects that do not meet appropriate standards.

Conclusion

The Cypriot economy faces large risks that demand a strong policy response. Implementation of the fiscal and financial policies outlined above is essential in order to put the public debt ratio on a firm downward path and to preserve the stability of the financial sector, thus restoring investor confidence and improving prospects for regaining market access in a reasonable timeframe. To that end, the fiscal and financial authorities need to act with unity and speed.

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[1] This statement contains the preliminary findings and main recommendations of the IMF's 2011 Article IV consultation mission to Cyprus. Article IV consultations are conducted with all IMF member countries on a regular basis. The IMF mission is grateful to the authorities for their hospitality and excellent cooperation.

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