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EX-POST EVALUATION

of the

Economic Adjustment Programme for Cyprus 2013-2016

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ABBREVIATIONS

ALMPs – Active Labour Market Policies

AMC – Asset Management Company

AML – Anti-money laundering

BoC – Bank of Cyprus

CBC – Central Bank of Cyprus

CCB – Cooperative Central Bank

CCIs - Cooperative credit institutions

COLA – Cost of living allowance

CPB – Cyprus Popular (Laiki) Bank

CRA – Credit rating agency

DMO – Debt Management Office

DSA – Debt sustainability assessment

EA – Euro area

EC – European Commission

ECB – European Central Bank

EDP – Excessive Deficit Procedure

ELA – Emergency Liquidity Assistance

ESM – European Stability Mechanism

EU – European Union

EWG – Eurogroup Working Group

GDP – Gross Domestic Product

HB – Hellenic Bank

IMF – International Monetary Fund

ISG – Inter-service Steering Group

MEFP – Memorandum of Economic and Financial Policies

MIP – Macroeconomic Imbalances Procedure

MoF – Ministry of Finance

MoU – Memorandum of Understanding

NPL – Non-performing loan

PPP – Public-private partnership

pps – percentage points

PPS – Post-programme surveillance

PSI - Private Sector Involvement

SGCY –Support Group for Cyprus

SOE – State-owned enterprise

SPEs – Special purpose entities

SRM – Single Resolution Mechanism

SRSS – Structural Reforms Support Service

SSM – Single Supervisory Mechanism

TA – Technical Assistance

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MAIN FINDINGS

Background

In March 2016, Cyprus exited an economic adjustment programme supported by financial assistance from the European Stability Mechanism (ESM) and the International Monetary Fund (IMF) that had started in April 2013. While the need for an adjustment programme was triggered by a banking crisis, it was preceded by imbalances that had built up for some time, notably due to capital inflows that had made access to credit particularly easy and financed a real estate boom. The programme identified as key challenges the high private sector debt and vulnerabilities in the financial sector, an unsustainable trend of public finances, and an economy too concentrated on financial and business services and too dependent on energy imports. To cover Cyprus' financing gap it provided financial assistance of up to EUR 10 billion, subject to favourable assessments of Cyprus' compliance with the agreed policy conditionality. The programme's main objectives were to restore the soundness of the Cypriot banking sector, to correct the excessive fiscal deficit and put public finances on a sustainable path, and to support competitiveness and a sustainable and balanced growth.

This report presents the findings of the ex-post evaluation of the adjustment programme for Cyprus. As already done for Spain, Ireland and Portugal, the Commission services (DG ECFIN) decided to submit the programme to an ex-post evaluation in order to draw lessons for future decision-making and to identify areas of improvement for any possible similar interventions in the future.([1]) The evaluation is guided by the evaluation criteria of effectiveness, efficiency, relevance, coherence and EU added value. In accordance, this evaluation is a performance-oriented rather than a compliance-oriented exercise. It was carried out by a team of Commission economists who have not been involved in the Cyprus economic adjustment programme. Main sources of evidence in the evaluation consisted of a general literature review on the Cypriot economy, programme document analysis, data-based economic analysis, and a targeted stakeholder consultation (see Annex 1).

General assessment

The programme was effective in restoring fiscal sustainability and stabilising the financial sector. This helped Cyprus to re-establish a gradual access to sovereign markets already during the programme. Two financial sector measures were introduced prior to the programme, namely a bail-in of unsecured depositors accompanied by temporary administrative restrictions and capital controls, which were considered necessary in view of the banking sector's unsustainable business model that heavily relied on external funding sources prior to the crisis. The financial situation of the banks gradually improved in the initial phase of the programme. Moreover, the successful financial stabilisation allowed for a withdrawal of the temporary administrative restrictions and capital controls already by spring 2015. A considerable deleveraging of the banking sector took place, which was a necessary step in the adjustment process. Fiscal consolidation was already frontloaded in 2012, before the programme started, and continued in 2013. Together with a better-than-expected macroeconomic performance, this contributed to an over-performance vis-à-vis the initially set fiscal targets. In the course of the programme, these achievements enhanced programme credibility and investor confidence, which allowed a gradual return to markets for medium-term sovereign financing already during the programme, in spite of ratings below investment grade. These achievements were confirmed post-programme with a remarkable economic performance as real GDP and investment growth was among the highest in the euro area since 2016 and unemployment has fallen sharply since it peaked in 2013/14.

The programme was less effective in addressing the underlying structural weaknesses of financial institutions and in reducing the Cypriot economy's overreliance on a few sectors. Progress in reducing the high level of non-performing loans (NPLs) was rather limited during the programme and more significant only from 2018 onward. The banking sector still represented

([1]) The conclusions chapter presents the general lessons learned from this evaluation.

a potential source of instability in 2019, with the Cypriot financial soundness indicators remaining among the weakest in the EU. Moreover, the changes introduced in the structure and governance of the cooperative banking system were insufficiently implemented to solve its main problems that contributed to the need to put it into liquidation after the programme. The implementation of several fiscal-structural and structural reforms remained incomplete at the end of the programme. In spite of good intentions by the authorities at the beginning of the programme, a visible change towards diversifying and strengthening the Cypriot economy towards more sustainable and balanced growth has essentially not materialised, but efforts are ongoing to diversify the services sector. The incomplete implementation of programme conditionality related to structural reforms in public finance and other areas - modest in cross-country comparison but ambitious with hindsight due to both political and administrative constraints - also had a certain negative effect in terms of credibility of the programme. However, as also the experience with other euro area adjustment programmes shows, it is very challenging to address deeply rooted structural problems within a 3-years programme horizon. Some, if not most of them, are only likely to be solved in the medium term, provided the respective government demonstrates political will also after the end of the programme. The programme could have insisted more on the government setting up and launching a credible and operational growth strategy that sets an economic perspective for the post-programme period.

While the programme objectives of stabilising the financial sector, restoring fiscal sustainability, implementing structural reforms were largely achieved and allowed regaining market access, external factors such as government action ahead of the programme, the euro area recovery and a buoyant tourism sector also contributed. In the absence of a quantifiable counter-factual situation, it is difficult to distinguish between the effects of the general economic and financial developments and the effects of the programme itself. First, key policy measures targeting the financial institutions and policies towards fiscal consolidation were already introduced ahead of the programme. Second, the programme period coincided with a buoyant global economy and the recovery of the euro area helped by the ECB's non-standard monetary policies. Third, the Cypriot economy benefitted from an unexpected boom in tourism due to a relative decline in attractiveness of competing tourist destinations following the Arab Spring and other geopolitical conflicts, in addition to some progress in implementing a tourism strategy and in improving cost competitiveness. Nevertheless, the programme clearly helped avoid a disorderly and precipitous deleveraging of the financial sector and the wider economy with the related social consequences.

There was a clear value added of the EU engagement in that adequate financing was provided at acceptable costs and in that the credibility of policies was boosted. When Cyprus had lost access to sovereign debt markets in mid-2011 no realistic alternative to an EU intervention was available. The Russian Federation, which had provided a loan end-2011, showed little willingness to engage with additional loans. The IMF was not in a position to contribute more than a minor share to a new euro area programme. Apart from financing, the intervention also added significant value in terms of credibility, expertise, and coherence with other EU policies. For example, there was a specific case for fiscal governance reform where the first year of the programme coincided with the national transposition of relevant EU legislation, hence the programme framework helped to ensure a proper and comprehensive transposition design.

An earlier start of the programme would have been more efficient as its delayed start increased the problems and the financing needs. The nearly two years that passed since sovereign market access was lost and nearly one year that passed since the request for a programme until its agreement is likely to have increased some of the problems and the financing needs as the underlying problems remained largely unaddressed. The government's initial reluctance to request a programme followed by a refusal to agree on the reforms sought by the programme partners implied a major delay until the programme was eventually agreed. As time passed

and the effects of the Greek crisis on some Cypriot banks became apparent, the liquidity and solvency situation of banks continued to deteriorate and bank financing increasingly relied on Emergency Liquidity Assistance (ELA). Also, as banks paid back subordinated bonds, bank capital available to be bailed in was shifting towards deposits that were also decreasing. Furthermore, in June 2012 the government recapitalised Laiki Bank with EUR 1.8 billion, only for it to be resolved less than one year later. In addition, sovereign financing got increasingly costly during that period of lost market access in terms of interest rates to be paid (e.g. the Russian loan).

The overall programme strategy and its main objectives were relevant in addressing the main challenges. The size of banks' balance sheets and their risky business model, coupled with risks to debt sustainability if supported by state aid, were no doubt the biggest problems underlying the need for a programme. However, a banks-only programme as previously designed for Spain would not have been sufficient in the case of Cyprus as its banking sector's problems were much larger compared to the rest of the economy, even though it could have been an option at an earlier stage when the problems were still of a more manageable size. While external imbalances and competiveness losses were not as aggravated in Cyprus as in other euro area programme countries, foregoing some crucial structural conditionalities would have ignored the underlying structural causes of the problems of banks and public finance. For example, addressing banks' high NPLs turned out to have a complexity that required broad-based reforms including those related to the insolvency and foreclosure framework, the backlog of title deeds, and the efficiency of the judiciary. On the public finance side, addressing fiscal risks such as PPPs or SOEs requires prior regulatory reforms to avoid an undue burden on taxpayers and consumers. With hindsight, some parts of the programme over-burdened the administrative capacity of a small country like Cyprus within the 3-year time horizon of the programme, notably regarding fiscal-structural and structural reforms.

The programme generally ensured coherence between its different objectives. This might have been helped by the fact that key policy conditionality in the Memorandum of Understanding was guided by various EU policy frameworks. Relevant EU legislation was applied to the reforms in the financial sector. The public deficit and debt path set out in the programme were determined by EU fiscal rules (Stability and Growth Pact) and the approach to debt sustainability, underpinned by EU rules on national budgetary frameworks. In the different areas of structural conditionality the relevant EU acquis provided an important anchor.

However, in some parts of the programme the coherence between its three objectives (financial, fiscal and structural policies) was initially insufficient. Regarding NPLs, the programme relied initially strongly on the reform of the insolvency and foreclosure framework. Only later in the programme, when this was implemented, the programme measures addressing the malfunctioning in the housing market (issuance of title deeds, efficiency of the judiciary) received more attention. Regarding fiscal policies, the privatisation of the telecom, electricity and ports SOEs were envisaged to support debt sustainability and reduce fiscal risks. However, to avoid the creation of private monopolies in such crucial network industries, prior regulatory reforms were required that were not really made explicit in the programme, except for a strengthening of the independence and functioning of the regulatory authorities.

From the outset, the programme was committed to mitigating any adverse social effects while addressing the imbalances. Reforms in the areas of social welfare, and to a lesser extent also pensions and health care were designed not only to reduce their overall cost, but also to rationalise the existing systems and bring more efficiency and effectiveness in the protection of the most vulnerable. Fiscal consolidation measures introduced more progressivity and compliance in the tax system to achieve a fairer distribution of the tax burden as well as more means-testing of benefits. The guaranteed minimum income (GMI) was prepared and swiftly implemented during the programme. It helped rationalise the multiplicity of often not means-tested benefit schemes, and helped in effectively

protecting against extreme poverty. However, other social flagship measures in the programme – notably the creation of a national healthcare system (NHS) providing universal access - got delayed and were not yet accomplished at the end of the programme, even though important progress in preparing them was made.

The social impact of the programme is difficult to assess. Due to the lack of a quantifiable counter-factual situation, it is impossible to distinguish between, on the one hand, the effects of the recession associated with income losses and high unemployment and, on the other hand, the effects of the programme itself. There was little systematic monitoring and reporting about the social effects of the programme and its measures that could provide a reference for an evaluation. As regards burden-sharing of the negative effects of the crisis and the programme, there was a perception among some stakeholders that those allegedly responsible for some of the problems, i.e. staff in banks, were not bearing their fair share of the necessary economic adjustment. The bail-in of unsecured depositors, perceived by many stakeholders as a part of the programme, also contributed to the perception of unfair burden-sharing that some stakeholders considered to be a possible reason for a high share of strategic defaults in non-performing loans.

At the end of the programme, the national authorities did not consider alternatives to its exit strategy. Although a continued rating below investment grade at the end of the programme did not allow Cypriot banks to use Cypriot bonds as collateral for ECB refinancing without a new programme arrangement, there was reluctance on the Cypriot side to request one. Given re-gained sovereign market access at the end of the programme, there was also no need for a new full programme to provide financing. A precautionary programme was not desirable for the Cypriot authorities because of its stigma, neither for some euro area partners because of the implied additional budget risks. The government's exit strategy was thus not seriously contested.

Preserving financial stability

The overall situation of the Cypriot financial sector gradually improved after its stabilisation was achieved at the beginning of the programme. A considerable deleveraging of the banking sector took place, notably following the bail-in decisions ahead of the programme. A gradual return of deposits, allowing a decline in the stock of Emergency Liquidity Assistance (ELA), confirmed a returning confidence in the Cypriot banking sector. The successful financial stabilisation allowed a swift withdrawal of the administrative restrictions and capital controls. Moreover, the Cypriot financial institutions adapted their operations to comply with supervisory rules, targeting more use of stable funding sources by relying less on external sources of funding and increasing the share of domestic deposits. Tighter rules on anti-money laundering/counter-financing of terrorism (AML/CFT) also contributed in this respect.

Yet, the Cypriot banking sector was still subject to high risks at the end of the programme. The Cypriot financial soundness indicators remained among the weakest in the EU. The banking sector's profitability remained negative during the programme, not least due to the high costs of loan loss provisioning. Very high levels of non-performing loans (NPLs) - especially in the real estate and construction sectors - remained a significant source of risks also after the end of the programme. The slow progress to reduce NPLs also resulted in a very low credit provision, notably to the corporate sector, which only eased more recently.

The programme could have been more effective and relevant by pursuing a more comprehensive approach to address the problem of NPLs. The programme strategy on NPLs relied strongly on reforming the legal framework for dealing with NPLs. The collateral recovery-related legislative package with regard to the insolvency and foreclosure procedures was finally introduced in 2015 after long discussions at the political level and several amendments of the legislative proposal by the Parliament. The introduced measures failed to deliver results, also because the final version was changed

substantially compared to the version agreed with programme partners. The existence of many loopholes implied that the actual implementation of foreclosures and insolvency procedures remained complicated. The judiciary procedures related to insolvency and foreclosures remained lengthy compared to other EU countries, which did not incentivise banks in initiating collateral recovery (see Chapter 5). More and earlier structural reforms concerning title deeds for houses and the judiciary could have facilitated faster progress in reducing NPLs, while acknowledging that frontloaded action on all these matters in parallel could have been constrained by the authorities' administrative capacity. As a result, amendments to the introduced legislative package were required and a new legislative package was introduced in July 2018 in order to make the measures more effective, while further progress towards a more effective legislative and judicial framework concerning the workout of NPLs remains to be done.

Although not obvious at the time on the basis of the available risk assessments, with the benefit of hindsight the programme could have been more efficient by pursuing a more determined approach on the cooperative credit institutions. While several changes to the governance of the cooperative banking system were introduced, including a higher degree of centralisation, these proved insufficient to prevent significant and recurrent recapitalisation needs that emerged later on, ultimately leading to its liquidation. Progress in dealing with the high NPLs was even slower in the cooperative banking system than in the commercial banks. This should also be viewed in the context of the initially ineffective collateral recovery-related legislative package, which was a common factor affecting negatively the whole financial sector. However, given the significant systemic importance for the Cypriot economy in view of its small depositors' structure, introducing major changes to the cooperative banks could have caused serious disruptions in the Cypriot financial sector. This also explains the strong political resistance that programme partners faced when proposing bolder action on the cooperative banks.

The programme was largely ineffective in reducing the private sector debt overhang, which persisted also post-programme, despite some deleveraging starting from 2016. Private debt-to-GDP remains among the highest in the EU. Slow deleveraging during the programme period was partly a result of insufficient contract enforcement based on the insolvency and foreclosures procedures introduced in 2015. The low - and at times negative – inflation rates in Cyprus were not helpful either in making more progress on deleveraging.

At the start of the programme, the responsibility for the supervision and resolution of banks in the EU was located at the national level, which presented a difficulty for preventing, assessing and addressing coherently the problems of banks in Cyprus. At the same time, despite progress towards a Banking Union, some of the persisting problems in the sector remain under national responsibility, for example the legal framework to facilitate working out the high amount of NPLs. Following the programme's financial sector conditionality, a number of reforms were implemented that improved supervision and regulation of credit institutions by the Central Bank of Cyprus. Only as of November 2014, the SSM supervised the systemic Cypriot banks on the basis of common standards for the euro area countries. This provided a good transition platform between the national supervisory rules and the SSM supervisory standards, as also stated by several stakeholders interviewed. The Single Resolution Mechanism (SRM), which was responsible for defining burden-sharing rules for failing banks, became operational only from January 2016.

Ensuring fiscal sustainability

Pessimistic macroeconomic projections at the outset of the programme had a two-sided effect on expectations and programme credibility. An apparent bias of programme partners towards cautious projections was partly driven by the large uncertainties on the macroeconomic effects of financial stabilisation measures and partly motivated by considerations on the relative balance of risks stemming from a potential underachievement versus a potential overachievement of real GDP growth. The room for positive surprises was to some extent seen as

potentially strengthening the market confidence in the programme. At the start of the programme, projections affected negatively expectations and foreign investor sentiment, dampened the economic outlook and had a bearing on the scope of fiscal policy measures. They further had an impact on debt sustainability analysis and credit rating agencies (CRA) ratings, i.e. those aspects of the programme that are crucial for programme design and the financial envelope. Later in the programme when it became obvious that the downturn would prove less severe, output growth was exceeding expectations, market sentiment improved, and the assessment by CRAs was positively affected.

In retrospect, the specific fiscal targets may appear ambitious, but they were relevant in effectively containing debt at the time, signalling to the markets that the government was capable to deliver fiscal discipline. Importantly, fiscal targets were consensual, being set in agreement with the Cypriot authorities who also concurred with their upward revision as they saw advantages to signalling fiscal over-performance. Macroeconomic over-performance, explained by conservative projections and a high resilience of the Cypriot economy, facilitated the achievement of fiscal targets even in a tightened form. Fiscal-structural policy conditionality such as the pension reforms crucially improved long-term fiscal sustainability, indirectly helping Cyprus' return to the markets. Measures on health care were not motivated by fiscal sustainability and were not needed to achieve the programme objectives, but stakeholders believe they adequately flanked fiscal consolidation. With hindsight, some items in the fiscal-structural conditionality could have been more front-loaded, for example privatisation and the comprehensive public administration reform, when there was still a social consensus on the need for urgent changes.

The programme was very effective and relevant in improving the long-term sustainability of Cypriot public finances. Significant and sustained fiscal efforts contained the surge in the government debt ratio that ensued from the disbursement of financial assistance and the materialisation of contingent liabilities. They are also key in projecting a steady fall in Cyprus' government debt ratio over the next decade, in 2019 one of the largest debt-to-GDP stocks in the EU.[2] Pension reforms legislated already ahead of the programme bore fruit on the ground and were well prepared by the Cypriot authorities; they reduced long-term pension expenditure substantially, at the same time as they avoided harsh policies.

Fiscal-structural measures varied in their effective contribution to fiscal consolidation during the programme horizon. Some that were foreseen to directly and immediately contribute to the planned fiscal adjustment, e.g. the immovable property tax reform, did not materialise or were explicitly reversed in the first years of the post-programme period. Other reforms that have a longer-lasting effect in promoting a sound budgetary position were more successful such as, most notably, a strengthened domestic fiscal framework, revenue administration reform, or an improved monitoring and management of risks. On welfare, the guaranteed minimum income (GMI) successfully streamlined welfare spending, improved targeting and featured smooth implementation.

The overall policy approach to fiscal consolidation, pension and welfare reform, and the revamp of fiscal governance was efficient, as it more than delivered on the fiscal sustainability objectives while using an adequate set of measures. Fiscal consolidation was deliberately frontloaded, intending to draw more on expenditure than revenue and foreseeing clearly-defined measures since the beginning. This strategy fully reflected the Cypriot authorities' fiscal policy intentions, as national proposals largely passed through to the MoU, in a bottom-up fashion. Pension sustainability improvements drew mainly on the link of the statutory retirement age to life expectancy, additional increases in pension contributions from both employers and employees, and an extension of the reference pensionable earnings to life-time service, all of which more socially viable than, for instance, pension benefit cuts. While achieving and exceeding their fiscal

(2) See Cyprus Country Report 2019 and Fiscal Sustainability Report 2018, Volumes 1 and 2.

sustainability targets, these measures had only limited social impact, thanks to a set of relevant features. Fiscal consolidation measures were detailed, transparent, introduced at once to avoid uncertainty, and targeted higher income groups. In some fiscal-structural areas, measures were prepared well before the programme started, through social consultation and negotiations about reforms. This set of actions increased social trust, gave credibility to the reforms and fostered ownership among Cypriot citizens. In other areas (public administration, privatisation, immovable property tax), the design of the reform steps took much longer than initially expected also linked to social consultations, delaying key plans of the implementation to a period when reform fatigue set in.

EU value added and coherence was ensured through EU policy frameworks that provided guidance on restoring fiscal sustainability. The rules of the Stability and Growth Pact were perfectly integrated in the programme conditionality. Commission - Member States cooperation established in committees at EU level were useful in designing and approving the pension and welfare reform. There was also a clear case of EU value added for fiscal governance reform as the first year of the assistance practically coincided with the national transposition of relevant EU legislation (Budgetary Frameworks Directive, Two-pack Regulation and the intergovernmental Fiscal Compact). Hence, the programme framework with its quarterly reviews and detailed negotiations helped to ensure a proper and comprehensive transposition. In areas where the EU did not have a legal prerogative to set policies, such as pensions or healthcare, fiscal sustainability assessment frameworks established by the Commission jointly with Members States provided useful advice in designing the reform.

Restoring competitiveness and balanced growth

The programme was effective in triggering a broad range of structural reforms that were implemented during and after the programme. These aimed to enhance cost and non-cost competitiveness, improve the functioning of the labour market and return to sustained and balanced growth. Reforms to goods and services markets focused on increasing competition and included specific provisions on housing (including title deeds and the efficiency of civil courts dealing with housing issues), tourism (later included in an 'action plan for growth') and the energy sector. In parallel, labour market reforms covered two main topics: the wage-setting framework and active labour market policies (ALMPs). The programme was also crucial in initiating a comprehensive reform agenda that continued after the programme.

The programme on structural reforms ran quite smoothly, but its implementation would have been more efficient had it been designed with a clearer prioritisation of reforms. Deadlines for implementing structural reforms were all equally tight and did not always take into account their urgency, the time necessary to prepare and pass a major reform, or constraints in administrative capacity (for a small administration) at times of crisis. The urgency of some crucial structural reforms to complement progress made in the areas of insolvency and foreclosure, notably the ones related to the issuance of title deeds and the efficiency of the judiciary, was fully recognised only in the middle of the programme. Earlier attention to these aspects could have contributed to a faster reduction of NPLs and an improved access to credit.

On the labour market, the coherence between activation policies and the welfare reform is a key success of the programme. The welfare reform was fully integrated 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. Indeed, several interviewees from both programme partners and the authorities mentioned the reform of the social assistance and benefit scheme, including its link with activation policies, as a key success of the programme.([3]) Active Labour

([3]) This was developed in close cooperation with the authorities and based on sound economic analysis using the existing tools (e.g. Euromod simulations) for simulating the distributional impact of different reforms options. The Cyprus Support Group also provided useful help for targeted technical assistance. Throughout the process, the Government consulted social partners as customary.

Market Policies (ALMPs) were also made more targeted and Public Employment Services reinforced, although much of the progress on the ground was made post-programme. In terms of outcomes, there are some positive signs but room for improvement remains, based on a more systematic use of evaluations, as participation in ALMPs is still well below the EU average.

In terms of cost competitiveness, similar outcomes in the labour market could probably have been obtained more efficiently with less prescriptive conditionality. The labour market in Cyprus is quite flexible and, during the decades preceding the crisis, it was among the best performing in the EU in terms of employment and unemployment rates. Although there was a deterioration of cost-competitiveness during the period 2003-09, wage adjustment took place in particular in 2013-14. Against this background, it is difficult to assess the effectiveness of the reform of wage indexation by the cost of living allowance (COLA) which was suspended during the whole duration of the programme, when deflation occurred, and applied thereafter, when inflation was below 1%. In a deflationary environment, the impact of the revised formula for the broader public sector is likely to have been quite negligible. In fact, adjustment also came through real variables. Real wages have been growing constantly below productivity from 2013 to 2018, fully offsetting the gap of 2009, and the real effective exchange rate (deflated by ULC) dropped significantly during the same period.

Structural reforms related to product and service markets correctly addressed many of the most relevant challenges. Indeed, improving the product and service markets required a broad set of measures. At the same time, some of the reforms were more relevant than others to meet the objectives of the programme. For instance, reforming the laws for ergo-therapists, agriculturists, veterinarians and psychologists – while certainly useful for the business environment – did not seem to be as urgent as reforming and reinforcing the Competition Authority, which was seen by some interviewees as one of the major successes of the programme. The latter was particularly urgent in view of the foreseen liberalisation and privatisation, even though it did not take place in the end. Moreover, improving the pace of civil courts' case handling – while in full respect of the autonomy of the judiciary - could have deserved more and earlier prominence in the programme. The long duration of legal disputes and backlog of pending decisions is an obstacle to the proper implementation of the insolvency and foreclosure frameworks. Moreover, these shortcomings can deter investment since they delay the enforcement of contracts. Given the relevance of the issue for the business environment in general, it may have been justified to give more and earlier priority to this matter. Awareness of its importance has grown over time and, after the programme, the Supreme Court drafted a reform plan highlighting the priorities in improving the justice system (e.g. introduction of streamlining procedures, hiring of judges, upgrading IT resources, creation of a commercial court). Indeed, the judiciary reform and several other reforms that were part of the conditionality to address some important framework conditions only started towards the end of the programme or well after it had ended.

Despite an overall positive track record in terms of implementation, the programme was less effective in making the country's growth more sustainable and balanced, and some of its underlying vulnerabilities remain to be addressed. Many reforms related to the liberalisation of services, more competition in the energy market, addressing the backlog of title deeds, action plans on tourism and growth were implemented, but they did not induce a permanent, structural change and vulnerabilities in those sectors remain. Ultimately, there does not seem to be a well-defined and truly shared vision of a medium-term strategy outlining where the authorities would realistically like to see the country in 10 years' time. The current growth model, heavily relying on housing, construction, tourists and non-residents' capital inflows and offshore financial services, does not appear too different from the pre-crisis model, although efforts to diversify the services sector are still ongoing.

Coherence between structural and fiscal reforms was clearly achieved in the case of labour market reforms, but less so for product

market reforms. The link between a new benefit system by introducing a guaranteed minimum income and labour market activation policies was one of the key achievements of the programme. However, on other fiscal measures, synergies with market reforms could have been more prominent, for example regarding privatisation plans and market regulation.

EU value added was achieved in the identification of relevant structural reforms conditionality in the context of the EU surveillance framework. First, the fiscal and structural challenges of the Cypriot economies had already been analysed and discussed in the context of the European Semester before the start of the programme. There was therefore already a shared analysis for assessing the challenges and reforms needed, including previous Council recommendations. On the other hand, the implementation of structural reforms that were mostly motivated by the objective of quickly enforcing EU *acquis* implementation and not strictly related to the main programme objectives (e.g. liberalisation of professional services) - could have been achieved at lower costs by making use of the procedures already in place at the EU level. Second, in April 2016, Cyprus was identified as experiencing excessive macroeconomic imbalances. The Macroeconomic Imbalance Procedure (MIP) provided a good governance framework to manage the transition after the programme exit and continue to monitor developments in crucial areas (e.g. NPLs, title deeds, fiscal framework). The policy challenges identified in the context of the MIP and the European Semester were in line with the issues covered by post-programme surveillance.

Ensuring sovereign financing

The programme was effective in achieving its objectives of providing the Cypriot state with sufficient financial breathing space to restore financial stability. The financing was sufficient to ensure that Cyprus was able to fund its obligations and needs while it embarked on the reforms needed to return to market financing and to sustainable growth. The continued fall in bond spreads during the programme period and thereafter is a testament to the faith that markets placed on its ability to repay its debt over the short and medium term.

In terms of the efficiency and coherence of the financial envelope, the programme financing turned out to be markedly higher than the actual needs, but reflected the objective to ensure that there was sufficient financing even under a worst-case scenario. The size of the financing relative to the actual needs during the programme meant that there was money that went unused and enabled a cash buffer to build up over the programme years, which was much higher than initially expected. This cash buffer enabled Cyprus to feel less need to comply with the reform programme towards the end of the programme. In this respect, it could be argued that the programme would have been more efficient by not providing unnecessary financing. The size of the buffer arguably undermined the coherence with programme conditionality as additional disbursements were not perceived as being as vital in the final months. However, this does not mean that the cash buffer was not justified, nor does it mean that the financing envelope was too large. The cash buffer was a consequence of ongoing uncertainty in the financial sector and the need to prefund any contingencies between disbursements, coupled with a concern that markets should remain reassured at programme exit. The financing envelope was set to provide reassurance that the programme was able to deliver support even under adverse and unknown needs for the financial sector for the whole three years. It would have been much more difficult for market participants to be reassured of Cyprus' ability to cope with unforeseen economic events during the programme with a more limited envelope. In this sense, the large envelope was necessary to provide comfort in the face of uncertainty. The question of efficiency and coherence can therefore only be posed in retrospect, and setting a lower envelope at the start might not have resulted in such good financial results over the programme years.

The financing envelope was clearly a relevant part of the programme. Cyprus was locked out of financial markets in 2011, at a time when financial uncertainty was high in parts of the euro area, including in neighbouring Greece. In the event, even accounting for the cash buffer, Cyprus

needed some EUR 6 billion of budget financing (corresponding to 30% of its GDP) over the programme period. Without the financing envelope it would simply not have been able to find this financing.

Regarding EU value added, no other institution apart from the ESM was able to provide Cyprus with all the financing it needed and at a price it could afford. Prior to the agreement on the programme, the Cypriot authorities had searched extensively for financing, and had agreed a EUR 2.5 billion loan from Russia in late 2011, at an interest rate of 4.5%. By mid-2012, the Cypriot authorities had exhausted the possibilities of receiving more financing from this or comparable sources, leading to the programme request. Providing a financial envelope of the size that the ESM had access to would have been vastly problematic for the IMF.([4]) In addition, the interest rate payable on ESM loans is under 1% for Cyprus; for the IMF the equivalent interest rate was substantially higher.([5])

Institutional arrangements of programme implementation

The programme was generally efficiently managed by the Cypriot administration. Most of those who had worked on the programme generally praised the Cypriot government and the administration for their strong ownership and efficiency, even though this posed a challenge for the small absolute size of the administration (which was still deemed large relative to the size of the country). Technical assistance, largely from the European Commission's Support Group for Cyprus, helped to overcome some of the administrative capacity constraints. The Ministry of Finance had de facto a coordinating role in the government and ensured that the different Ministries were aware of what was expected from them in the context of the programme, even though lacking some enforcement powers vis-à-vis line Ministries. Problems of compliance with key conditionality, as most visible in the 6th and the 8th and final reviews, occurred mainly after the government had lost parliamentary support from some political parties and reform proposals were blocked more frequently in Parliament, and following the gradual return of the Cypriot sovereign to the markets. To safeguard ownership as much as possible, government and programme partners maintained a continuous dialogue with social partners and other stakeholders to consult and inform on the programme.

Technical assistance provided by the Commission during the programme can be considered important and complementary EU value added to the programme. Some of the most important gains were only incurred towards the end of the programme or well after the programme's end, whereas some reforms, which were kick-started by the programme, are still ongoing today. The calendars and timelines of short-term problem-fixing and of looking at the root causes of the problems are different ones. The work of the 'Support Group for Cyprus' (SGCY) - and later the SRSS - was mainly related to structural reforms of which many ultimately got delayed beyond the end of the programme. However, these reforms were and still are addressing some of the framework conditions, which previously allowed the crisis to happen and may now prevent a similar crisis from happening again. There is a general perception that it supported the good collaboration of the Commission with the administration and provided solidarity by helping the Cypriots as much as possible in getting over the crisis. The main achievements were on the reform of the budgetary framework and the guaranteed minimum income, while preparing the ground for other important reforms that got finalised only post-programme in sectors such as healthcare or the judiciary. The Support Group for Cyprus (SGCY) ensured the relevance of its work for programme implementation by working closely with the Cypriot authorities and adopting a demand-driven approach.

([4]) The IMF's contribution to the financing envelope was 563% of Cyprus' IMF quota, against a normal lending limit of 145% of quota.

([5]) Because of this, Cyprus paid back pre-emptively 222 SDR of its IMF loan which faced an interest rate of 3½% in 2017 (corresponding to 28% of its loan), following the agreement of the Eurogroup to waive the clause on the right for equitable repayment. Its remaining IMF loans carry an interest rate of 1.6%.

Support received through the European Structural and Investment Funds (ESIF) proved effective in supporting investment during the programme and in implementing some of the relevant provisions in the MoU. The definition of strategic priorities for the multi-annual financial framework (MFF) 2014-20 coincided with the beginning of the programme. The authorities could hence conceive from the start an investment strategy that took the reform priorities of the programme and the necessary flanking measures as well as the crisis context into account. Synergies between the ESIF and the programme were quite successful in the field of active labour market policies. Although there remains room for improving monitoring and evaluation systems, the reform of active labour market policies made in conjunction with the benefit reform and the introduction of the guaranteed minimum income was largely financed by the European Social Fund and was useful to provide training opportunities to those who had lost their job during the crisis. The Structural Funds were also an incentive for the development and adoption of the 'smart specialisation strategy', which is a pre-condition for receiving the Funds. In this case, however, the link with the Action Plan for Growth could have been further exploited and low awareness by stakeholders in the private sector possibly suggests that ownership could have been enhanced by their higher involvement.

Main outcomes and remaining challenges

Positive macroeconomic and fiscal developments that had started during the programme continued thereafter. Real GDP growth, which had turned positive in 2015, remained above euro area average in subsequent years. Unemployment continued to decrease and social conditions improved. Public debt has been on a descending path (except for 2018 due to the one-off banking support measures related to the resolution of the Cyprus Cooperative Bank), and the costs of sovereign financing decreased to historic lows in summer 2019. Some of the fiscal-structural reforms envisaged under the programme, such as a national health system, were nearing completion in 2019.

While the programme had contributed to the stabilisation of the banking sector and the economy at large, their underlying structural weaknesses have not yet been fully addressed. The Commission's Country Reports, country-specific recommendations and post-programme surveillance reports document the extent to which the Cypriot banks and the economy continue to be challenged by structural legacy problems that were already identified during the programme. The economy continues to rely on few sources of income, related to tourism, construction and housing, and foreign capital inflows. It is important to remember though that a small open economy will always face limits in terms of possible economic diversification.

With the benefit of hindsight, this raises legitimate questions as to whether programme conditionality and its implementation had always been sufficiently complete and rigorous in addressing the deeper structural problems in the Cypriot economy. However, as could also be seen in other euro area adjustment programmes, it is clear that not all vulnerabilities can be addressed within a 3-year programme and that some of the structural problems can only be expected to be solved in the medium term. One option to address this general problem could be to consider extending the length of adjustment programmes from three to, say, five or six years. However, this would not solve the fundamental problem of programme ownership and implementation that tend to deteriorate once the sovereign financing constraints are easing, as could also be seen in the case of Cyprus. Another option could be to have an adjustment programme accompanied by a medium-term economic and social strategy that would include all policy elements that are not immediately contributing to the programme's objectives or unlikely to be accomplished during the programme period. It would provide linkages to the programme's macro-fiscal framework as well as to its policy conditionality with a view to preparing and starting medium-term reforms. Such a document could also include a public investment strategy, and the contribution of EU funding, also to avoid that public investment unduly falls victim to fiscal consolidation. Ideally, such a medium-term strategy should be supported by a broad

political and social consensus to avoid significant disruptions in its implementation over time.

A tighter surveillance regime right after the end of the Cyprus programme could have been considered to reinforce and accelerate key reforms that address legacy problems, such as the non-performing loans in Cyprus' banks. Options would have been enhanced surveillance or corrective action under post-programme surveillance and/or the Macroeconomic Imbalances Procedure, as is possible under current EU legislation. This would have allowed specifying conditionality-like actions to be taken within a given timeframe, something that is not foreseen under standard EU surveillance procedures.

The crisis and the adjustment process had less of a social impact than could be expected. In spite of the high unemployment, poverty and inequality started to improve already in 2014 despite a fall in expenditures on social protection in that year. This suggests an improvement in the targeting of social protection that could be partly explained by the introduction of the reforms implemented in the programme, notably the guaranteed minimum income scheme.

1. INTRODUCTION

In March 2016, Cyprus completed an economic adjustment programme supported by euro area-IMF financial assistance that had started in April 2013. As already done for Spain, Ireland and Portugal,[6] the Commission services (DG ECFIN) decided to submit the programme to an ex post evaluation because of the economic and financial importance of this type of intervention as well as its complex set-up, involving collaboration with national authorities and international institutions. The purpose of this evaluation is to assess the intervention from an economic point of view, in order to draw lessons for future decision-making and identify areas of improvement for any similar interventions in the future.

While the need for an adjustment programme was triggered by a banking crisis, it was preceded by imbalances that had built up for some time, notably due to capital inflows that allowed easy access to credit. Cypriot banks had developed a poorly supervised business model that was based on attracting deposits from non-residents and on channelling them into investment with high risk/return features. As a result, imbalances were building up, including a housing construction boom, an oversized banking sector and a current account deficit reflecting the high capital inflows and a gradual loss of competitiveness. These increasing financial vulnerabilities coupled with structural weaknesses in the rest of the economy became exposed by the global crisis and the euro area crisis. The situation was amplified by the Cypriot economy's strong links to Greece. Combined together, this triggered a need for stabilisation and reform as well as considerable financing needs relative to the size of the economy.

The programme for Cyprus aimed at addressing several needs and challenges through inputs with intended outputs, results and impacts. The identified challenges were the high private sector debt and vulnerabilities in the financial sector, an unsustainable trend of public finances, and an economy too concentrated on financial and business services and too dependent on energy imports. The main inputs were the disbursements of financial assistance of up to EUR 10 billion,[7] subject to favourable assessments of Cyprus' compliance with the agreed policy conditionality,[8] accompanied by technical assistance. The intended outputs took the form of financial sector measures, fiscal policy and fiscal-structural measures, and structural reforms. The main programme objectives and intended results were to restore the soundness of the Cypriot banking sector, to correct the excessive general government deficit and put public finances on a sustainable path, to support competitiveness and a sustainable and balanced growth, and to cover Cyprus' financing gap during the adjustment programme. The intended medium to long-term impacts were macro-financial stability, fiscal sustainability, and increased trend growth.[9]

This report presents the findings of the ex-post economic evaluation of the programme. The main purpose is to assess the adjustment programme in order to draw lessons to inform the policy debate and improve future policy-making, when designing and implementing similar interventions, whether in the euro area or elsewhere. To do so, it looks at how the programme contributed to the evolution of the Cypriot economy and the attainment of the programme's objectives. Main sources of evidence consist of a general literature review on the Cypriot economy, programme document analysis, data-based economic analysis, and a targeted stakeholder consultation. The approach is qualitative in the sense that the conclusions are economic judgements based on the various pieces of evidence rather than on an econometric model. This is because it is not possible to construct a

(6) The evaluation reports can be found at: http://ec.europa.eu/dgs/economy_finance/evaluation/completed/index_en.htm

(7) Of which EUR 9 billion from the European Stability Mechanism (ESM) and EUR 1 billion from International Monetary Fund (IMF).

(8) Programme conditionality was jointly developed by staff from the Commission, IMF, ECB and the Cypriot authorities, and subsequently endorsed by the Eurogroup and the IMF Executive Board.

(9) For an illustration of the programme's intervention logic see section 2.4 of this report.

credible counterfactual at a time of changing economic conditions in both Cyprus and its partners. In addition, models highly reduce complexity while a qualitative approach allows taking into account aspects of the programme – such as the political context - that cannot be quantified but may nevertheless be important for understanding the performance of the programme. This evaluation is based on information available until the end of September 2019.

The evaluation is in response to the European Commission's general requirement to evaluate the impact of its policies.([10]) It is guided by the evaluation criteria of effectiveness, efficiency, relevance, coherence and EU added value. In accordance, this evaluation is a performance-oriented rather than a compliance-oriented exercise. Therefore, the evaluation does not consider the action of the programme partners in isolation. The Commission's internal working arrangements, as well as those in relation to the IMF and the ECB fall outside its scope, as do the actions of the Cypriot authorities prior to the programme. Like all financial assistance programmes, flexibility was needed to enable the programme to adapt during its implementation to both internal and external developments. For this reason, it is not straightforward to disentangle systematically the difference between the initial design of the programme and its implementation in the evaluation. Similarities to the methodological approach of the ex-post evaluations on Spain, Ireland and Portugal are intentional to ensure coherence and comparability with the different findings. Annex 1 presents in greater detail the overall evaluation approach.

The evaluation was carried out by a team of Commission economists. To ensure the impartiality of the exercise, and in line with international best practice, particular care was taken to create an institutional separation between those who carried out the evaluation and those who had been involved in the implementation of the programme itself. Hence, members of the evaluation team have not been involved in the Cyprus economic adjustment programme.([11])

The report is organised as follows. It assesses the programme design and implementation - against the background of the economic context of the request for financial assistance (chapter 2) – with a view to the outcomes according to the main programme objectives (chapters 3 to 6). Institutional arrangements of programme implementation are assessed in chapter 7. Chapter 8 provides an overview of the main outcomes – both economic and social - and the remaining challenges before chapter 9 concludes with the main lessons learned.

([10]) See "Better regulation for better results – An EU agenda" (COM(2015) 215 final) and "Better Regulation Guidelines" (SWD (2017) 350: https://ec.europa.eu/info/law/law-making-process/planning-and-proposing-law/better-regulation-why-and-how/better-regulation-guidelines-and-toolbox_en)

([11]) As further explained in Annex 1, the team reported to an Inter-Service Steering Group whose members have not been involved in the Cyprus economic adjustment programme either.

2. ECONOMIC CONTEXT AND PROGRAMME DESIGN

2.1. A BOOM WITH IMBALANCES TURNING INTO A CRISIS

While the need for an adjustment programme was triggered by a banking crisis, it was preceded by imbalances that had built up for some time, notably due to capital inflows that allowed easy access to credit. Cypriot banks had developed a poorly supervised business model that was based on attracting deposits from non-residents and on channelling them into investment with high risk/return features. As a result, imbalances were building up, including a housing construction boom, an oversized banking sector and a current account deficit reflecting the high capital inflows and a gradual loss of competitiveness. These increasing financial vulnerabilities coupled with structural weaknesses in the rest of the economy became exposed by the global crisis and the euro area crisis. The situation was amplified by the Cypriot economy's strong links to Greece. Combined together, this triggered a need for stabilisation and reform as well as considerable financing needs relative to the size of the economy. The presentation in this section is essentially chronological, but this does not imply any weighting in terms of importance or causality given the strong interlinkages between the different elements of the Cypriot crisis.

A credit-fuelled boom

During the first decade of the millennium, when Cyprus entered the European Union in 2004 and adopted the euro in 2008, the Cypriot economy was growing faster than the euro area average. From 2000 to 2008, the average annual real GDP growth rate exceeded 4%. GDP per capita grew at an average rate of almost 3% between 1999 and 2008, lifting it from 77% of the EU28 average in 1999 to 94% in 2008. In a context of rising wages and employment, also due to the inflow of foreign workers, increasing real disposable income supported private consumption.

Private investment increased strongly on the back of capital inflows and easy access to credit. In an economic environment of capital account liberalisation, financial integration, the introduction of the euro and falling risk premia, Cyprus attracted strong inflows of foreign capital, mainly in the form of non-resident deposits in Cypriot banks. The resulting easy access to credit, also resulting from weak bank supervision, contributed to a housing construction boom associated with a rapid increase in property prices. At the peak of the housing boom in 2008, construction activities accounted for 11% of gross value added (against 6.4% in EU28) and gross fixed capital formation stood at 27.2% of GDP (of which 18.8% of GDP in construction, and including the activities of special purpose entities, SPEs ([12])).

During the first decade of the millennium, the stock of dwellings increased by more than 34%, mainly due to real estate investment by residents and foreigners. Property prices rose significantly, reaching a high price-to-income ratio and peaking in the first half of 2008. Private indebtedness, in consolidated terms, stood at 285% of GDP in 2008, although to some extent inflated by the debt of SPEs. Non-financial corporate indebtedness also kept rising, with an important share of credit given to property developers. Nevertheless, household debt was considered relatively well collateralised and the related NPLs appeared low then, but this resulted to a large extent from weak supervision and an inadequate definition of NPLs.

Favourable lending conditions made the uptake of mortgage loans possible for a broader range of the Cypriot population. In Cyprus, credit institutions had widened the types of redemption schemes, and new products had been introduced that provided for lower payments at the beginning of the mortgage contract ("teaser" loans). Interest-only mortgages, for instance, with a full capital reimbursement only required at the end of the contract, covered more than 15% of loans granted in Cyprus (against 7.5% in the euro area in 2007).

([12]) According to the Central Bank of Cyprus, an SPE is defined as a legal entity that resides in a country, is controlled by a non-resident parent, has no or few employees and little or no production in the host economy, and its core business consists of group financing or holding activities.

Furthermore, as in some other euro area countries, Cypriot households were also subject to (mostly unhedged) exchange rate and (foreign) interest rate risks, as part of the mortgage loans was provided in foreign currency, mainly Swiss francs.

The boom was accompanied by high and persistent current account deficits, despite a high trade surplus in services. The current account balance, including SPEs'activities, reached a low of -15.5% in 2008. While the trade surplus in services was regularly around 20% of GDP, the trade balance of goods was increasingly negative, reaching -30% of GDP in 2008. Exports were suffering from the shift of productive resources to the non-tradables sector, while strong domestic demand was requiring high imports of goods. Exogenous factors, such as rising prices for oil, food and other commodities, on which Cyprus was highly dependent, also played a role.

Cypriot exports were heavily dependent on a few services sectors. Financial intermediation and business services were notable growth drivers in Cyprus, constituting an increasing share of production and employment. They accounted for 29% of total services exports in 2009 whereas transportation and travel services accounted for 34% and 24%, respectively. A number of factors may have contributed to the pivotal role of these services in the Cypriot economy, including the accession to the EU and euro adoption (and the role of a bridge with third countries), as well as a relatively low-tax and business-friendly environment. At the same time, tourism had been stagnant or declining during the first decade of the millennium, also due to the emergence of competitors in neighbouring countries offering comparable services at lower prices.

Strong inflows of foreign capital, mainly deposits and foreign direct investment, supported the credit boom but increasingly weighed on the income balance and the net international investment position. Inward foreign direct investment was strong, but a large part was directed to deposits by non-residents to Cypriot banks (including by SPEs), bringing their deposits to more than 100% of GDP in 2008 and coming mainly from former Soviet Union countries. These inflows were only partially matched by banks' acquisition of external assets, including in Greece, while the remaining part allowed giving more credit to domestic companies and households. As a result, the income balance turned highly negative and the net international investment position increased to -79.1% of GDP in 2008.

The Cypriot budgetary position improved considerably, supported by a steady increase in revenues while hiding fiscal-structural weaknesses. Between 2000 and 2008, total tax receipts as a percentage of GDP increased by 7.5 points, contributing to a budget surplus of 0.9% of GDP in 2008. Despite this increase, tax administration was not based on a comprehensive compliance management. Against the background of shortcomings in public financial management and fiscal governance, government expenditure was also growing fast. It increased from 34.4% of GDP in 2000 to 38.4% of GDP in 2008, reflecting in part the institutional weakness in fiscal planning (no numerical rules and no medium-term framework). In particular, social benefits and public health expenditure increased significantly, but some of the schemes were not well targeted to needs. On the back of considerable increases in public sector employment over the years preceding the crisis, the compensation of government employees as a share of GDP became one of the highest in Europe.

Imbalances exposed by external crises

The global financial crisis exposed the large internal and external imbalances in Cyprus, in particular due to an oversized banking sector. Initially, the impact of the global financial crisis was moderate and Cyprus experienced the mildest recession among the euro area countries in 2009. However, the end of the real estate boom and the abrupt slowdown in construction not only had a direct impact on economic activity but also implied a sharp deterioration of banks' asset quality in addition to the large exposure of Cypriot banks to Greece. The reassessment of risks, including a series of downgrades by rating agencies that started in late 2010, depressed investor sentiment. This impacted not only on bank lending but also had major implications for public finances as bond yields surged and Cyprus lost

access to long-term sovereign debt markets in mid-2011.

The credit-fuelled boom came to an end in 2008. After their peak in Q1-2008, real residential house prices dropped by about 25% by Q1-2012. Real GDP declined in 2009, due to a fall in private consumption and total investment (-6.5% and -13.6%, respectively) which was only partially compensated by a deficit-financed increase in government consumption expenditure (+6.3%). In 2010, GDP growth rebounded, but it decelerated again sharply in 2011, also because of an accident in July 2011 that destroyed the Vassilikos electricity producing plant responsible for close to half of Cyprus' electricity-generating capacity. Domestic demand decreased again, on the back of falling investment as bank lending tightened, foreign demand for housing receded, and corporate balance sheets were deleveraged (see Table 2.1).

Following the short respite in 2010/11 the economic crisis exacerbated in 2012 as the crisis in Greece and in the euro area was increasingly felt in Cyprus. The protracted downward adjustment of house prices already implied significant risks for the banks and the economy as a whole, given the increased importance that construction activities and the housing sector had gained in the past. The financial sector vulnerabilities were however magnified by links with crisis-hit Greece while the large size of the banking sector implied substantial economy-wide repercussions (see below).

The fiscal position deteriorated sharply. Lower corporate profitability, deteriorating labour market conditions, a less tax-rich growth pattern and some counter-cyclical expenditure measures resulted in a rising public deficit. The small budget surplus in 2008 turned into a high deficit in 2009. The public deficit remained excessive in 2010 and 2011, as revenues were subdued while expenditure kept on increasing. Despite a fiscal tightening with measures amounting to an estimated 4% of GDP in the 2012 budget, the deficit was hardly decreasing.

As economic adjustment to the crisis was slow, unemployment increased strongly. The unit labour cost-based real effective exchange rate had appreciated during the first decade of the millennium. Initially, the real effective exchange rate did not depreciate significantly in response to the downturn in 2009, including because of downward wage rigidities arising from collectively-agreed wages indexed to inflation ('COLA' – cost of living allowance). The minimum wage, although relatively high, covered only some specific professions. Meanwhile, unemployment kept on rising and reached double-digit rates in 2012.

Only a limited adjustment of the external imbalances took place after 2009. In 2010, the current account deficit exceeded again 10% of GDP before it decreased to between 4% and 6% of GDP during 2011-2013. Some foreign trade correction took place during 2008-2011 with goods export volumes rising, albeit from a very low basis, and imports falling. On the back of these developments, the net international investment position continued to deteriorate and external debt to increase. The valuation losses on holdings of Greek government bonds associated with the Private Sector Involvement (PSI) and on NPLs extended to the Greek market contributed to a further strong rise in the net international investment position to nearly -130% of GDP in 2011 (including SPEs).

The unfolding of a banking crisis

Before the crisis in 2012, the banking sector in Cyprus was dominated by two types of financial institutions: commercial banks and cooperative credit institutions. The main domestic commercial banks were Bank of Cyprus (BoC),

Table 2.1: **Key macroeconomic indicators of Cyprus, 2008-2013**

	2008	2009	2010	2011	2012	2013
Real GDP (% change)	3.6	-2.0	1.3	0.4	-2.9	-5.8
Unemployment (% of active population)	3.7	5.4	6.3	7.9	11.9	15.9
Budget balance (% of GDP)	0.9	-5.4	-4.7	-5.7	-5.6	-5.1
Public debt (% of GDP)	45.6	54.3	56.8	66.2	80.1	103.1
Current account deficit (% of GDP)	-15.5	-7.7	-11.3	-4.1	-6.0	-4.9
Net International Investment Position (% of GDP)	-79.1	-100.3	-111.2	-129.9	-129.1	-138.7

Source: European Commission, AMECO Database

Cyprus Popular (Laiki) Bank (CPB) and Hellenic Bank (HB). This segment of the Cypriot banking system accounted for 48% of deposits and 45% of loans extended by banks in Cyprus. Poor risk management practices, insufficient capacity to exercise prudential supervision compared to the size of the financial sector and excessive concentration of investments led to unprecedented challenges for the system.

In contrast to the large commercial banks, the cooperative credit institutions (CCIs) were primarily focused on retail banking for domestic clients. The cooperative credit sector was constituted of the Central Cooperative Body that included the Cooperative Central Bank (CCB) and the 95 CCIs as well as the cooperative savings society of Limassol. Relying on domestic deposits for their funding, cooperatives provided 19% of the loans to residents and held about 10% of the total Cypriot public debt. As compliance with prudential requirements (such as liquidity and capital requirements) was assessed on a consolidated (cooperative sector-wide) level, the CCIs were under no obligation to comply with the prudential requirements on an individual basis.

The Cypriot banking sector expanded rapidly and reached a peak in 2009. Assets held by banks jumped from EUR 62.5 billion at the end of 2005 to a peak of EUR 141.5 billion in 2009, about 8.5 times the Cypriot GDP. A moderate and gradual deleveraging started taking place since mid-2009, but at the end of December 2012, prior to the Cypriot financial crisis, total assets still amounted to around 6 times GDP, double that of the euro area average (Graph 2.1).

High corporate interest rates coupled with high deposit rates had led to the build-up of a specific business model for the commercial banking sector in Cyprus. The expansion of funding capacity by Cypriot banks was mainly driven by attracting deposits, especially from non-residents, who found a favourable tax and business environment in Cyprus. In March 2013, 29% of funding was based on external liabilities.

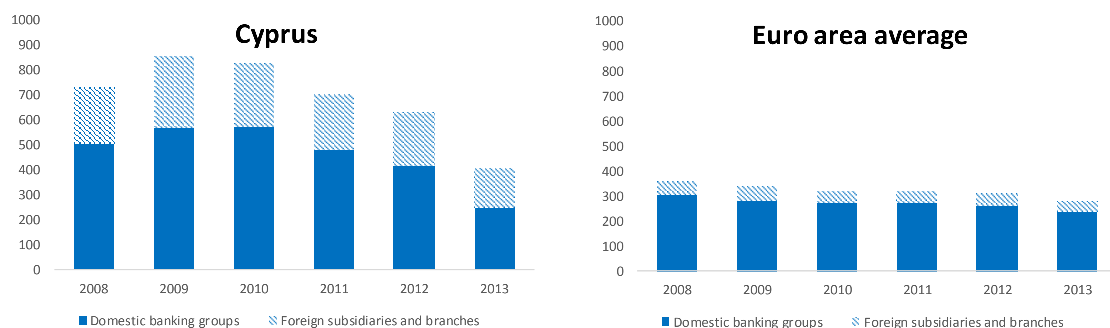
The major Cypriot commercial banks had substantial exposure to the domestic real estate sector, and in particular to property developers. This had significant repercussions, given that loans to residential developers and the construction sector exceeded 50% of GDP in 2011, with an estimated more than half of them already having been rescheduled. The domestic corporate sector was characterised by large outstanding loans related to real estate (about 20% of GDP).

Banks' profitability declined after 2007. Cypriot banks reached the peak of their profitability in 2007 with a net after-tax profit of EUR 1.2 billion. Since then, profit has been gradually declining and turned negative by the end of December 2011 with EUR 4.4 billion in losses after tax. Due to a substantial increase in provisioning and non-performing loans, banks' return on assets stood at -3.7% at the end of 2011.

The CCIs' losses were driven by weak internal governance and a weak culture of loan repayment and enforcement. The situation in this segment of the banking sector deteriorated further also due to the fact that for historical, social and political reasons the CCIs were not under the unified supervision of the Central Bank of Cyprus.

The abrupt end of the real estate boom in 2008

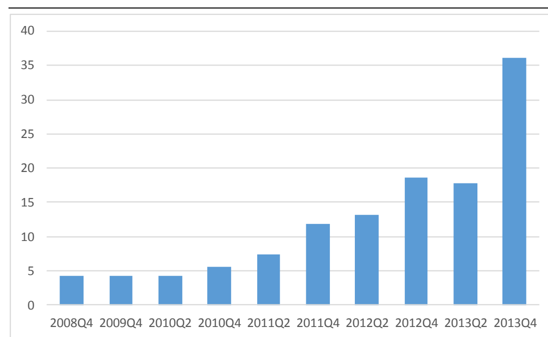
Graph 2.1: **Total assets of domestic banking groups and foreign-controlled subsidiaries and branches in percent of GDP in Cyprus and the euro area average, 2008-2013**



Source: ECB (2014): Banking Structures Report, October 2014.

led to a severe deterioration in the loan quality of Cypriot banks. Non-performing loans (NPLs) increased since the second half of 2010 (see Graph 2.2). In 2013/14, the larger Cypriot banks, as for example Hellenic Bank, reported NPLs related to the construction sector above 80% and real estate above 60%. The cooperative sector in Cyprus registered the highest NPLs in the loans taken up for construction (above 70%) and real estate development purposes (above 50%).

Graph 2.2: **Non-performing loans in Cypriot banks, 2008-2013**



Note: Figures based on the previous definition of NPLs.
Source: ECB, CBC

The long duration and high costs of foreclosure procedures complicated a recovery of the collaterals to the banks. Taking into account the time needed for the completion of court proceedings, the sale of the asset and the distribution of the proceeds to the creditors, the period typically required for the completion of foreclosure proceeding was between 56 and 132 months in Cyprus in 2009. On average for the euro area, the usual time needed for the entire procedure was close to 24 months. It should be noted, however, that in Cyprus a foreclosure procedure did not require a court order. Nevertheless, there were other technical and legal obstacles (e.g. land registry in Cyprus) that delayed the process.

Furthermore, commercial Cypriot banks, and in particular CPB and BoC, had substantial risky cross-border exposures, notably to Greece. The banks had extended their operations to Greece, which left them exposed to the adverse economic developments there. In September 2012, domestic banks' direct loans to the Greek economy amounted to EUR 19 billion, almost equivalent to the Cypriot GDP in 2012. The full exposure to Greece also included holdings of Greek government bonds and Greek bank bonds.

Following the voluntary participation in the Greek PSI, the Cypriot banks applied a haircut of about 74% to the nominal value of their Greek government bond holdings by the end of March 2012. Some additional haircuts had to be recognised by end-June 2012 after an audit. Subsequently, the sovereign exposure to Greece of domestic banks was reduced from EUR 5 billion to about EUR 1 billion by end-September 2012 and virtually disappeared in the Greek buy-back exercise of December 2012. Due to their high exposure, BoC and CPB were particularly affected by these measures.

Solvency coefficients for Cypriot commercial banks were significantly reduced. They fell below local regulatory levels because of both increasing non-performing loans and following substantial impairments in the nominal values of the Greek government bonds. The Core Tier 1 ratio for Cypriot commercial banks fell from 8.6% in June 2011 to 4.3% by the end of the year and their capital adequacy ratios dropped from 12.4% to 8.3%. Given the 9% Core Tier 1 requirement following the recommendation from the EBA, valid as of June 2012, this implied a substantial capital shortfall for the domestically-supervised institutions.

The Cypriot authorities took supervisory actions. Following discussions about the PSI in Greece and the EBA stress tests, in July 2011 the Central Bank of Cyprus (CBC) raised the minimum Core Tier 1 ratio to 8% and included a GDP factor to reflect size. The December 2011 EBA Capital Exercise revealed that BoC and CPB needed additional capital of EUR 1.56 billion and EUR 1.97 billion, respectively.

State aid appeared unavoidable, and a crisis management legislative act was adopted. As Cyprus had no legal framework for the management of banking crises up to that point, a framework needed to be developed in the course of the crisis. The Council of Ministers approved two bills in mid-December 2011, which brought significant changes to the financial system in Cyprus by giving the possibility to the State to

cover 100% of the issuance of capital titles. The legislation in question, prepared by the Ministry of Finance in close co-operation with the Central Bank, related to government intervention in times of crisis and to the establishment of an independent Financial Stability Fund.

Domestic banks needed to raise capital. At the end of March 2012, BoC increased its capital base by EUR 594 million through a voluntary exchange of convertible capital securities into shares and through a rights issue. Following CPB's failure to raise funds in the capital markets, the government recapitalised CPB in June 2012 with a EUR 1.8 billion unfunded government bond.

Banks came also under liquidity pressure. In 2011, the loan-to-deposits (LTD) ratio increased to 112.7%, mainly due to deposit outflows from the Greek branches and from foreign-owned companies in Cyprus. At the same time, the overall deposits in the consolidated banking system decreased by 11%. Borrowing from the Eurosystem increased to EUR 13.6 billion in September 2012, which represented almost 70% of GDP and 8.5% of banks' total liabilities.

2.2. THE RUN-UP TO THE PROGRAMME

Cyprus was shut out of financial markets for long-term financing. By mid-2011, 10-year government bond yields reached unsustainable levels. Due to the also rising yields of medium-term government bonds, Cyprus resorted to short-term borrowing. But throughout 2012, yields on short-term issuances were also rising. A EUR 2.5 billion bilateral loan from the Russian Federation granted in December 2011 helped cover the financing needs for 2012, but reduced the political willingness of the Cypriot authorities to act more resolutely in addressing the root causes of the crisis. Financing needs for 2013 were also high, even if most of them were related to the roll-over of existing debt from domestic investors, in particular BoC and CCB.

In 2012, credit rating agencies downgraded Cyprus' sovereign debt and banks to speculative grade. On 13 March 2012, Moody's reduced Cyprus sovereign credit rating to speculative status, warning that the Cyprus government would have to inject more fresh capital into its banks to cover losses incurred through Greece's debt swap. By June 2012, all three main credit rating agencies (S&P's, Fitch, Moody's) had downgraded the Cypriot sovereign debt to non-investment grade which disqualified it from being accepted as collateral by the European Central Bank. The rationale provided for the downgrades included the fiscal imbalance, the high exposure of the Cypriot banks to Greek debt, and the large size of the Cypriot banking sector relative to the size of the economy.

On 25 June 2012, Cyprus requested financial assistance from the euro area Member States and from the IMF. The request was for financing with a view to supporting the return of Cyprus' economy to sustainable growth, ensuring a properly-functioning banking system, and safeguarding financial stability in the Union and the euro area. On 27 June 2012, the Eurogroup invited the Cypriot authorities to agree with the European Commission, in liaison with the ECB, and the IMF on a macroeconomic adjustment programme. By November 2012, Cyprus and EC/ECB/IMF had made decisive progress in the discussions on the key policies. These needed to strengthen public finances, restore the health of the financial system, and strengthen competitiveness.

The Cypriot authorities decided key measures of fiscal consolidation already ahead of a programme agreement. In early-December 2012 the Cypriot Parliament passed almost unanimously a number of bills that covered the vast majority of fiscal measures for the period 2012-14 as outlined in the draft programme, as well as important first steps in relation to fiscal-structural reforms (e.g. pension system, health sector, budgetary framework, welfare benefits, public administration).

The finalisation of the agreement was expected in a few weeks, once the preliminary results of a bank due-diligence exercise became available. An international consultancy firm (PIMCO) conducted an accounting and economic value assessment (due diligence review) of the credit portfolios of BoC, CPB, HB and a sample representing about 63% of the CCIs' assets, as well as Alpha Bank Cyprus and Eurobank Cyprus. The

assessment started formally on 4 October 2012.([13]) It formed the basis for the bank-by-bank stress tests, which resulted in an assessment of an overall capital shortfall of EUR 6 billion under a baseline scenario with a Core Tier 1 target ratio of 9% and of EUR 8.9 billion under the adverse macroeconomic scenario with a Core Tier 1 target ratio of 6%. The specific capital needs were communicated to each participating bank on 18 March 2013.

Given the large capital shortfall of Cypriot banks and considering the sector's size, it became increasingly evident that a full bail-out would raise serious concerns regarding fiscal sustainability. An initial political agreement, reached at the Eurogroup meeting of 15 and 16 March 2013, was based on a proposal to introduce a tax on all bank depositors, insured and uninsured alike, in all Cypriot banks. In particular, the proposal foresaw a one-off bank deposit levy of 6.7% for deposits up to EUR 100,000 and of 9.9% for higher deposits on all domestic bank accounts, both for residents and non-resident customers. The proceeds were meant to be used for liquidating some of the banks and for recapitalising the rest. The measure was presented as a 100% withholding tax on interest income to be received in the following two to three years against the background of the high deposit interest rates of 3.5% and more in Cyprus at that time.

The measure did not receive the approval of the Cypriot Parliament. With large demonstrations outside the House of Representatives in Nicosia by Cypriot people protesting against the bank deposit levy, the measure was rejected by the Cypriot Parliament on 19 March 2013. The initial plan of the Cypriot authorities was therefore withdrawn.

In March 2013, CPB was subjected to resolution measures mandated by the CBC. The bank was resolved and split into a legacy unit ('bad bank') and a healthier unit. The legacy unit included limited assets, mainly stakes in foreign subsidiaries and a compensatory equity stake in BoC. It was funded by all uninsured deposits and was put into liquidation. The healthier unit assumed the remaining assets and liabilities and was integrated into the BoC. At the same time, a bail-in on the creditors of BoC was imposed. In addition, with a view to deleveraging the banks and cutting the contagion channel from Greece, all Greek operations and assets of Hellenic Bank, CPB and BoC were sold to the Greek Piraeus Bank ("carve-out").

To avoid a general deposit drain, a bank holiday was declared for Tuesday 19 March 2013 (Monday 18 March being a regular bank holiday). It was continuously extended until the banks eventually reopened on Thursday 28 March 2013. During the bank holiday, as during weekends, all payments and transfers within a banking group as well as inter-bank transactions were prohibited, with few exemptions related to essential payments. In addition, limits on cash withdrawals for the two stressed banks were imposed. The exceptions concerned payments of systemic relevance, meaning those with a risk of default for the credit institution or of further harming financial stability, and included payments of salaries, payments for food, oil and tuition fees, as well as payments by government services for humanitarian reasons. In addition, cash withdrawals were capped at EUR 300 per day per person. There were no restrictions on credit cards, which remained generally accepted with a few exceptions, mainly at gasoline stations.

([13]) PIMCO's work on the assessment was overseen by a Steering Committee that included representatives of the Cypriot authorities, European Commission, ECB, EBA, and the ESM (as members) as well as the IMF (as an observer).

Box 2.1: **Key events ahead of the adjustment programme for Cyprus**

Mid-2011	Cyprus sovereign loses market access.
From October 2011	Bank of Cyprus and Laiki Bank receive Emergency Liquidity Assistance (ELA) from the CBC
23 December 2011	EUR 2.5 billion bilateral loan from Russia was agreed.
March 2012	Following the voluntary participation in the Greek private sector involvement (PSI), Cypriot banks reduced by about 74% the nominal value of their holdings of Greek sovereign bonds.
March to June 2012	The credit rating agencies Standard&Poor's, Moody's and Fitch downgrade Cypriot sovereign debt to non-investment grade.
25 June 2012	The Cypriot government requests financial assistance from the euro area and the IMF.
30 June 2012	Following a lack of interest from private investors, the Cypriot government recapitalises Laiki Bank with a EUR 1.8 billion unfunded government bond.
4 October 2012	PIMCO starts its assessment of the Cypriot banks.
December 2012	The Cypriot government adopts a fiscal consolidation package.
2 February 2012	The results of the financial sector due diligence exercise ('PIMCO assessment') become available.
24 February 2013	Nicos Anastasiades is elected President of Cyprus.
4 March 2013	Finance Ministers of euro area Member States meeting in the Eurogroup inform the Cypriot Finance Minister that the financial assistance to Cyprus will have a maximum of EUR 10 billion.
16 March 2013	The Finance Ministers of euro area Member States meeting in the Eurogroup indicate their support for a programme with the Cypriot government, once a one-off levy on deposits in all Cypriot banks to recapitalise banks is introduced.
19 March 2013	The Cypriot Parliament rejects the agreement.
25 March 2013	The Finance Ministers of euro area Member States meeting in the Eurogroup indicate their support for a programme with the Cypriot government, once unsecured deposits are used to finance the resolution of Laiki Bank and the restructuring/recapitalisation of the Bank of Cyprus.
19 to 27 March 2013	Cypriot bank holidays, while ensuring a minimum of liquidity provision.
28 March 2013	The Cypriot authorities introduce administrative restrictions and capital controls.
24 April 2013	The euro area countries approve the Memorandum of Understanding (MoU) with EUR 9 billion of financing from the ESM, subject to an IMF contribution.
15 May 2013	The IMF Executive Board approves the Memorandum of Economic and Financial Policies (MEFP) with around EUR 1 billion of financing.

After the Cypriot authorities had taken resolution measures, the European Commission, the European Stability Mechanism (ESM), the European Central Bank (ECB) and the International Monetary Fund (IMF) entered into further discussions with the Cypriot authorities on the details of a 3-year economic adjustment programme. The

programme was agreed at staff level on 2 April 2013. The Memorandum of Understanding (MoU) was signed by the Cypriot authorities and the Commission, acting on behalf of the ESM, on 26 April 2013. The Memorandum on Economic and Financial Policies (MEFP) was approved by the IMF Board on 15 May 2013. The financial package covered up to EUR 10 billion, with the ESM providing up to EUR 9 billion and the IMF contributing around EUR 1 billion. The financial envelope for the banking sector, within the total financial envelope, was EUR 2.5 billion.

2.3. ECONOMIC SURVEILLANCE IN CYPRUS

EU surveillance in place at the time could not prevent the build-up of risks leading to the need for an adjustment programme. EU surveillance procedures were applicable to Cyprus before and after the programme, while MIP and SGP-related surveillance remained effectively suspended during the programme. Cyprus was in the excessive deficit procedure (EDP) of the Stability and Growth Pact (SGP) from 2004 to 2006 and again from 2010 onward. With fiscal efforts originally on track**,** the Commission considered in January 2012 that Cyprus had taken effective action towards a timely and sustainable correction of the excessive deficit and that no further steps appeared necessary regarding the EDP at that stage.([14]) Yet, as the previously described risks were unfolding, especially from the banking sector, the Commission 2012 Spring Forecast revealed that Cyprus required in fact additional measures to correct its excessive deficit;([15]) similarly, the 2012 in-depth review under the MIP concluded that Cyprus was experiencing very serious macroeconomic imbalances, which were not excessive but needed to be urgently addressed. In particular, macroeconomic developments as reflected in the current account, public finances and the financial sector were found to require close monitoring and urgent economic policy attention in order to avert any adverse effects on the functioning of the economy and of EMU. Soon after, in June 2012, Cyprus requested financial assistance from the euro area Member States and from the IMF. Later that year it became evident that Cyprus would not be able to correct its excessive deficit by 2012 and the Council revised its EDP recommendation in 2013, extending the deadline for correction to 2016. In accordance with the 'two-pack' Regulation on programme countries,([16]) during the adjustment programme Cyprus was exempted from certain obligations under the EDP and from the application of the MIP, and more generally, from the monitoring and assessment under the European Semester.

External surveillance by non-EU institutions was pointing to the imbalances in the Cypriot economy, but concrete advice was mostly not taken up by the authorities. The IMF's Article IV report of 2009 noted that the overheating of the economy in 2007–08 had given rise to vulnerabilities, notably a highly leveraged private sector, large current account deficits, and a large exposure of banks to property prices. IMF staff expressed concerns regarding financial sector stability, fiscal sustainability and the steady deterioration in competitiveness threatening medium-term growth and viability. On the related policy recommendations, the government expected to be able to meet its fiscal objectives without altering current plans, while recommendations to improve financial sector stability were well received.

Following the programme exit, Cyprus became subject to standard EU economic surveillance again. Cyprus exited the adjustment programme in March 2016 without a successor arrangement ("clean exit") while the last review was not completed as the prior action related to the privatisation of the Cypriot Telecommunications Authority was not met.([17]) In the end, Cyprus had only used EUR 7.8 billion of the financing

([14]) Communication from the Commission to the Council on Assessment of the Budgetary Implementation in the Context of the Ongoing Excessive Deficit Procedures after the Commission's Services 2011 Autumn Forecast, COM(2012)4final.

([15]) European Commission: 'Implications for budgetary surveillance of the Commission services' 2012 spring forecast'. Note to the EFC, 11/05/2012

([16]) Cf. Articles 10 and 11 of Regulation (EU) No 472/2013 of the European Parliament and of the Council.

([17]) Eurogroup Statement on Cyprus of 7 March 2016.

available under the programme. Subsequently, EU surveillance procedures were fully applied again. In the context of the MIP, following the in-depth review included in the country report of April 2016, Cyprus was found to be in excessive imbalances. In June 2016, the EDP was abrogated, bringing Cyprus under the obligations of the preventive arm of the SGP. In line with Regulation (EU) 472/2013, post-programme surveillance takes place twice per year.

Box 2.2: **The evolution of the EU economic surveillance framework before and during the Cyprus adjustment programme**

The adjustment programmes for Cyprus and some other euro area countries made a major shortcoming of euro area governance evident in that, after the start of EMU, EU economic surveillance was mainly geared to monitoring the fiscal position of Member States and did not focus on internal and external imbalances and their underlying factors. Prior to the third phase of EMU, competitiveness was still perceived as a policy priority in view of the possibility of competitive devaluations, potentially costly for the other countries in a Single Market. After the introduction of the euro, the attention of surveillance given to intra-area inflation differentials, real exchange rates and current accounts declined and focussed mainly on the application of the Stability and Growth Pact (SGP). However, the narrowing of interest rate differentials and large capital flows from the euro-area core to the euro-area periphery allowed growing current account imbalances, inflation differentials and divergent price competitiveness, which in some cases contributed to the financing of asset price bubbles in recipient countries, notably housing. At the time, such imbalances were often deemed to have become less relevant in a monetary union. In the absence of strong and forceful surveillance mechanisms with respect to these imbalances, EMU in its first years might also have weakened the incentives to undertake structural reforms. Meanwhile, the existing broad economic policy guidelines lacked "carrots and sticks" and Member States' ownership of the recommendations was limited.

Only in 2011 was this gap in the EU economic governance covered with the Macroeconomic Imbalance Procedure (MIP) in order to support economic and financial stability. The 2008-2009 financial crisis had underscored the necessity to strengthen the macroeconomic surveillance framework in the EU in aspects going beyond fiscal policy. Macro-financial and macro-structural aspects driving the accumulation of both external (e.g. large current account imbalances) and internal imbalances (e.g. excess debt accumulation or the building up of housing bubbles) revealed themselves as key factors in triggering balance of payment crises and debt crises, and the need for financial assistance in some cases. The MIP legal framework (Regulation No 1176/2011) outlines the conditions for the application of the procedure and, applying only to euro-area economies, provides for an enforcement mechanism, including pecuniary sanctions. To ensure an integrated economic surveillance, the EU's economic governance framework was organised in an annual cycle, known as the European Semester, of which the application of the MIP forms an integral part.

During the financial crisis a vicious circle of sluggish growth, tensions in sovereign debt markets, and banking sector fragility evolved dangerously and revealed a lack of the interconnectivity surveillance in the economic governance of EMU. The role of the macro-prudential oversight of the financial system within the EMU was intrusted to the European Systemic Risk Board (ESRB) in order to contribute to the prevention or mitigation of systemic risks to financial stability. As part of the European System of Financial Supervision (ESFS), the ESRB was created in 2010 (Regulation (EU) No 1092/2010). The ESRB tasks include identifying and analysing systemic risks, issuing non-binding warnings and recommendations.

In response to the financial crisis, the EU pursued a number of initiatives to create a safer financial sector by establishing the Banking Union as a new policy framework. The EU institutions committed to implementing the measures towards establishing a Banking Union step by step: shifting supervision to the European level, establishing a single framework for bank crisis management, and setting up a common system for deposit protection. As of November 2014, the Single Supervisory Mechanism (SSM) - the first pillar of the Banking Union - became the new system of banking supervision in the Banking Union, comprising the European Central Bank and national supervisory authorities of the participating Member States. The Single Resolution Mechanism (SRM), a second pillar of the Banking Union, became fully operational on 1 January 2016.

2.4. ASSESSMENT OF THE PROGRAMME DESIGN

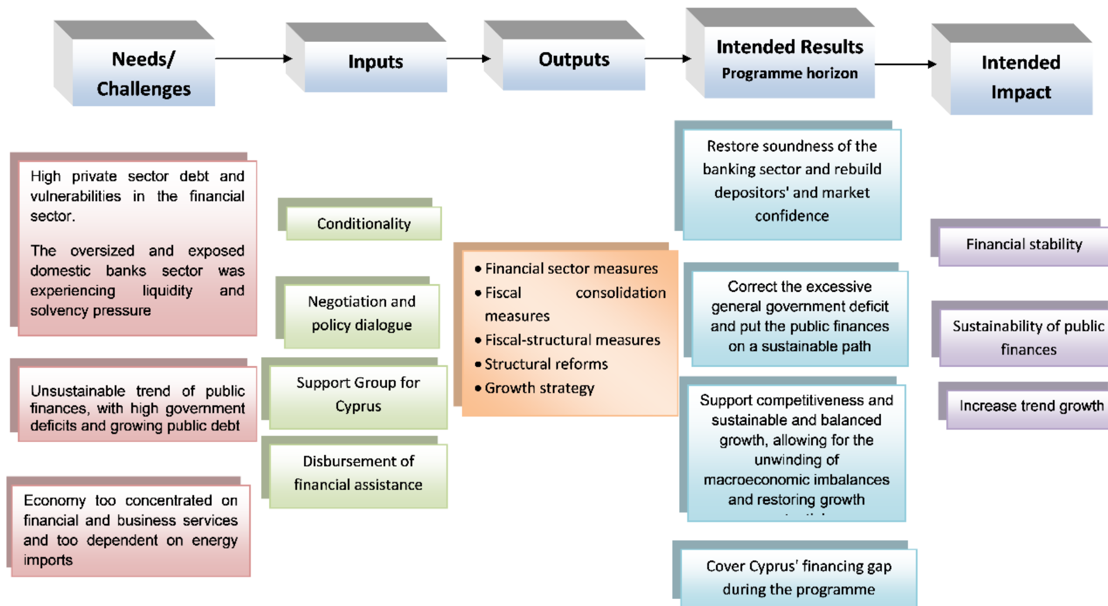
The programme aimed to address a number of economic needs and challenges. These were notably: (1) High private sector debt and vulnerabilities in the financial sector as the oversized and exposed domestic banks sector was experiencing liquidity and solvency pressures; (2) An unsustainable trend of public finances, with high government deficits and growing public debt; and (3) An economy too concentrated on financial and business services and too dependent on energy imports.

The intervention consisted of inputs designed to achieve the programme objectives. This included conditionality in the form of negotiated measures to be implemented by Cyprus during the programme period, with a timetable for implementation. The measures were monitored during the programme and adapted as required, either in terms of design or timeline, in response to developments. Negotiations and policy dialogue on the conditionality involved Cyprus, the European Commission (in liaison with the ECB and the IMF) and other euro area Member States, in view of the approval of the economic adjustment programme, the quarterly reviews, sometimes involving changes in policy conditionality, and related disbursements of the financial assistance. Technical assistance was provided by the European Commission's "Support Group for Cyprus" and others. Finally, disbursements of financial assistance were subject to favourable assessments of Cyprus' compliance with the policy conditionality.

It was anticipated that these inputs would lead to a number of intended outputs.
Financial sector measures covered the following fields:
(i) Maintaining the liquidity of the banking sector, while restrictions on capital movements would be gradually relaxed;
(ii) Recapitalisation and restructuring of financial institutions in difficulties;
(iii) Other measures to improve financial stability;
(iv) Improving the regulation and supervision of credit institutions;
(v) Improving the legal framework for private debt restructuring.

Fiscal policy measures were foreseen on both the revenue and expenditure sides, in order to achieve reductions in both the public deficit and public debt and put public finances on a sustainable path. In addition, fiscal-structural measures were to ensure the long-term sustainability of public finances, provide the fiscal space necessary to support the diversification of the economy, and alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. These measures covered a wide range of areas:
(i) reforming the pension system, to bridle expenditure increase, ensure long-term viability and limit fiscal subsidy;
(ii) improving the efficiency of public healthcare provision;
(iii) enhancing the budgetary framework and public financial management, including with reference to Public and Private Partnerships (PPP);
(iv) better regulating, reviewing and strengthening SOEs; (v) Privatisations;
(vi) improving revenue administration, tax compliance and international cooperation;
(vii) reforming the immovable property tax;
(viii) reforming the public administration;
(ix) reforming the welfare system.
Finally, structural reforms were covering both the labour market and goods and services markets. Concerning the labour market, these measures included:
(i) reforming the wage indexation system;
(ii) reforming public assistance, including measures to activate benefit recipients;
(iii) improving activation policies and services;
(iv) supporting youth employment.
Concerning the goods and services markets, structural reforms covered:
(v) implementation of the Services Directive;
(vi) improving access to and exercise of regulated professions;
(vii) strengthening the competition authority and national regulatory authorities;
(viii) enhancing the functioning of the housing market;
(ix) developing the tourism sector;
(x) implementation of the Third Energy Package and rearrangement of the energy sector.
At a later stage in the programme, the authorities committed to design a growth strategy for Cyprus.

Graph 2.3: **Intervention logic of the Economic Adjustment Programme for Cyprus 2013-2016**



Source: Authors

The intervention was set up to achieve the following intended results: (1) restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence; (2) correct the excessive general government deficit and put public finances on a sustainable path; (3) support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances and restoring growth potential; and (4) cover Cyprus' financing gap during the adjustment programme.

These intended results were seen as instrumental to secure a medium to long-term impact of macro-financial stability, fiscal sustainability, and increased trend growth. The time horizon of such impacts exceeds partly the timing of this evaluation, which it therefore not fully covers.

There was a clear value added of the EU engagement in that adequate financing was provided at acceptable costs and in that the credibility of policies was boosted. When Cyprus had lost access sovereign debt markets in mid-2011 no realistic alternative to an EU intervention was available. The Russian Federation, which had provided a loan end-2011, showed little willingness to engage with additional loans. The IMF was not in a position to contribute more than a minor share to a new euro area programme. Apart from financing, the intervention also added significant value in terms of credibility, expertise, and coherence with other EU policies. For example, there was a specific case for fiscal governance reform where the first year of the programme coincided with the national transposition of relevant EU legislation, hence the programme framework helped to ensure a proper and comprehensive transposition design.

An earlier start of the programme would have been more efficient as its delayed start increased the problems and the financing needs. The nearly two years that passed since sovereign market access was lost and nearly one year that passed since the request for a programme until its agreement is likely to have increased some of the problems and the financing needs as the underlying problems remained largely

unaddressed. The government's initial reluctance to request a programme followed by a refusal to agree on the reforms sought by the programme partners implied a major delay until the programme was eventually agreed. As time passed and the effects of the Greek crisis on some Cypriot banks became apparent, the liquidity and solvency situation of banks continued to deteriorate and bank financing increasingly relied on Emergency Liquidity Assistance (ELA). Also, as banks paid back subordinated bonds, bank capital available to be bailed in was shifting towards deposits that were also decreasing. Furthermore, in June 2012 the government recapitalised Laiki Bank with EUR 1.8 billion, only for it to be resolved less than one year later. In addition, sovereign financing got increasingly costly during that period of lost market access in terms of interest rates to be paid (e.g. the Russian loan).

The overall programme strategy and its main objectives were relevant in addressing the main challenges. The size of banks' balance sheets and their risky business model, coupled with risks to debt sustainability if supported by state aid, were no doubt the biggest problems underlying the need for a programme. However, a banks-only programme as previously designed for Spain would not have been sufficient in the case of Cyprus as its banking sector's problems were much larger compared to the rest of the economy, even though it could have been an option at an earlier stage when the problems were still of a more manageable size. While external imbalances and competiveness losses were not as aggravated in Cyprus as in other euro area programme countries, foregoing some crucial structural conditionalities would have ignored the underlying structural causes of the problems of banks and public finance. For example, addressing banks' high NPLs turned out to have a complexity that required broad-based reforms including those related to the insolvency and foreclosure framework, the backlog of title deeds, and the efficiency of the judiciary. On the public finance side, addressing fiscal risks such as PPPs or SOEs requires prior regulatory reforms to avoid an undue burden on taxpayers and consumers. With hindsight, some parts of the programme over-burdened the administrative capacity of a small country like Cyprus within the 3-year time horizon of the programme, notably regarding fiscal-structural and structural reforms.

The programme generally ensured coherence between its different objectives. This might have been helped by the fact that key policy conditionality in the Memorandum of Understanding was guided by various EU policy frameworks. Relevant EU legislation was applied to the reforms in the financial sector. The public deficit and debt path set out in the programme were determined by EU fiscal rules (Stability and Growth Pact) and the approach to debt sustainability, underpinned by EU rules on national budgetary frameworks. In the different areas of structural conditionality the relevant EU acquis provided an important anchor.

However, in some parts of the programme the coherence between its three objectives (financial, fiscal and structural policies) was initially insufficient. Regarding NPLs, the programme relied initially strongly on the reform of the insolvency and foreclosure framework. Only later in the programme, when this was implemented, the programme measures addressing the malfunctioning in the housing market (issuance of title deeds, efficiency of the judiciary) received more attention. Regarding fiscal policies, the privatisation of the telecom, electricity and ports SOEs were envisaged to support debt sustainability and reduce fiscal risks. However, to avoid the creation of private monopolies in such crucial network industries, prior regulatory reforms were required that were not really made explicit in the programme, except for a strengthening of the independence and functioning of the regulatory authorities.

Finally, the design of policy conditionality in the programme included provisions giving attention to the social impact of the crisis and the adjustment process. Since it was the fourth fully-fledged programme after Greece, Portugal and Ireland, several stakeholders mentioned that many of the lessons learned in designing conditionality in the context of previous programmes were taken into account. Indeed, the social dimension was comparably more developed from the start in the Cyprus programme. The first and following drafts of the MoU focused not only

on enhancing the growth potential and stabilising public finances and the banking sector, but also on the social and distributional impacts of the related policies. Nevertheless, the social costs of the crisis were high, and support for the EU was the second lowest in the EU after Greece at the end of the programme.

3. PRESERVING FINANCIAL STABILITY

3.1. PROGRAMME DESIGN AND IMPLEMENTATION

In relation to the financial sector, the key objective of the economic adjustment programme was to restore the soundness of the Cypriot banking sector and to rebuild depositors' and market confidence. In particular, policy conditionality was organised along a few main objectives, each composed of several specific objectives, to be achieved by implementing measures. Main objectives were thorough restructuring of financial institutions in difficulties, maintaining banks' liquidity, and restoring their solvency.

Recapitalisation, restructuring and resolution of the Cypriot financial institutions in difficulties

In light of the large size of the Cypriot banking system relative to the economy, downsizing of the banking sector was considered a necessary step in the adjustment process. Initially by application of the national supervisory and resolution framework and later on the basis of the policy framework attached to the Banking Union, a decrease in the banking sector's assets took place.

Addressing the private sector debt overhang was an important programme objective. At about 340% of GDP (including SPEs), Cyprus had the largest private sector debt among the euro area countries in 2013. The Cypriot authorities stepped up the monitoring of the indebtedness of the corporate and household sectors and prepared quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. The credit register served also as an effective tool in monitoring private sector indebtedness. These enhanced monitoring actions were put in place shortly after the beginning of the programme.

(i) Following up on the recapitalisation/resolution and restructuring of Cyprus Popular (Laiki) Bank (CPB) and Bank of Cyprus (BoC) initiated prior to the programme

The programme followed up on the implementation of the decision to proceed with the restructuring of Cyprus Popular (Laiki) Bank (CPB) and Bank of Cyprus (BoC). With the bill passed prior to the programme, the Cypriot authorities preserved all insured deposits of 100,000 EUR or less without the imposition of any levy. However, uninsured deposits were bailed-in: in CPB all uninsured deposits were left (and therefore bailed in) in the bad bank, while in BoC 47.5% of uninsured deposits, mostly held by non-residents, were bailed in and converted into shares of the bank. With a view to deleveraging the banks and cutting the contagion channel from Greece, all Greek operations and assets of Hellenic Bank, CPB and BoC were sold to the Greek Piraeus Bank.

About EUR 9 billion of liabilities, roughly half of Cyprus' GDP in 2013, were bailed-in. At CPB, the burden of EUR 4.9 billion was distributed between holders of senior debt (EUR 0.1 billion), holders of subordinated debt (EUR 0.8 billion) and uninsured depositors (EUR 4.0 billion). The overall burden of EUR 4.0 billion bailed in at the BoC was distributed between EUR 0.1 billion of subordinated debt and EUR 3.9 billion of uninsured deposits. On the other hand, the Hellenic Bank managed to complete a voluntary liabilities management exercise that converted EUR 300 million of subordinated debt into equity.

The EUR 7.9 billion of uninsured deposits used for resolution measures in CPB and BoC amounted to more than 11% of the total deposit volume of Cypriot banks before the crisis. Of these, resident depositors accounted for approximately EUR 3.2 billion, amounting to 7.5% of their pre-crisis deposit volume. Subordinated bonds, roughly EUR 1 billion in total, which were used in the resolution process were also widely held by resident retail investors in the belief that they were high-yielding but safe instruments.

As a result of the bail-in, the capital structure of the BoC was transformed profoundly. After the recapitalisation, former shareholders held less than 1% of the capital, while former uninsured depositors held 81% of the capital. The remaining 18% were held by CPB (in special administration in view of being liquidated), who received the BoC

shares in exchange for the transfer of the healthier entity split off from the bank was. These shareholdings were further diluted in September 2014 due to a necessary capital increase by EUR 1 billion. Following further steps of restructuring, BoC was taken out of resolution in July 2013.

(ii) Recapitalisation and restructuring of cooperative credit institutions

One of the main pillars of the financial sector conditionality was the restructuring and recapitalisation of cooperative credit institutions. The due diligence of the banking sector identified at the time a EUR 1.5 billion capital shortfall in the cooperative credit institutions (about 8.5% of GDP). Given the lack of interest from private investors, the government decided that it would provide the necessary funds, made available through the financial sector envelope of the programme. In line with EU state aid rules, the Cooperative Central Bank received state aid in 2014, which was used to recapitalise the individual cooperative banks. The Cypriot authorities prepared the restructuring plan for the cooperative banking sector, which targeted improving their efficiency and governance as well as a sustainable return to profitability.

A centralisation was targeted to improve the governance and efficiency of the cooperative banking sector. The decentralised structure and closeness to borrowers was identified as one of the main reasons for the sector's poor performance. The number of cooperative credit institutions was reduced via mergers from close to one hundred to 18.

The first aid package provided to the cooperative credit institutions (centralised to the Cooperative Central Bank) turned out to be insufficient and was subsequently stepped up by about 1% of GDP in 2015. The assessments carried out in 2015 by the European Central Bank (ECB) in its capacity as Single Supervisory Mechanism (SSM) identified that the bank did not make sufficient provisions compared to the size of its defaulted loans portfolio. The bank made the requested additional provisioning in its third quarter 2015 account but, as a consequence, needed additional capital of EUR 175 million. Mainly due to its complex structure and the resulting lengthy process to list its shares on the stock exchange, the Cooperative group was not in a position to raise the required additional amount from private investors within the short deadline set by the supervisor.

This additional state aid to the Cooperative Central Bank was accompanied by supplementary restructuring measures. The measures had to ensure that the bank would become viable without continued state support in the future and that the distortions of competition created by the state aid would be mitigated. In particular, Cyprus' commitment to either list the Cooperative group's shares on the stock exchange or sell a significant part of the capital to solid investors was expected to restore the bank's access to capital markets and enable it to finance the recovery of the Cypriot economy on a sustainable basis. Moreover, the group committed to deepen the rationalisation of its structure and accelerate the development of central divisions, which were deemed to be key for a prudent and efficient management of the bank and was expected to enhance its viability.

Maintaining the liquidity of banks

In order to prevent massive liquidity outflows and a collapse of the banking system, the Cypriot authorities had imposed temporary administrative restrictions and capital controls. Following the bank holidays from 16 March until 27 March 2013, temporary administrative restrictions and capital controls were put in place in order to avoid excessive capital outflows. Initially, the restrictions limited cash withdrawals from accounts to 300 euro per day per person. Transfers between accounts with different banks within Cyprus as well as cross-border transfers were also restricted. Moreover, the opening of new accounts was forbidden.

There was a general ban on cashless payments or transfers of deposits/funds to accounts held abroad or with other credit institutions, but an authorisation regime applied for transactions falling within "normal business practices" (e.g.

buying goods). Initially, payments of up to EUR 5,000 per day per account were allowed, but then the ceiling increased to EUR 25,000, while from EUR 25,001 to EUR 200,000 they were subject to approval, and beyond EUR 200,000 prior authorisation was necessary, taking into account the liquidity buffer of the credit institution. Furthermore, payments for salaries were exempt from restrictions and living expenses up to EUR 5,000 per quarter. In addition, the Cypriot residents with immediate family relatives who studied abroad and had tuition fees were exempted.

Individuals were affected in particular by several measures. These included: (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 prior to their maturity was regulated; and (iii) cash withdrawals were limited to EUR 300 per day and per bank account. Finally, exports of euro cash above EUR 1,000 or the equivalent in another currency were prohibited. This comprehensive framework for administratively managing liquidity was further tightened by freezing uninsured deposits in the context of the bail-in to cover losses and address the recapitalisation of Laiki Bank and Bank of Cyprus.

At its first review, the programme included the roadmap developed by the Cypriot authorities leading to a gradual lifting of the administrative measures and temporary capital controls. The Cypriot authorities developed a roadmap, which identified a series of milestones for the gradual relaxation of the remaining measures, also taking into account indicators of 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. It foresaw two major stages of relaxation: the first pertained to restrictions within the Republic and the second related to cross-border movements of capital. Liquidity conditions and the impact of restrictions in the banks were monitored on a daily basis and the restrictions were reviewed and relaxed by the authorities according to agreed milestones and in consultation with the programme partners. The roadmap for a return to free capital movements, including clear targets that could be checked against outturns, permitted Cyprus to lift controls in a transparent manner.

The regime was applied to all banks including foreign banks and was initially implemented for 16 days, but was then prolonged and eased on some points after April 2013. The overall objective was to allow more and more current transactions for goods and services inside and outside the country, while keeping limits on larger capital transactions. Cyprus lifted all restrictions on domestic financial operations after one year and two months on 31 May 2014, although the temporary administrative restrictions and capital controls were not fully lifted until 6 April 2015. Some entities were exempted from the restrictive measures including the Central Bank, the state and the local authorities.([18])

Restoring the solvency of the financial institutions

Several policy measures aimed at restoring the soundness of the financial institutions (i-iv).

(i) Reducing NPLs

The prolonged recession and a debtor-friendly legislative environment caused bad loans to rise across all economic sectors. Banks were required in 2015 to meet quarterly targets on offered and concluded restructuring solutions for customers in mortgage arrears. Cypriot banks were also requested to report on the early arrears cure rate.([19]) Banks were asked to explain why targets

([18]) A detailed timeline of the administrative measures and capital controls, taken from a recent publication by the Central Bank of Cyprus, can be found in Brown M., Evangelou I., Stix H. (2017), Banking Crises, Bail-ins and Money Holdings, Central Bank of Cyprus Working Paper 2017-2, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3102815.

([19]) In particular, specific targets were set for (i) proposing sustainable restructurings; (ii) concluding sustainable restructurings; (iii) the share of restructured loans that are less than 8 days in arrears; and (iv) the cure rates for early arrears.

had been missed, if the case, and supervisory action was possible, including additional capital requirements under Pillar II. An arrears management framework and a code of conduct for the banks were established and targets on key performance indicators (KPIs) to incentivise banks to accelerate the resolution of NPLs were set.

Reforms of corporate and personal insolvency laws were adopted in 2015. Banks and their clients were envisaged to take up the use of these new tools, which facilitate voluntary agreement between creditors and debtors, since they provided for more balanced incentives than in the past. Together with the enhanced foreclosure framework, this framework was envisaged to be an important instrument to help reducing the excessive level of NPLs. In 2015, political opposition to pass these laws via Parliament was considerable. Accordingly, the changes introduced to the law proposals made it easier to circumvent their actual application.

The adoption of a law in late 2015 making it possible to sell NPLs has been a prominent requirement under the economic adjustment programme for Cyprus, with the aim of creating an additional tool for reducing NPLs. With a view to protecting small borrowers, the law regulated the sales of loans below EUR 1 million to individuals and SMEs, while loans above that amount became essentially free to be sold. There is also an establishment requirement for non-banks (e.g. specialised distressed asset managing companies must be licensed by the Central Bank of Cyprus) wanting to buy non-performing loans. The creditor must either publicly announce or bilaterally inform the borrower of its intentions and offer 45 days to purchase the loan, without making the offer binding for the creditor.

A credit register was created and became fully operational in the same year for credit assessment purposes in the context of supervisory activity. The availability of reliable and comprehensive financial information on borrowers is a key condition to promote lending based on the actual repayment ability of borrowers. Data held in the register was expanded and their quality improved in order to use the credit register for macroprudential purposes. Moreover, the credit register of commercial banks' borrowers was expected to be fully integrated with the register of the cooperative banks to provide a comprehensive view of a borrower's total liabilities. A credit scoring system was additionally required to develop a scoring system for a better appreciation of households' risks.

(ii) Improving financial transparency

To strengthen the anti-money laundering (AML) framework, a comprehensive action plan for financial transparency was agreed upfront. Measures covered mainly cooperation with foreign counterparts, customer due-diligence and suspicious-transaction reporting procedures, transparency of beneficial ownership of corporations and arrangements (including the establishment of trust registers and improvement of the registrar of companies). In addition, the relevant authorities had to improve their off-site and on-site supervisory procedures and a risk-based approach. According to the MoU, the Central Bank of Cyprus was required to, strengthen its AML supervisory competences and to reinforce its dedicated unit with this aim as well as that of staff recruitment. During the programme, there was progress on the implementation of the AML Action Plan, albeit with partial compliance on some elements.

(iii) Improving regulation and supervision of credit institutions

The programme partners agreed on the introduction of mandatory supervisory actions based on capitalisation levels and a unified data reporting system for banks and cooperative credit institutions. Stress-testing should be integrated into regular off-site bank supervision. The regulation and supervision of cooperative credit institutions was to be aligned to that of commercial banks and integrated into the CBC. CBC was required to provide more staff to fulfil its responsibilities and tasks. In order to ensure alignment with best practices, the regulatory and supervisory framework should be assessed against

the relevant Basel core principles. As of November 2014, the SSM supervised the systemic Cypriot banks on the basis of common standards for the euro area systemic banks. Before the SSM became operational, a number of supervisory reforms in line with the financial sector conditionality were introduced.

(iv) Improving the legal framework for private debt restructuring

Cyprus reformed the bankruptcy law for physical persons in order to establish the possibility of a fresh start for the debtor. Additionally, a restructuring process was set up for borrowers in financial difficulties in order to avoid bankruptcy and, in particular, to avoid foreclosure of primary residences. The law established a voluntary Personal Insolvency Arrangement by copying the Irish model, although with a reversed majority requirement.

The tool targeted debtors who had experienced a reduction in their repayment capacity and were undergoing financial stress but still had a regular income and a repayment capacity compatible with the conditions of the restructured loan. Additionally, whenever an agreement was not reached a compulsory enforcement was set up to allow the debtor to apply to the court for the imposition of a restructuring plan on the creditors, subject to certain criteria. Also, a new foreclosure law was adopted as efficient enforcement instruments were considered crucial for ensuring contractual and property rights of the creditor and to avoid wrong incentives ("moral hazard") in a debt restructuring process.

Cyprus also introduced a number of reforms in 2015 to improve payment discipline by corporates while giving companies the possibility of a "fresh start", and to introduce specific mechanisms for vulnerable debtors with smaller debts. Secured or unsecured creditors were enabled to request the court to order a company liquidation. All corporate assets were subject to liquidation to satisfy creditors. Secured creditors could furthermore force a company into receivership, where the owner loses control of operations and is replaced by a receiver. The business or assets were sold to satisfy creditors. A new reorganisation scheme for viable companies was a going concern, by creating temporary protection from creditor actions while an examiner devises a restructuring plan.

A clear definition of property rights was identified as an important element to enable the enforcement of collateral, and some measures were targeted to address weaknesses in this area. An important element in collateral recovery was the authorities' commitment to substantially reduce the backlog in the issuance and transfer of title deeds. The title deeds system had been revised, because the mismatch between the legal owner (usually developers) of the property and its final buyer impeded the resolution of NPLs. The adoption of the legacy cases law (for property sales up to end of 2014) created some momentum for transfer of titles deeds.

3.2. OVERALL OUTCOME AND ASSESSMENT

Recapitalisation, restructuring and resolution of the Cypriot financial institutions in difficulties

It is difficult to see a viable alternative to the bail-in decisions taken prior to the programme. While an assessment of the decisions taken before the programme commenced regarding the restructuring of CPB and BoC and the related bail-in of unsecured depositors is outside the mandate of this evaluation, it can still be hypothetically asked if a bail-out by state aid financed with programme financing would have been feasible. At the start of the programme, the government debt ratio was already at about 80% of GDP in December 2012, which limited options regarding the size of the programme envelope. The simulation exercise exploring some alternative debt scenarios in Chapter 4 of this report allows concluding that it would have been difficult for Cyprus to reconcile a bank bail-out financed by the programme with debt sustainability considerations. This also confirms the views expressed by several stakeholders, including those in the written surveys where this question was explicitly asked (see Annex 1). The additional fiscal burden of a bank bail-out in 2013 could have essentially prompted a

debt overhang, a condition Cyprus would have found difficult to surmount without tough fiscal consolidation and its macroeconomic implications. Also, several Ministries of Finance of Member States and Cypriot stakeholders in their replies to the written questionnaire for this evaluation believe that a bail-out would have been unfair to taxpayers while saving a high share of non-resident depositors from contributing to a solution. On the other hand, had the bail-in decision been taken sooner when the amount of banks' outstanding unsecured bonds (first in line in burden-sharing) had not yet fallen to low levels, the burden on often unsophisticated depositors would have been lower.

The programme's follow-up on the bail-in decisions further stabilised the banking system. Significant steps were taken in BoC to absorb the assets and liabilities taken over from CPB. Supervision and banks' reporting obligations were tightened, notably with a view to improving their risk management. The carve-out of Greek operations in the two largest commercial banks effectively reduced contagion from the Greek adjustment programme. This sheltered Cyprus from further losses on Greek loan portfolios, which materialised in 2015 during the discussions on the third Greek programme, and from the temporary capital controls imposed in Greece in the summer of 2015.

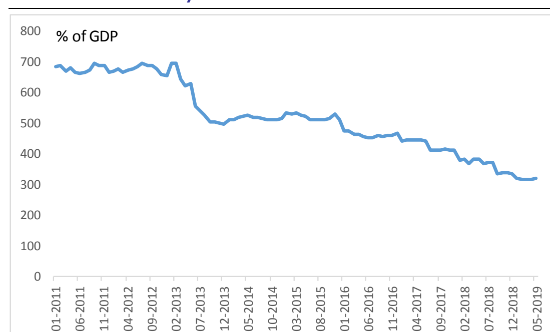
With the benefit of hindsight, the programme could have pursued a more determined approach to the cooperative credit institutions. The accounting and economic value assessment of the Cypriot financial institutions by PIMCO turned out to be on the high side, partially because the assessment was launched prior to the bail-in after which the financial soundness indicators of the Cypriot financial institutions deteriorated considerably. This concerned especially the cooperative banks where significant recapitalisation needs emerged later on and governance needed to be significantly improved. After operationalisation of the SSM, additional amounts of state aid were required for the Cooperative Central Bank in 2015 (about 1% of the Cypriot GDP) and in 2018 (18% of the Cypriot GDP as liquidation aid). The difference in the amounts of state aid approved in 2015 and 2018 is large, which reflects a strong deterioration of the bank's balance sheets over this period. This is despite the fact that the bank committed to return to viability in the period of five years following the first bail-out in 2014 (of about 8.5% of GDP). This points to continuing problems of governance.

However, a more determined approach towards the cooperative banks was not obvious at the time of the programme. As mentioned by several stakeholders, the cooperative banking sector had a significant systemic importance for the Cypriot economy as it attracted the highest share of domestic deposits in Cyprus, and many of them with smaller amounts. Hence, introducing major changes to the cooperative banks could have caused serious disruptions of the Cypriot financial sector with uncertain outcomes. Most stakeholders consulted for this evaluation pointed to a strong political resistance during the programme to major changes in the way the cooperative banking system was run.

Overall, considerable progress in deleveraging of the banking sector was achieved, which was a necessary step in the adjustment process. Banks' balance sheets shrank overall, from 622% of total banking sector assets relative to GDP in April 2013 to 465% in March 2016 (Graph 3.1). The biggest drop in assets occurred in spring 2013 when the main decisions on bank restructuring took place.([20])

([20]) In 2018, the total consolidated assets of the Cypriot banking sector also decreased markedly which was largely due to the CCB exiting the banking system as well as the Helix portfolio sale by the Bank of Cyprus (see Chapter 8).

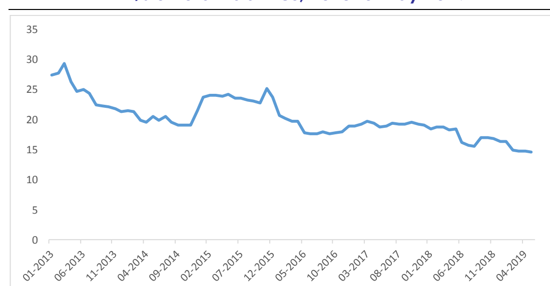
Graph 3.1: **Cypriot financial institutions' total assets, 2011 to May 2019**



Source: Central Bank of Cyprus

The banks increasingly adapted their business models to comply with programme conditionality and supervisory rules regarding stable funding sources. Over the period under review, the restructuring of the Cypriot banks' balance sheets has brought them closer to a more traditional business model by relying less on external sources of funding and maintaining high ratios of domestic deposits. The reliance on external funding sources decreased from 26% of external liabilities (as share of total liabilities) in April 2013 to 19% in March 2016 (Graph 3.2). Reliance on domestic deposit funding remained high and stood at 53% (as share of total liabilities) in March 2016 compared to 55% in April 2013.

Graph 3.2: **Evolution of Cypriot banks' external funding in % of total liabilities, 2013 to May 2019**



Source: ECB, BSI

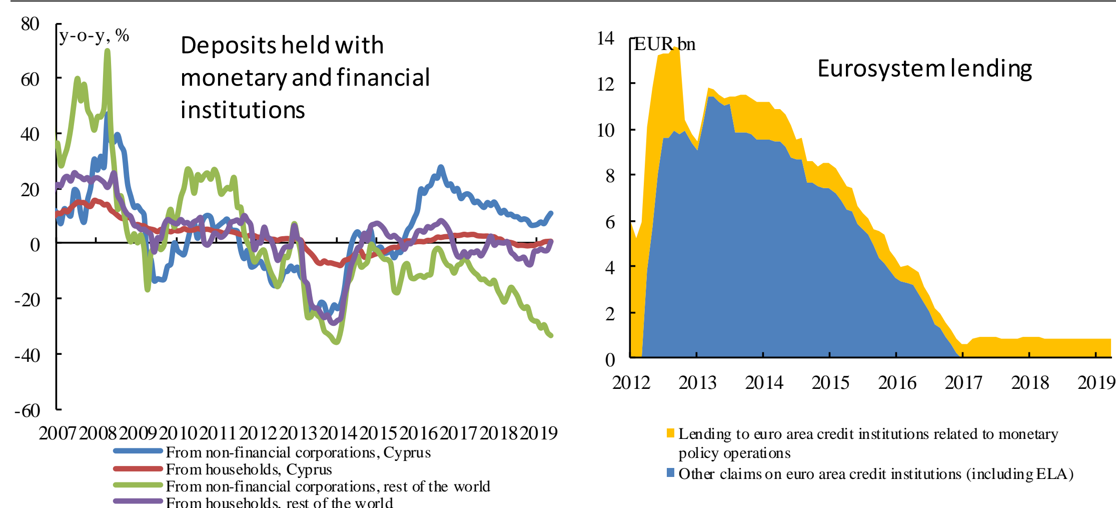
Maintaining the liquidity of banks

In order to address the liquidity shortages, the Cypriot banking sector drew extensively on the ELA (Emergency Liquidity Assistance) of the CBC already ahead of the programme. Deposits were declining already since 2011, in particular those held by non-financial corporations and from abroad (see Graph 3.3, left-hand chart). Other claims of the Cypriot banking sector on the euro area institutions increased significantly just prior to the start of the programme, by depicting an increasing loss of confidence in the Cypriot financial sector. Further needs for funding via ELA decreased after the administrative measures restricting the withdrawal of deposits and transfers were introduced, which triggered a gradual decline in the stock of the claims on the euro area credit institutions (see Graph 3.3, right-hand chart).

The strong commitment of the national authorities to a transparent roadmap for a return to free capital movements, including clear targets, were important factors that permitted to lift the temporary controls in a timely manner. This was proportionate to the legitimate objectives of preventing the immediate risk to the financial stability related to an uncontrollable outflow of deposits and contributed to a fast crisis stabilisation.([21]) The programme partners considered different risk factors before abandoning the administrative measures restricting the withdrawal of deposits and transfers. The Cypriot authorities supported an early exit, which was the right strategy as proven by the deposit dynamics following lifting of the controls. The administrative restrictions and capital controls were also released much earlier after their introduction compared to the experience in Greece. A gradual decline in the stock of the Cypriot banking sector's claims on the euro area institutions (ELA) started after the temporary administrative restrictions and capital controls were introduced. The trend continued thereafter, which confirmed markets' confidence in the Cypriot banking sector. Moreover, Cyprus indirectly benefitted from the ECB's non-standard monetary policy measures through portfolio rebalancing in other euro area countries that contributed to capital inflows into Cyprus.

([21]) European Commission. Press release. Brussels, 28 March 2013. Statement by the European Commission on the capital controls imposed by the Republic of Cyprus. Available at: http://europa.eu/rapid/press-release_IP-13-298_en.htm.

Graph 3.3: **Liquidity in Cypriot banks**



Source: Central Bank of Cyprus

Table 3.1: **Financial soundness indicators of Cyprus, 2012-2018**

	2012 Dec	2013 Dec	2014 Dec	2015 Dec	2016 Dec	2017 Dec	2018 Dec
NPLs*, all loans (EUR billions)	15.6	26.0	27.3	26.7	23.8	20.6	10.3
NPLs*, all loans (% of total)	22.6	41.5	47.8	45.8	47.2	43.7	30.3
NPLs*, loans to NFCs (% of total)	..	..	58.0	56.0	56.4	50.3	33.3
Restructered non-performing (% of total)	..	12.5	23.3	25.9	25.7	22.8	14.5
Restructured performing (% of total)	..	12.2	5.3	7.5	9.4	8.6	6.7
NPLs*, loans to households (% of total)	..	43.3	52.7	56.2	55.9	53.9	37.7
Restructered non-performing (% of total)	..	6.7	13.9	18.0	20.0	19.7	17.2
Restructured performing (% of total)	..	10.4	8.9	6.7	7.7	8.3	7.6
Coverage rate (Impairments / NPLs)*	47.9	37.7	32.9	37.8	41.7	46.8	50.9
Cost-to-income ratio**	55.6	53.4	40.4	44.1	52.5	53.6	60.0
Net interest margin**	2.3	2.4	2.9	2.8	2.6	2.3	1.8
Common Equity Tier 1 ratio **	..	..	14.2	15.6	15.9	14.9	14.1
Return on assets (annualised)**	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.5

Note: The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis.
*The local NPL definition was used for 2012 and 2013 figures. Starting end-2014, the EU NPL definition was used, as defined in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278. Figures exclude exposures to central banks and credit institutions.
** Latest available data for September 2018
Source: CBC

Restoring the solvency of the financial institutions

The overall financial situation of the banks gradually improved after the initial crisis stabilisation was achieved. The banking sector's profitability improved in the period under review, but remained negative (Table 3.1). Profitability (measured as return on assets) stood at -0.3% in December 2016 compared to -4.3% in December 2013 as poor asset quality and low interest margins continued to push banks' performance down. Loan loss provisioning costs increased gradually and reflected negatively on profitability. In 2016, net interest margins stood almost at the same level as at the beginning of the programme, whereas the cost-to-income ratio increased almost back to the level of 2013 after a temporary decline in 2014-2015.

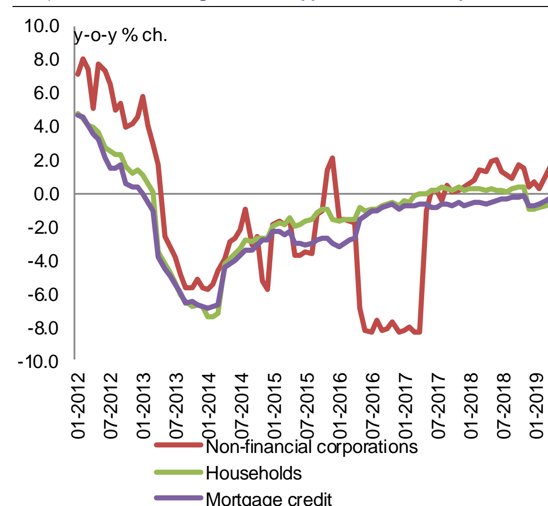
However, progress in solving the NPLs issue was rather limited. NPLs increased from about 42% in 2013 to about 47% in 2016 (see Table 3.1), which relative to both total loans and GDP were at the time among the highest in the world. Accordingly, very high levels of NPLs - especially in the real estate and construction sectors - remained a significant problem also after the end

of the programme. Still, it should be noted that to some extent a high level of NPLs can be explained by other factors than only the governance of the banks or the rigidity of the existing policy framework. First, from 2015, the definition of NPLs was harmonised at EU level and, as a result, some of the loans, which previously were specified as performing, were re-classified as not performing as long as they fulfilled the new criterion (more than 90 days past due). Secondly, as the balance sheets of the banks were shrinking (due to the ongoing deleveraging) and the overall amount of loans was decreasing, accordingly the ratio of existing NPLs over total NPLs increased.

Regarding the low repayment discipline of loans, the IMF and CBC provided quantitative evidence about the importance of strategic default based on the Eurosystem's Household Finance and Consumption Survey.[22] The survey results suggest that, despite a major reduction in income and in the value of assets between 2010 and 2014, households with NPLs still owned a considerable amount of immovable properties, including the main residence and other types of real estate. This, in conjunction with the fact that households with NPLs had on average a higher value of real assets than their total credit liabilities, indicated that many households would be able to service their debt obligations, either fully or partially, via the sale of real assets, other than the main residence. When talking to the evaluation team, staff of the Cypriot authorities also mentioned that more needed to be achieved in the area of financial literacy of the Cypriot population, as evidenced by Cyprus' weak performance in the financial illiteracy index.

Delayed implementation of banks' plans to reduce NPLs may have hindered banks' ability to support growth through new lending. According to the ECB's Bank Lending Survey, credit demand by non-financial corporations and households was rather robust during the program period under the review. Credit to households remained negative over the whole programme period (Graph 3.4). Also credit to non-financial corporations remained negative during the programme, with a temporary improvement at the end of 2015 largely due to EIB and EBRD programmes to support SMEs in Cyprus, albeit on an unsustainable basis. The situation in credit to non-financial corporations deteriorated again between the end of the programme and mid-2017 due to a number of factors including efforts to reduce NPLs through loan restructurings, stricter regulatory guidelines on lending practises and tighter credit standards applied by banks.

Graph 3.4: **Credit growth in Cyprus, 2012 to May 2019**



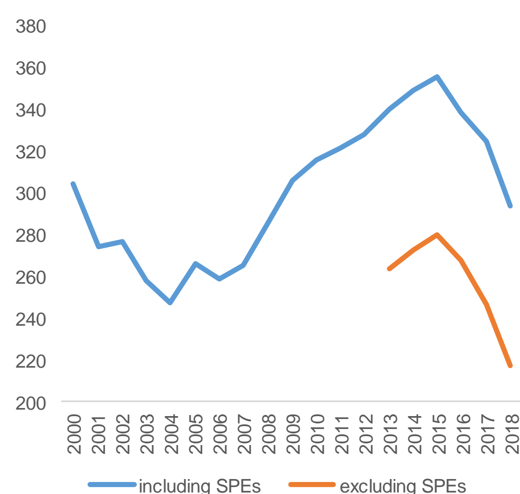
Note: The annual growth rates are computed as the changes in outstanding amounts adjusted for all non-transaction related issues, i.e. revaluations, reclassifications, and exchange rate adjustments.
Source: ECB

The private sector debt overhang persisted also in the period after the programme, despite some deleveraging achieved starting from 2016. The private sector indebtedness hardly changed between 2013 and 2016 (from 340% to 339% of GDP, including SPEs, and from 264% to 268% of GDP, excluding SPEs; see Graph 3.5). Yet, a decline started in the period after the programme. The slow deleveraging during the programme can be partly explained by GDP denominator effects, as real GDP growth was weak in the years 2013 to 2015 and inflation was low, and even negative in some years. Furthermore, there was not much progress in the resolution of NPLs. The drop in private debt in 2018 was largely due to two one-off transactions, i.e. the transfer of the non-performing CCB assets to the state-owned asset management

(22) See IMF 2018 Article IV Report on Cyprus (No. 18/338); see also CBC (2018).

company KEDIPES and the sale of a large NPL portfolio by the Bank of Cyprus (see also Chapter 8).

Graph 3.5: **Consolidated private sector debt in Cyprus, 2000-2018**



Note: Private sector debt to monetary and financial institutions in Cyprus.
Source: European Commission, CBC

The number of foreclosure procedures barely increased during the time of the programme (see Table 3.2). After the legislation concerning foreclosures was passed in 2015, an increase in the number of handled and closed foreclosure was very low. Thus, foreclosure legislation did not give sufficient incentives to defaulting borrowers to resume paying or restructure their debts. The same trends were observed for bankruptcies. The value recovered through foreclosure was also negligible, but improved since 2018 after approval of the new legislative package in July 2018. ([23])

([23]) For further details see section 8.3.

Table 3.2: **Insolvency and foreclosure cases in Cyprus, 2015-April 2019**

	2015	2016	2017	2018	2019 (up to April)
Bankruptcies	46	26	36	30	10
Liquidations	53	59	73	31	7
Properties sold via auction	-	21	136	693	326

Note: Data refer to cases handled (i.e. examined, submitted to Court, sold via auction etc.)
Source: Cypriot Ministry of Finance

In addition, progress on insolvency procedures seems to have been limited (Table 3.2). In 2015, with the adoption of the Insolvency Framework, the Insolvency and Clearing Process was modernised pursuing the introduction of tools (ADOs), Personal Repayment Plans (RSCs) and Examination. The objective was to give a new opportunity to entities in financial difficulty and avoiding bankruptcy and liquidation. After approval of the new legislative package in July 2018, there has been a slight increase in all proceedings, including examined applications.

During the period under review, the Cypriot authorities made progress on addressing AML. Cyprus is a member of Moneyval, a permanent monitoring body of the Council of Europe entrusted with the task of assessing compliance with the principal international standards for Anti-money laundering/Counter-financing of terrorism (AML/CFT) and the effectiveness of their implementation, as well as making recommendations to national authorities of necessary improvements to their systems. While progress was made on implementing the AML Action Plan, adequate staffing and training of the supervisory authorities was a remaining concern at the end of the programme. The CBC initiated some enforcement actions with regard to breaches of compliance with the relevant obligations under the AML regulations. In one case where the breaches were of a more systematic nature, the CBC imposed a sanction. In recent years, the Commission's country reports and the EU's country-specific recommendations to Cyprus did not see AML as a challenge for Cyprus.

Overall assessment

Key evaluation questions:

- *Effectiveness: To what extent were financial stabilisation objectives achieved?*
- *Efficiency: To what extent was the strategy for financial stabilisation appropriately designed for achieving the programme objectives?*
- *Relevance: Was there a proper diagnosis and strategy on financial stabilisation before the identification of related conditionality?*
- *Coherence: To what extent was the strategy for the stabilisation of the financial sector conceived and developed in a coherent manner?*
- *EU added value: To what extent did the EU's legal framework – especially in the context of the Banking Union - contribute to addressing the Cypriot banking crisis?*

The overall situation of the Cypriot financial sector gradually improved after its stabilisation was achieved at the beginning of the programme. A considerable deleveraging of the banking sector took place, notably following the bail-in decisions ahead of the programme. A gradual return of deposits, allowing a decline in the stock of Emergency Liquidity Assistance (ELA), confirmed a returning confidence in the Cypriot banking sector. The successful financial stabilisation allowed a swift withdrawal of the administrative restrictions and capital controls. Moreover, the Cypriot financial institutions adapted their operations to comply with supervisory rules, targeting more use of stable funding sources by relying less on external sources of funding and increasing the share of domestic deposits. Tighter rules on anti-money laundering/counter-financing of terrorism (AML/CFT) also contributed in this respect.

Yet, the Cypriot banking sector was still subject to high risks at the end of the programme. The Cypriot financial soundness indicators remained among the weakest in the EU. The banking sector's profitability remained negative during the programme, not least due to the high costs of loan loss provisioning. Very high levels of non-performing loans (NPLs) - especially in the real estate and construction sectors - remained a significant source of risks also after the end of the programme. The slow progress to reduce NPLs also resulted in a very low credit provision, notably to the corporate sector, which only eased more recently. **The programme could have been more effective and relevant by pursuing a more comprehensive approach to address the problem of NPLs.** The programme strategy on NPLs relied strongly on reforming the legal framework for dealing with NPLs. The collateral recovery-related legislative package with regard to the insolvency and foreclosure procedures was finally introduced in 2015 after long discussions at the political level and several amendments of the legislative proposal by the Parliament. The introduced measures failed to deliver results, also because the final version was changed substantially compared to the version agreed with programme partners. The existence of many loopholes implied that the actual implementation of foreclosures and insolvency procedures remained complicated. The judiciary procedures related to insolvency and foreclosures remained lengthy compared to other EU countries, which did not incentivise banks in initiating collateral recovery (see Chapter 5). More and earlier structural reforms concerning title deeds for houses and the judiciary could have facilitated faster progress in reducing NPLs, while acknowledging that frontloaded action on all these matters in parallel could have been constrained by the authorities' administrative capacity. As a result, amendments to the introduced legislative package were required and a new legislative package was introduced in July 2018 in order to make the measures more effective, while further progress towards a more effective legislative and judicial framework concerning the workout of NPLs remains to be done.

Although not obvious at the time on the basis of the available risk assessments, with the benefit of hindsight the programme could have been more efficient by pursuing a more determined approach on the cooperative credit institutions. While several changes to the governance of the cooperative banking system were introduced, including a higher degree of centralisation, these proved insufficient to prevent significant and recurrent recapitalisation needs that emerged later

on, ultimately leading to its liquidation. Progress in dealing with the high NPLs was even slower in the cooperative banking system than in the commercial banks. This should also be viewed in the context of the initially ineffective collateral recovery-related legislative package, which was a common factor affecting negatively the whole financial sector. However, given the significant systemic importance for the Cypriot economy in view of its small depositors' structure, introducing major changes to the cooperative banks could have caused serious disruptions in the Cypriot financial sector. This also explains the strong political resistance that programme partners faced when proposing bolder action on the cooperative banks.

The programme was largely ineffective in reducing the private sector debt overhang, which persisted also post-programme, despite some deleveraging starting from 2016. Private debt-to-GDP remains among the highest in the EU. Slow deleveraging during the programme period was partly a result of insufficient contract enforcement based on the insolvency and foreclosures procedures introduced in 2015. The low - and at times negative – inflation rates in Cyprus were not helpful either in making more progress on deleveraging.

At the start of the programme, the responsibility for the supervision and resolution of banks in the EU was located at the national level, which presented a difficulty for preventing, assessing and addressing coherently the problems of banks in Cyprus. At the same time, despite progress towards a Banking Union, some of the persisting problems in the sector remain under national responsibility, for example the legal framework to facilitate working out the high amount of NPLs. Following the programme's financial sector conditionality, a number of reforms were implemented that improved supervision and regulation of credit institutions by the Central Bank of Cyprus. Only as of November 2014, the SSM supervised the systemic Cypriot banks on the basis of common standards for the euro area countries. This provided a good transition platform between the national supervisory rules and the SSM supervisory standards, as also stated by several stakeholders interviewed. The Single Resolution Mechanism (SRM), which was responsible for defining burden-sharing rules for failing banks, became operational only from January 2016.

4. ENSURING FISCAL SUSTAINABILITY

4.1. PROGRAMME DESIGN AND IMPLEMENTATION

Macroeconomic projections

Programme projections for real GDP growth, especially for 2013 and 2014, were lower than subsequent realisations. The initial programme forecasts for real GDP growth were more pessimistic than those of the Cypriot authorities at the time. Even when outturn data was already partly available pointing to a better-than-expected outcome, programme partners remained cautious in adjusting their forecasts. However, projections of the programme partners and the Cypriot authorities converged over the programme period.

Compared to real output, forecasts of nominal GDP turned out to be more accurate than those of real GDP. Initial projections for nominal GDP proved to be relatively close to the outturn (see Graph 4.1), as forecast errors related to real GDP growth and the GDP deflator pointed in opposite directions and partly offset each other. Wages adjusted sharply downwards in 2012-14 and consumer prices fell in 2014-16. The GDP deflator dropped between 2013 and 2016, while programme partners expected subdued but positive price developments. While the initial forecast for wages and salaries was close to final outcomes, the pass-through of falling wages to inflation proved stronger than initially estimated.

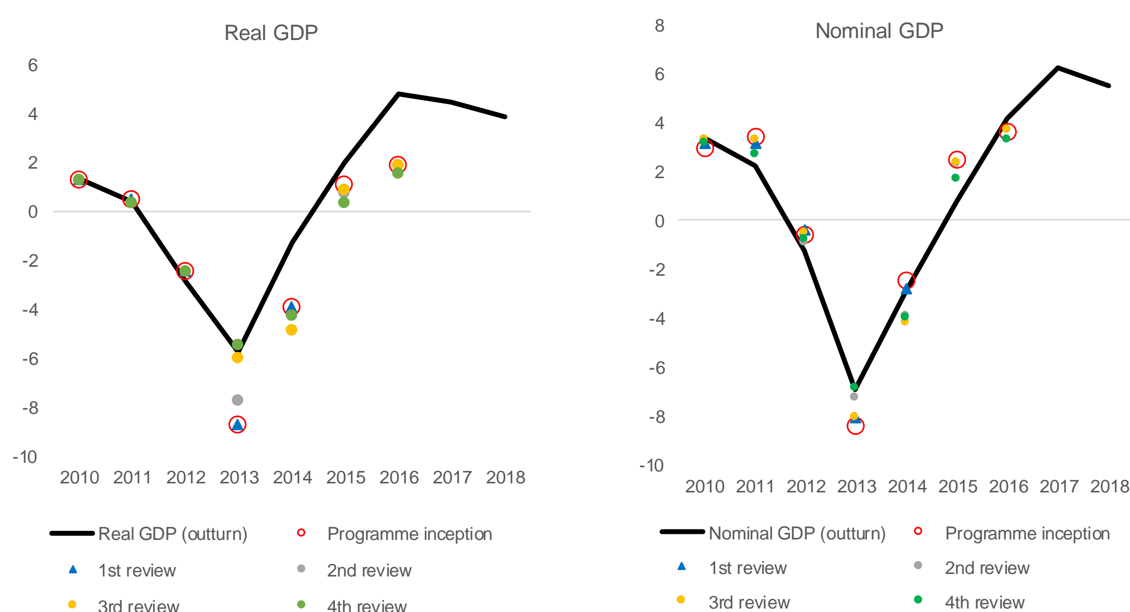
Uncertainty on some key forecast aspects could explain the relatively pessimistic initial forecasts. At the beginning of the programme, as explained by several stakeholders involved, projections were subject to particularly high uncertainty as the working of several transmission channels were hard to assess. Specifically, the negative effects of the bail-in of depositors and the financial deleveraging on consumer spending, housing and business investment were very difficult to predict. In addition, projections for the tourism sector, even though identified as a possible growth driver, were difficult to make given geopolitical developments in the Mediterranean.

Additionally, some unexpected factors influenced GDP growth positively. Most prominently, the liquidation/compensation of the Laiki pension fund in 2014/15, with an order of magnitude of EUR 1.1 billion (about 5-6% of GDP), had a smoothing effect on consumption. Moreover, the financial sector recorded a positive value added in Q1-2013 in spite of the bail-in.

Fiscal policy

Already ahead of the programme, Cyprus was

Graph 4.1: **Real and nominal GDP projections for Cyprus during the programme compared to outturn, 2010-2018**



Source: European Commission, Eurostat.

subject to an Excessive Deficit procedure (EDP) and took important decisions on fiscal consolidation.([24]) Obligations under the EDP required fiscal consolidation measures with a cumulated effect of about 7% of GDP over 2012-2014 (see Table 4.1). These measures were decided and implemented by the Cypriot authorities at the end of 2012, hence already before the official start of the programme, even though most of the measures were agreed in the programme negotiations. They included a first round of cuts in public sector wages and pensions, reductions in social transfers, reduced transfers to state-owned enterprises and other semi-governmental organisations, healthcare expenditure control, and increases in direct (tax on interest income, corporate income tax and property tax) and indirect taxes (VAT and excise duties on energy, alcohol and tobacco).

Table 4.1: **Planned fiscal consolidation measures in Cyprus, 2012-2014**

% of GDP	2012	2013	2014	2012-2014
Total measures	0.3	4.5	2.2	7.0
Revenue measures	0.2	2.0	1.6	3.8
Expenditure measures	0.1	2.6	0.6	3.3

Source: First Review of the Economic Adjustment Programme for Cyprus, Annex A5.3. Assessment of Effective Action

The programme enshrined this consolidation path for the general government primary balance to ensure its implementation. According to fiscal targets established in the original programme document, Cyprus was supposed to improve its fiscal position from a primary deficit of 2.4% of GDP in 2013 to a primary surplus of 1.2% of GDP in 2016 (Table 4.2). The consolidation effort was frontloaded to 2013 while measures for 2015-2016 were not specified except that they should be focused mainly on the expenditure side**.** Fiscal targets were tightened as the programme advanced.

([24]) When the Two-Pack entered into force in May 2013, it established a prevalence of programme-enhanced surveillance over the EDP, although EDP objectives became in fact integrated in the programme conditionality. See Box 3.3 in the Second Review Report for a discussion of the interactions between programme-enhanced surveillance and the EDP (frameworks that were mutually supportive, but set different operational targets).

Table 4.2: **Fiscal targets in the Cyprus programme, government primary balance in % of GDP**

	2012	2013	2014	2015	2016
Programme (4/2013)	-3.3	-2.4	-4.3	-2.1	1.2
First review (7/2013)	-3.1	-2.4	-4.3	-2.1	1.2
Second review (11/2013)	-3.3	-3.6	-3.1	-2.1	1.2
Third review (2/2014)	-3.2	-1.8	-1.8	-2.1	1.2
Fourth review (5/2014)	-3.2	-2.0	-1.7	-1.6	1.2
Fifth review (7/2014)	-3.2	-2.0	-1.3	-1.6	1.2
Sixth review (5/2015)	-2.9	-1.8	2.6	1.5	2.5
Seventh review (7/2015)	-2.9	-1.8	-6.0	1.9	2.4

(1) The initial programme also indicated primary balance targets for 2017 (3%) and 2018 (4%)
(2) Shaded values represent forecasts
Source: Various programme reviews.

Fiscal-structural reforms

A wide set of fiscal-structural reforms was included in the programme. The objectives were to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, to improve the efficiency of the broad public sector, and last, but not least, to alleviate the adverse impact on jobs and growth arising from the crisis. Notably, reforms were agreed in the following areas: pensions, health care, budgetary frameworks, state-owned enterprises at central and local levels, tax collection and administration, re-regulation of the recurrent property tax, public administration, and the welfare system.

Pension reform

The overarching objective of the pension reform, launched already ahead of the programme, was to reduce the increase of pension spending and ensure the long-term sustainability of the pension system, while limiting fiscal subsidies to the general pension scheme (GSIS). By the start of the programme, the Cypriot authorities had already legislated, implemented or agreed to implement significant reforms, for both GSIS and GEPS.([25]) For GEPS, some reforms already effective in October 2011 had included closing the scheme to new entrants,

([25]) GSIS is the general pension scheme in Cyprus; it is a compulsory earnings-related scheme that covers both the private and public sector. GEPS provides supplementary pensionable benefits to central government employees.

indexing benefits in payment to prices instead of wages, and raising pension contributions for existing members (from about 1% to 5% of pensionable income.([26]) Additional measures for GEPS were agreed in the context of the programme, in particular increasing the statutory retirement age, extending the pensionable earnings reference to life-time service, reducing preferential treatment of specific groups (so-called special pensions for beneficiaries such as army, police, tax tribunal) and restricting funding and eligibility conditions for widower pensions. Similarly, for GSIS, programme-related measures included a tightening of measures previously adopted in a 2009 reform, with additional extensions of the minimum contributory period and further increases of employers and employees' contributions ([27]). More programme-related measures regarding both schemes encompassed the introduction of an automatic adjustment of the statutory retirement age in line with changes in life expectancy, an increase of the minimum age entitling to full pension, penalties for early retirement, full taxability of pensions as personal income and a pension freeze over 2013-2016.

During the programme, most of the above-mentioned reforms became MoU actions to ensure their implementation, being marked off in the first reviews. Moreover, the Cypriot authorities committed to separate the insurance-based (contributory) pension scheme from the non-contributory pension and make the latter tax-financed. The authorities were also supposed to make sure that all measures aimed at GEPS would apply also to pension schemes in the broader public sector and to pension schemes of hourly-paid public employees. In addition, a cap on pension benefits for public sector employees and state officials was to be enforced. Furthermore, the Cypriot authorities committed to conduct an actuarial study for the GSIS, to provide additional reform options to ensure long-run viability of the national pension system. If needed, a comprehensive reform was supposed to be carried out.

Health care reform

The programme included a wide range of measures to strengthen the sustainability of the funding structure and the efficiency of public healthcare provision. The programme envisaged abolishing access to public health care services at reduced rates on the basis of income ("B" beneficiaries), reviewing income thresholds for free access ([28]), and eliminating all exemptions for free access that were not income-related. For non-beneficiaries the fees were to be increased, keeping them low for visiting general practitioners. Financial disincentives were envisaged to control spending, limiting an unnecessary use of emergency care, laboratory tests and pharmaceuticals. The Cypriot authorities considered establishing a system of family doctors acting as gatekeepers for access to further levels of care.

As a first step towards a system of universal coverage, a compulsory health care contribution for public servants and public servant pensioners was to be introduced. After an actuarial study, the programme envisaged the implementation - including the completion of the related IT-infrastructure - of a National Health System (NHS) providing universal coverage.

The Cypriot authorities committed to proceed with a restructuring plan for public hospitals to

([26]) To the purpose of the evaluation herewith, these three measures concerning GEPS effective in October 2011 are considered outside the scope of the programme pension reform, as they were not linked to the programme negotiations. They would therefore not reflect in the quantifications presented in section 4.2. Conversely, all other pension reforms listed above constitute the programme package and can be associated with the quantitative effects presented in section 4.2.

([27]) In 2009, the minimum contributory period had already been extended from 3 to 10 years and contribution rates were set to gradually increase to 9.1% by 2039. The programme further increased the minimum contributory period from 10 to 15 years and the contribution rates were set to increase gradually from 7.8% to 10.3% over the period 2016-2039.

([28]) While ensuring that co-payments were set to protect households from catastrophic health expenditure.

improve their quality and optimise costs. [29] Activities to introduce a hospital payment system based on diagnosis-related groups (DRG) were to be advanced. To rationalise expenditure, (i) protocols for laboratory tests and prescription of pharmaceuticals were to be created, (ii) a coherent framework for pricing and reimbursement of goods and services was to be introduced, (iii) the implementation of new clinical guidelines was to be prepared, (iv) the cost-effectiveness of a basket of publicly reimbursed products was to be increased (also through an integrated system for health-technology assessment). The revision of regular working time, stand-by shifts, overtime pay and mobility of healthcare staff was envisaged.

With the first review, the adoption of a binding set of contingency measures was envisaged.[30] These were meant to ensure respect of the agreed limits of public health expenditure, whilst ensuring equitable access to health care.

Fiscal governance

A comprehensive budgetary reform was included in the programme with a view to addressing the institutional gaps and to transpose the relevant European legislation. Before the programme, the fiscal governance provisions were broadly insufficient and Cyprus was one of the few EU Member States with neither national fiscal rules nor a functioning Medium-Term Budgetary Framework (MTBF). This meant that fiscal planning was conducted without firm multi-annual numerical anchors consistent with EU Stability Pact rules. The programme aimed at a comprehensive reform embodied in the Fiscal Responsibility and Budget Framework Law (FRBFL) adopted in early 2014. This 'umbrella law' included, inter alia, new numerical rules, strengthened procedures for annual and medium-term budgetary planning, and the establishment of an independent Fiscal Council, in line with the reform avenues contained in the relevant EU legislation (i.e. Budgetary Frameworks Directive, Two-pack Regulation and the intergovernmental Fiscal Compact).

Beyond the traditional pillars of fiscal frameworks, the FRBSL also reformed key aspects of public financial management. In order to better monitor and manage various types of fiscal risks, the publication of a dedicated annual report was legislated. It covers the following factors: (i) macroeconomic risks; (ii) contingent liabilities; (iii) semi-governmental organisations; (iv) state-owned enterprises and public private partnerships (PPPs); (v) financial sector. In addition, a guarantee office was set up to ensure a critical evaluation of guarantee requests. In addition, a strengthened legal and institutional framework was adopted for public-private partnerships and for public investments, providing for higher levels of certainty in the fiscal affordability of planned infrastructure and other development projects.

Privatisation and State-Owned Enterprises

The planned reform of the governance of State-Owned Enterprises (SOEs) eventually reached a standstill. The required inventories of publicly owned assets, including financial holdings, real estate and land, and the related studies on SOEs finances and operations were completed early in the programme. The new law on SOEs' corporate governance was drawn up to complement the FRBFL in improving financial management in the public sector. Its key features consisted of, most notably, increased budgetary control exercised by the Ministry of Finance, clearer auditing and supervision requirements, and the introduction of a more rigorous approval procedure for the creation of new SOEs. The draft SOEs law was submitted to Parliament already with a significant delay of

(29) At the time of the fourth review (May 2014), this commitment was included in a more general measure that envisaged health sector reforms, including restructuring all public hospitals/public health facilities, the Ministry of Health, the Health Insurance Organisation, and other associated facilities/organisations based on a Reform Plan to be approved.

(30) 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.

around a year and a half, where it failed to make further progress.

The ambitious privatisation programme, with an overall revenue target of EUR 1 billion, faced serious implementation delays. The new privatisation law, adopted in March 2014, established a dedicated Privatisation Unit, which became fully operational in autumn 2014. This law laid down a new legal framework, also by setting out the decision-making process for privatisation deals. Building on the work of external advisers, detailed plans with asset-specific timelines were prepared for the three main targets (CyTA (telecoms), EAC (Electricity Authority of Cyprus), CPA (Cyprus Ports Authority)), and legal and economic preparations were progressing, albeit with repeated and increasingly serious delays. During the programme, only individual projects in the ports sector were eventually concluded, which were overseen not by the Privatisation Unit, but by the Ministry of Transport.

Public administration reform

A wide-ranging reform of the public administration was considered to be vital both for efficiency considerations and from a fiscal consolidation point of view. In 2011, total employment in the broader public represented about 19% of total employment and compensation of government employees as a share of GDP was the second highest in Europe and exceeded the EU average by around 2.5 pps. A number of "quick wins" were adopted at the beginning of the programme, such as working time arrangements that became harmonised across public institutions, and mobility rules became more flexible within the public administration and also vis-à-vis state-owned enterprises. Importantly, the nominal wage and headcount freeze was maintained until end-2017. However, a more comprehensive horizontal reform effort, comprising of new rules for the remuneration structure, recruitment procedure, promotion system as well as the establishment of regular appraisals, was stalled. This fate was shared by the draft local government act as well, which targeted a more efficient provision of public services.

Tax policy reforms

The programme measures in revenue administration aimed at streamlining the institutional dimensions and stepping up the fight against tax evasion. The main reorganisation steps were the merger of the VAT services and the Inland Revenue Department under the tax commissioner (the logistical and informatics unification is still ongoing), as well as the set-up of a large taxpayers unit in the tax administration. Also in view of the estimated potential size of tax evasion([31]), the policy conditions included strengthened competences for the tax authority, and in particular new enforcement powers to ensure the payment of outstanding tax obligations (e.g. by having the authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts). As part of a longer-term project on comprehensively promoting compliance, a debt management strategy was developed, including more consumer-friendly approaches, such as greater options for out-of-court settlements.

The long overdue revamp of immovable property taxation was one of the flagships initiatives of the reform programme, also for modernising the tax structure. In late 2012, there was a fivefold increase in the property tax (chiefly via updating the 1980's prices by applying the cumulative CPI index), totalling around 0.5% of GDP. The General Valuation Project was launched in September 2013 and completed with accumulated delays, also linked to an extended appeals period regarding objections to the new values. Draft reform legislation was adopted by the government end-June 2015, which envisaged a revenue-neutral revamp, even paying for a 50% reduction in (non-recurrent) duties on property transactions. It would have replaced the municipal and communal recurrent property tax, leading to a simplification of the tax structure. Moreover, the

([31]) In Schneider (2013), the size of the shadow economy was estimated at 26% of GDP for Cyprus in 2012, the worst in the EU except for some transition economies in Central and Eastern Europe, and clearly above the EU average of somewhat below 20% of GDP.

draft law would have introduced the principle of regular re-evaluation of properties every five years. Discussions in the Parliament quickly reached a stalemate; finally, the halving of transaction duties was the only element being approved, followed by the abolishment of the property tax as of 1 January 2017.

4.2. OVERALL OUTCOME AND ASSESSMENT

Macroeconomic outcomes

Against expectations, financial and fiscal adjustment did not result in a steep decline in private consumption. The initial forecasts at programme inception predicted a massive drop in consumer spending for 2013-14 on the back of financial deleveraging, fiscal consolidation and rising unemployment. The projections for the labour market proved more or less accurate but private consumption expenditure fell far less than predicted in 2013 and resumed already in 2014. In their interviews with the evaluation team, stakeholders pointed to a number of explanations. First, instead of scaling back consumption sizeably, households managed to smooth consumption by reducing accumulated savings (indeed, the saving rate of households is negative since 2013). The relative resilience of consumer spending is further explained by households' decision to use those pension funds assets that did not suffer from losses due to the bail-in (in total EUR 1.1 billion or 5% of GDP) to prop up consumption (but also housing investment) in 2014. Second, a buoyant tourism sector supported incomes and thus consumption, as Cyprus benefitted from geopolitical developments and safety concerns in other Mediterranean countries that made the island a relatively more attractive tourist destination. Finally, many households did not service their outstanding debt. The de-facto defaults freed resources for consumer spending, but put the burden of deleveraging almost exclusively on the financial sector, which is still struggling under a high NPL ratio (see Chapter 3).

The pessimistic macroeconomic projections at the outset of the programme had a two-sided effect on expectations and programme credibility. As explained by various stakeholders, an apparent bias of programme partners towards cautious projections was partly motivated by considerations on the relative balance of risks stemming from potential upside and downside surprises of real GDP growth. The room for positive surprises was to some extent seen as potentially strengthening the market confidence in the programme. At the start of the programme, however, projections had a negative impact on investor sentiment, and had a bearing on the size of fiscal consolidation. They pointed to a weaker sustainability of public debt, since growth projections fed into the DSA and implied less favourable credit rating agencies (CRA) ratings, i.e. those aspects of the programme that are crucial for programme design and the financial envelope. Later in the programme, when it became obvious that the downturn would be less severe and output growth was exceeding expectations, market sentiment and the assessment by CRAs was positively affected.

Fiscal policy

Fiscal targets, already ambitious at the onset, were tightened further during the programme out of prudent fiscal planning and with the intention to use windfalls to reduce debt. Fiscal projections, similarly to the macroeconomic ones, were prudent, with the aim of creating a virtuous circle of overachievements as explained by several stakeholders interviewed. Indeed, Cyprus overachieved those targets, thanks to macroeconomic over-performance and tight budget execution.

The pace of fiscal consolidation was deliberately frontloaded to enhance programme credibility and foster confidence. The fiscal package, which foresaw a correction of some 6 pps. of GDP in the primary balance targets between 2013 and 2017, was designed to introduce all fiscal consolidation measures at once, even before the official start of the programme. As confirmed in stakeholder interviews, both the national authorities and the programme partners supported this approach. The national authorities saw merit in signalling to economic agents the size of the adjustment upfront, thus avoiding the fiscal fatigue of successive rounds of tightening. Programme

Table 4.3: **Output gap of Cyprus, % of potential GDP**

	2011	2012	2013	2014	2015	2016
Output gap, projections, autumn 2013	1	-0.2	-5.3	-7.5	-4.3	-1.2
Output gap, outturn, spring 2019	-1.6	-4.4	-8.7	-8.0	-5.2	-1.5

Source: European Commission, AMECO database and Table 2.2. of the Second Review Report for the values of autumn 2013

partners shared this view as a lesson learned from other euro area programmes and they were especially keen on showing to the markets a strong fiscal performance. When positive surprises later on materialised, this outcome was instrumental in Cyprus' re-gaining access to markets.

The above strategy was bold in an environment likely to feature large fiscal multipliers and a GDP far from potential. A few characteristics of the Cypriot economy, especially those of a temporary nature, suggested it could be a case of large short-run multipliers, whereby frontloaded fiscal consolidation measures posed a risk of slipping into recession.([32]) Importantly, the output gap in Cyprus was negative and large, though admittedly of a magnitude unknown at the time (Table 4.3). Empirical evidence increasingly cautioned against rapid fiscal consolidation. A nascent literature had already started to provide evidence of various structural and temporary characteristics of the economy that increased fiscal multipliers. ([33]) Structural characteristics of this sort specific to Cyprus are small automatic stabilisers.([34]) Temporary characteristics increasing multipliers are the state of the business cycle in particular bad times (downturn, recession, financial crisis, economic slack, level or change in the output gap),([35]) a high degree of monetary accommodation to fiscal shocks (expansionary monetary policy) or a monetary policy at the zero lower bound.([36]) The latter was further confirmed by studies which found that fiscal consolidation or tightening in bad times, times of crisis, negative output gap, fiscal or banking stress from high debt or liquidity crisis featured, in advanced economies, fiscal multipliers close to 1 or larger.([37]) Yet, such elements did not prevent the policy-makers to choose an early and ambitious consolidation profile. As explained by various stakeholders to the evaluation team, the main rationale was to tackle the debt overhang upfront to avoid adjustment fatigue and foster confidence. With hindsight, this strategy was successful. A key aspect of this success was, ultimately, pursuing a pace of fiscal consolidation that is in line with the evolution of private sector demand.([38])

Fiscal consolidation foresaw to draw more on expenditure than on revenue measures (with respective shares of 2/3 versus 1/3), but it ended up with a balanced composition. According to the Cypriot authorities, some fiscal measures were more fruitful than others. Revenues performed better than expected, beyond what macroeconomic performance would explain, and despite the Ministry of Finance's rather prudent approach to expenditure, which it endeavoured to contain in all line ministries. The measures more effective than expected in each category were, on the expenditure side, the reduction of the wage bill following the employment freeze. On the revenue side, VAT increases yielded results significantly above expectations, essentially thanks to the macroeconomic performance, in particular

([32]) When fiscal multipliers are large and GDP is far from potential, the drag on growth from fiscal consolidation is bigger than usual, so caution against recession would favour backloading. See Blanchard and Leigh (2013a and 2013b); in't Veld (2013).

([33]) Batini, Callegari, and Melina (2012); Riera-Crichton *et al.* (2014); Corsetti and Müller (2015).

([34]) Carnot and de Castro (2015); Batini *et al.* (2014).

([35]) Blanchard and Leigh (2013a); Blanchard and Leigh (2013b); Auerbach and Gorodnichenko (2012); Carnot and de Castro (2015).

([36]) Batini *et al.* (2014).

([37]) IMF (2010), Baum and Koester (2011), in`t Veld (2013) , Hernandez de Cos and Moral-Benito (2013)

([38]) Blanchard and Leigh (2013a and 2013b); in't Veld (2013).

consumption, while better compliance on the property tax also surprised positively.

The overall approach to the composition of fiscal consolidation - including efforts to control spending, improve its efficiency, and the strategies to raise revenue - appears economically justified. Evidence in the economic literature on the relative appropriateness of revenue and expenditure-based fiscal consolidation is recently lending more support to expenditure-based consolidation, which it shows to be less harmful to growth and more sustainable, as spending cuts have much smaller costs in terms of output losses than tax increases ([39]). Previously, some studies using a narrative approach also challenged the then common wisdom that short-term multipliers for government spending are higher than those on taxes. ([40]) Beyond composition, what is desirable is that both revenue and expenditure measures support growth, a principle that was broadly followed for most of the consolidation measures chosen in the programme. On the spending side, several measures aimed at expenditure control and increased spending efficiency, such as streamlining allowances, benefits and privileges to state officials, housing support schemes, controlling the public sector wage bill or public pension expenditure. On the revenue side, the policy-mix also reflected well the principles of growth-friendly taxation promoted by the Commission and generally supported by empirical findings in the literature. This set reflected a desirable shift towards more housing and consumption taxation, in particular by raising property taxes through higher rates and updated cadastral values, increasing excise duties on tobacco, alcohol, energy, environmentally-minded motor vehicle tax hikes, taxing gaming, increasing VAT, and broadening the tax base to pension income. Some of these measures were particularly successful due to the low starting levels (e.g. VAT rates) and the resilient behaviour of consumption observed ex-post. On the downside, however, the package also included measures known to be more harmful to growth such as corporate income tax ([41]), while some stakeholders pointed to the limited information available regarding the elasticities of certain measures like excise duties, regarding the best practices to score/assess VAT reforms, or on more general features of the Cypriot tax system.([42])

The Cypriot authorities fully supported the fiscal package design in terms of pace, composition and granularity of the fiscal consolidation. As confirmed in the interviews, the upward revisions in the fiscal path over the programme's lifetime were not a point of controversy with programme partners, as the Cypriot government and the political parties saw advantages in signalling fiscal over-performance. Some voices on the opposition side did advocate, however, that the extra performance should have been used to alleviate the fiscal burden. The authorities also had ownership of the detailed fiscal revenue and expenditure consolidation measures, which were agreed upon and reflected in the programme with a bottom-up approach. Not least, the authorities were aware of the macroeconomic risks of frontloading, which imposed the bulk of fiscal consolidation measures simultaneously, in a slump. Their motivation for this choice was twofold: On the one hand, the authorities were keen to signal to the public that no additional severe policies would ensue thereafter and, on the other hand, they expected this approach to yield good results once the economy normalised. The Cypriot authorities had no simulations of the expected macroeconomic impact of fiscal measures foreseen at the time.

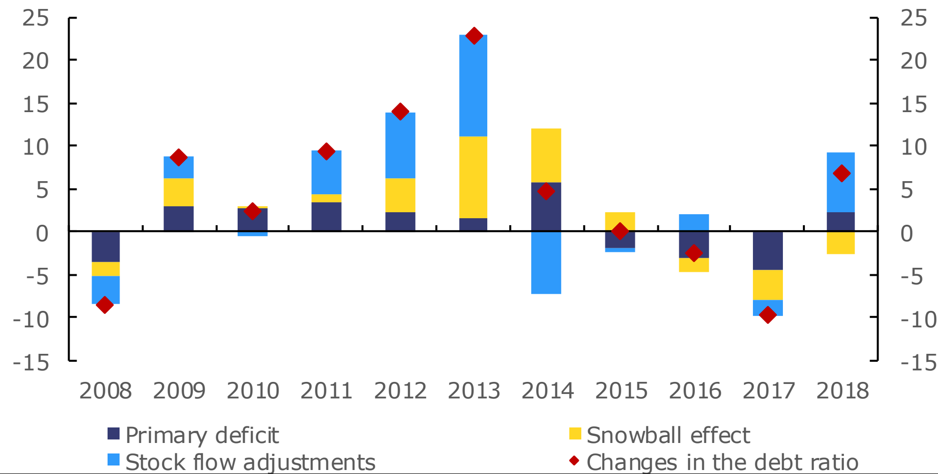
([39]) Alesina *et al* (2019), "Austerity. When It Works and When It Doesn't", Princeton University Press, 2019.

([40]) Batini *et al*. (2014).

([41]) VAT increases in the context of downturns could also be disputed. Atinasi and Klemm, (2014) show some surprising results such as the finding that raising consumption taxes is harmful *in a recession*. More generally, they find that revenue based adjustment is more harmful than expenditure based consolidation, with the strongest impairment for growth in each category coming from indirect tax increases on the revenue side and from reductions in government investment and consumption on expenditure side.

([42]) Based on interviews with Commission officials and DG ECFIN's internal horizontal assessment framework on taxation, 2015.

Graph 4.2: **Government debt ratio change and breakdown in Cyprus, % of GDP**



Source: AMECO

The correction of the excessive deficit as required by the EDP recommendation was essentially on track throughout the programme. This is not a coincidence, as the Commission is required to ensure that the fiscal path set in an adjustment programme is coherent with the Excessive Deficit Procedure (EDP). A European Court of Auditors (ECA) report issued in 2016([43]) flagged no concerns regarding the implementation of the EDP in Cyprus. The ECA report looked at the EDP as applied between April 2009 and May 2015, auditing a large set of national authorities - the Supreme Audit Institution, the National Statistical Institute, the Ministry of Finance, the Fiscal Council, the Central Bank and the DG Economic and Financial Affairs resident representative. Amongst the cases audited at the time (CY, IT, FR, DE, CZ, MT), Cyprus' EDP implementation was flagged as exceptional in terms of sufficiently detailed corrective measures and clearly identified associated fiscal impact.

Fiscal Sustainability and Debt Sustainability Analysis

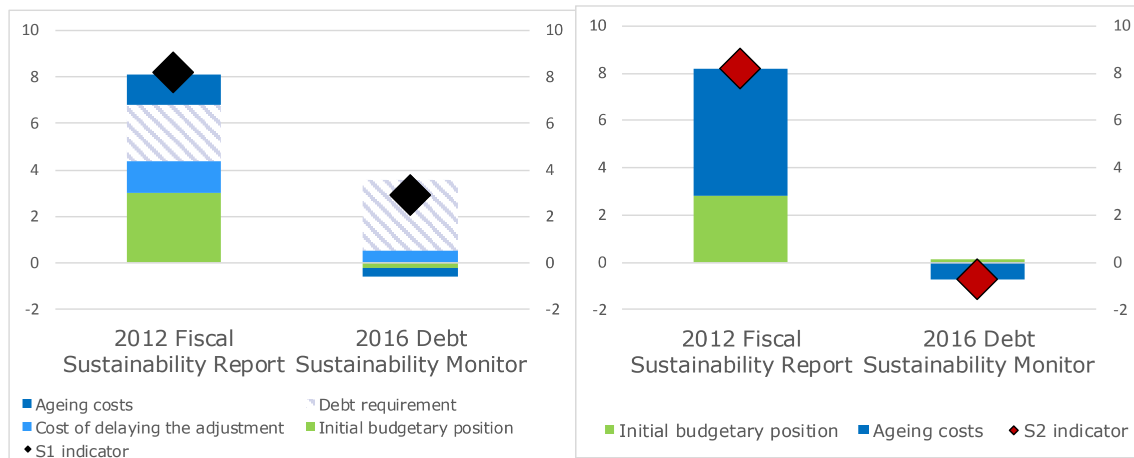
The materialisation of contingent liabilities originating from the financial sector placed a significant burden on the country's public finances at the start of the programme. The crisis that led Cyprus to an economic adjustment programme was not one primarily of a fiscal nature. High budget deficits combined with the disbursement of financial assistance and the materialisation of contingent liabilities such as bank recapitalisations and other support measures to the financial sector prompted large increases in the Cypriot government debt via stock-flow adjustments and primary deficits. In this manner, the government debt- to- GDP ratio rose by 62.4 pps between 2008 and 2014-2015 (from 45.6 % to 108 %, respectively), with the sharpest year-on-year surge occurring in 2013 (23 pps). With low or negative growth underpinning adverse interest rate-growth rate differentials, unfavourable snowball effects also fuelled the debt ratio increases of 2009-2015 (Graph 4.2). During the programme, the debt ratio stabilised at its peak of 108% of GDP in 2014 and 2015, after which its dynamics started turning. ([44])

Consequently, before the start of the programme, the government debt ratio was already high, at about 80% of GDP in December 2012. This level allowed Cyprus limited options regarding the size of the programme envelope. Considering the fiscal policy challenges described in section 4.2, the decision of

([43]) ECA (2016)

([44]) In 2018, additional banking support measures caused a new spike in debt.

Graph 4.3: **Cyprus' fiscal sustainability gaps before and after the programme, Medium-term indicator (S1) and long-term indicator (S2)**



(1) The S1 indicator measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % over a 15-year period. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast; this effort must then be sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively.
(2) The S2 indicator shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively.
(3) As shown in the graph, policy factors such as fiscal policy and reforms affecting the cost of ageing played the main role in reducing medium- and long-term fiscal sustainability gaps. The change in demographic and macro-economic assumptions between the rounds of projections shown played a subsidiary role. Source: Commission Sustainability Reports 2012 and 2016.
Source: European Commission 2012 Fiscal Sustainability Report and 2016 Debt Sustainability Monitor.

an early fiscal consolidation commitment and keeping debt on the lowest possible path appeared crucial to restoring confidence.

A simulation exercise indicates that a bank bail-out financed by the programme would have been difficult to reconcile with debt sustainability considerations. This also confirms the views expressed by several stakeholders, including those in the written surveys where this question was explicitly asked (see Annex 1).([45]) Box 4.1 explores some alternative debt scenarios that could have materialised, had Cyprus further propped up its financial sector with public money. In the 'ex-ante risk scenario', which broadly corresponds to the information available to the Cypriot authorities and programme partners at the start of the programme, debt appeared set on an explosive path. Moreover, while the authorities had performed no specific analysis of contingent liabilities from the banking sector at the time, there was certainly a sense that vulnerabilities remained in the banking sector.([46]) The additional fiscal burden of a bank bail-out in 2013 could have essentially prompted a debt overhang, a condition Cyprus would have found difficult to surmount without even tougher fiscal consolidation and its macroeconomic implications.([47])

([45]) Moreover, the Cypriot authorities stated in the 2013 MEFP Chapter A. Objectives, Strategy and Outlook that "given massive needs of the financial sector, burden sharing with bank creditors, including uninsured depositors, was also required to ensure that public debt does not become unsustainable. In this way, we have ensured that the Cypriot taxpayer does not need to bear the full burden of bank recapitalization costs."

([46]) Indeed, contingent liabilities from the banking sector continued to materialise later on, with a state aid value of 17% of GDP to the banking sector leading to an increase of about 7 pps in the debt–to-GDP ratio in 2018.

([47]) Staff from the Cypriot authorities (DMO, MoF) added in the interviews with the evaluation team that with the extra burden of a bail-out Cyprus would have found it difficult to reach investment grade in 2018.

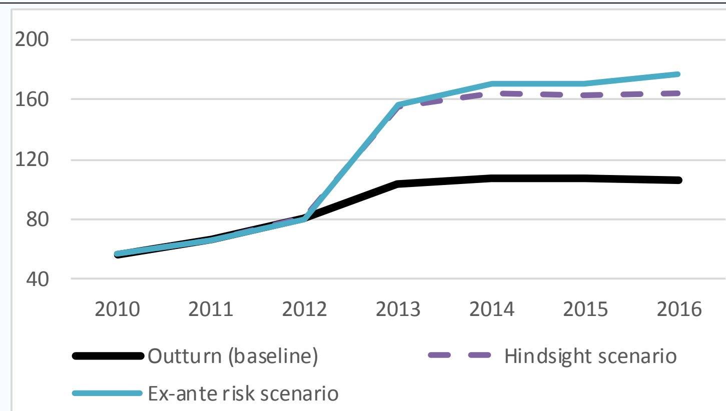
Box 4.1: **Alternative debt paths: Could a bank bail-out have been an option?**

To portray the path the Cypriot government debt could have followed in the hypothetical case in which the country had lent more support to its banking system with programme money, this box presents two alternative scenarios against the actual (outturn) debt ratio or the baseline (Graph 1).

These stylised alternative trajectories labelled the 'Hindsight scenario' and the 'Ex-ante risk scenario' rely on the following main assumptions:

- The bail-in value of about EUR 9 billion corresponding to the financial sector events occurred in Cyprus between June 2012 and August 2013 is considered as a bail-out financed with additional programme money, being recorded as a single entry to the government debt stock-flow adjustments in 2013; ([1])
- The primary balances underpinning the ex-ante risk and hindsight alternative scenarios are considered to be those agreed in April 2013 in the original programme MoU, i.e. lower fiscal targets compared to the actual primary balances observed later([2]). In both cases, a fiscal multiplier of 0.75 applies to the difference (fiscal effort) between the primary balance outturn and the initial primary balance projection. This effect, which is strictly on growth, considers a mechanical impact of fiscal consolidation (fiscal expansion, respectively) on GDP growth whereby a 1 pp. of GDP consolidation effort (expansion, respectively) impacts negatively (positively, respectively) baseline GDP growth by 0.75 pp. in the same year), as in Carnot and de Castro (2015).
- The 'Hindsight scenario' uses outturn GDP figures; conversely, the 'Ex-ante risk scenario' debt trajectory relies on a lower GDP growth path than outturn GDP, reflecting, similar to the initial primary balance, the more pessimistic projections made at the time of programme design. ([3])

Graph 1: **Alternative government debt ratio paths, outturn and counterfactuals, % of GDP**



Note: Simulations based on the Debt Sustainability Monitor methodology. See the European Commission "Fiscal Sustainability Report 2018" and the "Debt Sustainability Monitor 2017".
Source: Authors' estimates

Furthermore, it is assumed that (i) the additional official loan-funded bank bail-out neither changes the implicit interest rate (IIR) observed in the baseline, nor impacts any of the other fiscal or macroeconomic variables (e.g. fiscal efforts are equivalent to those in the baseline etc.); and that (ii) the maturity of the additional official loan is longer than the period covered by the projection (2012-2016), so no repayments are scheduled over this horizon.

(1) For details on the bail-in value, see chapter 3. State aid to Cypriot banks over the period 2010-2016 is not included as additional programme money, since such state aid values are presumably already contained in the stock flow adjustment (SFA) data inputting the baseline/outturn debt stocks.
(2) See the set of primary balances in the initial programme document (MoU, Table 7, page 65). The lower fiscal effort in this scenario, i.e. the difference between the primary balance (PB) initially targeted in May 2013 and the PB realised, is loaded on the SPB. Consequently, the cyclical component and the one-off budgetary measures are assumed identical to the values effectively observed historically in the baseline/outturn.
(3) See Table 7, page 65 in the initial (MoU) programme document.

When looking at fiscal sustainability more broadly,([48]) the associated indicators for Cyprus improved considerably during the programme. The S1 and S2 indicators represent, respectively, medium- and long-term fiscal gaps derived from the government's inter-temporal budget constraint. They essentially show the fiscal adjustment effort a government has to make in order to control its debt ratio and finance any additional costs from an ageing population expected in the future. The two indicators show how a reversal of the fiscal policy stance (as reflected in the initial budgetary position) together with health care and pension reforms curbing projected ageing costs in Cyprus have significantly reduced fiscal sustainability risks in the medium term (S1) and more than offset them in the long term (S2) (Graph 4.3).

Fiscal-structural reforms

Pension reform

The pension reform constitutes a key element to restoring long-term fiscal sustainability. Taken together with the closure of the government employee pension scheme (GEPS) which had been legislated in 2011 before the programme, the link of retirement age to life expectancy yielded a substantial reduction in long-term ageing costs related to pensions – a cost containment of 6.5 pps. of GDP over the 2010-2060 projection period. With the reform, Cyprus moved from being one of the EU's biggest long-term spenders on public pensions to the middle of the ranking of EU member States (Graph 4.4).

The thorough groundwork done by the Cypriot authorities, the main parameters chosen for the reform, and the relatively gradual ageing pressures granted the reform more social acceptance. At the time of adoption of the pension reforms included in the programme, a rich national debate had already taken place with social partners on aspects such as raising pension contributions or extending working lives. Importantly, the adopted reform left pension benefits unaffected and the largest source of long-term pension expenditure containment came through the coverage ratio (Graph 4.5). Moreover, the fact that Cyprus' pension sustainability challenges were not immediate allowed the reforms to avoid painful pension benefit cuts and focus on more socially acceptable measures, such as increases in pension contributions for which there was a leeway, and strategies increasing the effective retirement age, in a forward looking way.

However, risks to reform implementation still exist. Two core drivers of the improvement in pension system sustainability, the increase in pension contributions and the first increase in the statutory retirement age, are to be implemented in the future, which exposes the reform to some risk of reversal (see Chapter 8). As recently seen in some EU Member States, pension reforms are more easily implemented when well understood and adopted with wide political support.

The Cypriot authorities' views and those of the programme partners were largely aligned regarding the measures to be included in the programme, which also facilitated the reform. A certain short-term bias existed in the beginning, as some programme partners favoured measures aiming at quick fiscal savings.([49]) More generally, though, the broad directions of the reform were non-controversial, as the measures eventually

([48]) The European Commission evaluates a country's fiscal sustainability in a multi-dimensional framework whereby debt sustainability analysis (DSA) is a part. In this framework, fiscal risks are assessed at three time dimensions: short, medium and long-term. In the short-term, the risk classification relies on an early-warning indicator of fiscal stress (S0). In the medium-term, the risk classification derives from a combination of the medium-term fiscal sustainability gap indicator (S1), which studies fiscal gaps intertemporally, and the DSA, which considers different scenarios of deterministic and stochastic debt projections. In the long-term, the risk classification is based on a combination of the long-term fiscal sustainability gap indicator (S2) and the DSA. Other elements such as the government debt profile, gross financing needs, contingent liabilities from the banking sector or public assets inform the analysis, but do not count towards a country's risk classification. For more information on the Commission's fiscal sustainability assessment framework, see European Commission (2019).

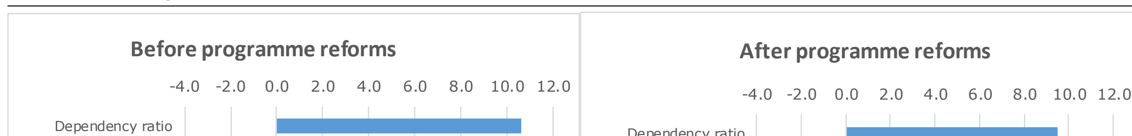
([49]) Following an actuarial study conducted by the Cypriot authorities and reviewed by peers at the Economic Policy Committee's technical working group on Ageing-related cost projections (AWG), this tendency was eventually corrected.

adopted largely reflected plans that had previously featured on the national agenda. Views differed regarding the exact calibration of some parameters such as the statutory retirement age link or the right timing of measures such as pension freezes or penalties for early retirement. Concretely, the Cypriot authorities would have preferred extending working lives by 2/3 of a year for every 1-year gain in life expectancy, whereas the reform option that eventually prevailed was a one–to-one increase. Regarding the increase in pension contributions or pension freezes, the authorities would have rather not adopted such measures in a crisis.

The joint Commission-Member States' methodology and framework established for pension sustainability evaluation at Council committees like the Ageing Working Group (AWG) were useful in designing and approving the reform. Technical committees of the Council operating at EU level largely facilitated the discussion of the pension and welfare reforms. In particular, Member States represented in the AWG and EPC together with the Commission and the ECB peer-reviewed and supported the reform, following a procedure established for such purposes.

According to the Cypriot authorities, the lessons learned from the pension reform are fourfold. First, maintaining social trust when designing reforms is crucial to the success of the reform. Second, a long-term perspective is necessary for a comprehensive and balanced assessment. Third, the structure of a system should be preserved as opposed to a complete overhaul, since the former fosters social trust. Fourth, where

Graph 4.4: **Drivers of the gross public pension expenditure increase in Cyprus from 2010 to 2060, before and after programme reforms in pps. of GDP**



(1) For the exact measures evaluated here as part of the programme package see section 4.1. Pension reform
(2) All figures are based on ESA 1995. However, the accounting standard does not influence the results which represent differences in projected pension expenditure with respect to the base year, as % of GDP
Source: Ageing Report 2012 projections before and after the reform (Pension country fiche for Cyprus)

the national capacity exists, allowing leeway in the design and implementation of the reform increases ownership and chances of success.

Health care reform

Health care reforms in the programme were not fiscally motivated, but rather structurally. Cyprus had constantly spent less on health care with respect to the EU average. Similarly, all projected spending increases are relatively small in Cyprus, according to the Ageing Report and the Commission's fiscal assessment framework. An overview of ageing-related expenditure projections for Cyprus before and after the programme confirms that the main public expenditure item making sustainability-related reforms necessary was pensions, not health care (Graph 4.5). As explained by some stakeholders, the weaknesses of the Cypriot health care system were more of a structural nature: the system featured sub-optimal design, inadequate access, unsustainable funding, inefficient spending, failing to achieve the best value for money.

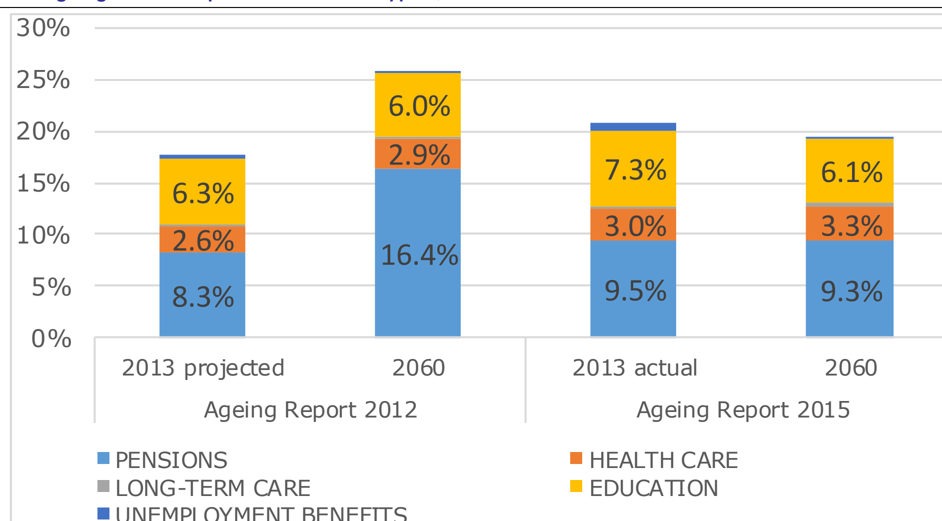
In reality, the health care reform was neither vital nor instrumental to the main programme objectives and Cyprus' return to markets and could have remained outside the programme. Health care was a non-core policy area on which the programme partners were not ready to spend political capital. There was probably a sense that large structural reforms were not feasible to achieve over the short time horizon of a 3-year programme, so programme disbursements were not conditional on the health system developments. Given this evidence since the beginning, arguments for including health care in a programme are not straightforward. Indeed, standard multilateral surveillance under the European Semester is sufficiently equipped to tackle policy recommendations addressing the challenges listed above. Moreover, including conditionality for large reforms would have required more resources, more technical knowledge, and more political leverage.

Health care was a high-risk structural reform marked by large delays in the different measures adoption and implementation. Political economy factors and rivalling interests of the main stakeholders involved – such as the patients lobby, trade unions, professions, and private physicians – posed risks to the reform and delayed the adoption and implementation of programme measures.

Fiscal governance

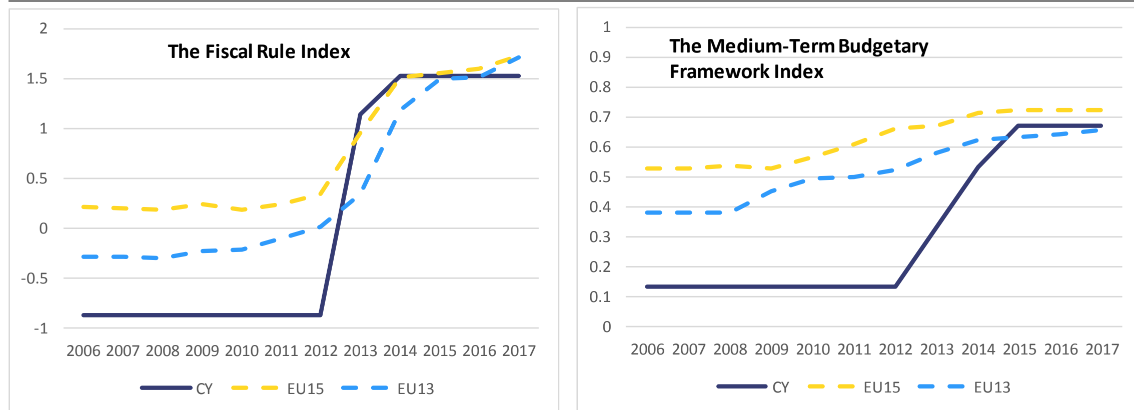
The comprehensive fiscal governance reform introduced during the programme ensured compliance with EU legislation. The programme reviews were utilised to safeguard the proper national transposition of the relevant EU level

Graph 4.5: **Ageing-related expenditure items in Cyprus, % of GDP**



Source: Ageing Reports 2012 and 2015

Graph 4.6: **Fiscal governance indices in Cyprus, EU15 and EU13, 2006-2017**



Note: EU15 refers to 'old' Member States, EU13 to 'new' Member States (that joined the EU in 2004 or later).
Source: DG ECFIN Fiscal Governance Database

legislation (Budgetary Framework Directive, Two-pack, and Fiscal Compact). The stipulation of new domestic fiscal rules and the enhancement of the medium-term orientation of budget have elevated Cyprus' fiscal governance framework from the bottom of the league to the average level of the EU (see Graph 4.6 showing the strength of the numerical rules and medium-term budgetary frameworks procedures). The programme, in general, did not intend to go beyond what was supposed to be adopted by all concerned EU Member States. However, the EU's value added in designing programme conditionality and of regular reviews offered the opportunity to ensure that the national transposition measures were as close as possible to the Commission's interpretations.

Overall, the design of the fiscal framework reform was appropriate in terms of improving fiscal discipline and institutional efficiency. Stakeholders from the Cypriot authorities singled out the phasing-in of medium-term budgeting as the most important breakthrough in the Cypriot budgeting processes. It has been rigorously implemented at the central level over the recent years, which is also shown by the strict enforcement of the multi-year expenditure envelopes defined for line ministries. Furthermore, the establishment of the independent Fiscal Council strengthened the credibility of the framework by providing an alternative source of expertise in budgetary affairs, in particular by delivering regular compliance assessments with national fiscal rules and critically evaluating the macroeconomic forecasts underlying fiscal planning.

Privatisation and State-Owned Enterprises

The repeated delays in designing and implementing the conditionality on privatisation meant that reform fatigue set in before key steps were completed in the sale process (e.g. launch of international call for expression of interest). Drawing up reliable inventories of public sector financial and non-financial holdings and commissioning-related studies from private advisors were long overdue as relevant information was often not available in this field.([50]) The observed delays with the originally planned transactions also implied that the EUR 1 billion revenue target was not achieved, and the potentially associated benefits (reduction in contingent liabilities, reducing public debt, attracting foreign direct investments) could not be realised. According to the Cypriot authorities, the SOE reform plans seem to have suffered from a widely perceived interlink with the privatisation plans: the societal reservations against the notion

([50]) A large study by consultants on public assets in the EU identified Cyprus as a country with important data limitations regarding the operation of its SOEs. See the documents at: https://ec.europa.eu/info/evaluation-reports-economic-and-financial-affairs-policies-and-spending-activities/analysis-public-assets-and-their-management-european-union_en

of privatisation also hampered the restructuring and modernisation of SOEs, associated by stakeholders as the start of a wider privatisation strategy. During the first two years, privatisation deals were not designated to be prior actions, and towards the end of the programme the international creditors' leverage also significantly weakened, in particular once it was clear the programme would be perceived as a success and a clean exit was viable.([51])

Public administration reform

While there have been some early improvements in the staff regulation for public officials, the comprehensive public administration reform laws could not get the support of the Parliament. The political rejection for the legislative package on horizontal reforms was the most startling development as it had been finalised following very thorough discussions between the authorities and public sector trade unions and with outreach to all political forces as well. As mentioned by several stakeholders, a key reason for the poor record in this domain is likely to have been that these public reforms were not a high priority for the Cypriot authorities or the international creditors as these were not critical to achieving the primary financial and fiscal sector objectives of the programme.

Tax policy reforms

The measures to revamp the organisational structure of tax administration were broadly successful, whereas fewer results were achieved to fight tax evasion and reduce outstanding tax obligations. The institutional unification of tax offices led to some immediate results (e.g. simplified registration for new companies), but the physical merger had just started during the programme, which might explain that it did not lead to a reduction in the overall headcount. The newly granted powers to reduce outstanding tax debt were not equally useful: these were successfully applied for real estate, but not effective for garnishing deposits. There was an increase in the number of administrative penalties imposed by the tax authorities on companies breaching the tax code. Overall, in the national authorities' view, the efficiency of tax collection has increased, but it was only enough to halt the increase in outstanding tax debt.

The new design of the immovable property tax (IPT) was appropriate but its implementation faced considerable political and technical challenges. The massive hike implemented before the reform amplified the inequity of the tax inherent in the system linked to outdated valuations dating back to 1980. While the intention to merge existing local taxes into the new central IPT was commendable from an efficiency viewpoint, it may have contributed to the political deadlock as it would have required the removal of taxing powers from the local authorities to the central government. According to the Cypriot authorities, more intensive communication about the economic merits and fairness of the reform would have been desirable to overcome some of the resistance from opposition parties and influential property developers.

Overall assessment

Key evaluation questions:

- *Effectiveness: To what extent were fiscal sustainability objectives achieved? To what extent were public finance management and fiscal governance objectives achieved?*
- *Efficiency: To what extent could the fiscal sustainability objectives have been achieved at lower costs in terms of growth and social impact? To what extent did conditionality target the right measures to improve public finance management and fiscal governance?*
- *Relevance: To what extent were the fiscal targets (originally and after revisions) appropriate to achieve the fiscal sustainability objectives? Why were macroeconomic*

([51]) In autumn 2015, launching the expression of interest for CyTA was made a prior action for the 8th review that was never concluded mainly for that reason.

outcomes better than projected and what were the implications for fiscal targets? To what extent were compliance requirements on fiscal-structural policy conditionality appropriate?

- *Coherence: To what extent was there an underlying medium-term growth strategy which ensured coherence across all policies? To what extent were fiscal-structural measures and other programme measures coherent?*
- *EU added value: To what extent was the programme guided by the rules of the Stability and Growth Pact? To what extent was the programme guided by the transposition requirements of EU legislation (Budgetary Frameworks Directive, Two-pack Regulation and the intergovernmental Fiscal Compact)?*

Pessimistic macroeconomic projections at the outset of the programme had a two-sided effect on expectations and programme credibility. An apparent bias of programme partners towards cautious projections was partly driven by the large uncertainties on the macroeconomic effects of financial stabilisation measures and partly motivated by considerations on the relative balance of risks stemming from a potential underachievement versus a potential overachievement of real GDP growth. The room for positive surprises was to some extent seen as potentially strengthening the market confidence in the programme. At the start of the programme, projections affected negatively expectations and foreign investor sentiment, dampened the economic outlook and had a bearing on the scope of fiscal policy measures. They further had an impact on debt sustainability analysis and CRA ratings, i.e. those aspects of the programme that are crucial for programme design and the financial envelope. Later in the programme when it became obvious that the downturn would prove less severe, output growth was exceeding expectations, market sentiment improved, and the assessment by CRAs was positively affected.

In retrospect, the specific fiscal targets may appear ambitious, but they were relevant in effectively containing debt at the time, signalling to the markets that the government was capable to deliver fiscal discipline. Importantly, fiscal targets were consensual, being set in agreement with the Cypriot authorities who also concurred with their upward revision as they saw advantages to signalling fiscal over-performance. Macroeconomic over-performance, explained by conservative projections and a high resilience of the Cypriot economy, facilitated the achievement of fiscal targets even in a tightened form. Fiscal-structural policy conditionality such as the pension reforms crucially improved long-term fiscal sustainability, indirectly helping Cyprus' return to the markets. Measures on health care were not motivated by fiscal sustainability and were not needed to achieve the programme objectives, but stakeholders believe they adequately flanked fiscal consolidation. With hindsight, some items in the fiscal-structural conditionality could have been more front-loaded, for example privatisation and the comprehensive public administration reform, when there was still a social consensus on the need for urgent changes.

The programme was very effective and relevant in improving the long-term sustainability of Cypriot public finances. Significant and sustained fiscal efforts contained the surge in the government debt ratio that ensued from the disbursement of financial assistance and the materialisation of contingent liabilities. They are also key in projecting a steady fall in Cyprus' government debt ratio over the next decade, in 2019 one of the largest debt-to-GDP stocks in the EU.([52]) Pension reforms legislated already ahead of the programme bore fruit on the ground and were well prepared by the Cypriot authorities; they reduced long-term pension expenditure substantially, at the same time as they avoided harsh policies.

Fiscal-structural measures varied in their effective contribution to fiscal consolidation during the programme horizon. Some that were foreseen to directly and immediately contribute to the planned fiscal adjustment, e.g. the immovable property tax reform, did not materialise or were explicitly reversed in the first years of the post-programme period. Other reforms that have a

([52]) See Cyprus Country Report 2019 and Fiscal Sustainability Report 2018, Volumes 1 and 2.

longer-lasting effect in promoting a sound budgetary position were more successful such as, most notably, a strengthened domestic fiscal framework, revenue administration reform, or an improved monitoring and management of risks. On welfare, the GMI successfully streamlined welfare spending, improved targeting and featured smooth implementation.

The overall policy approach to fiscal consolidation, pension and welfare reform, and the revamp of fiscal governance was efficient, as it more than delivered on the fiscal sustainability objectives while using an adequate set of measures. Fiscal consolidation was deliberately frontloaded, intending to draw more on expenditure than revenue and foreseeing clearly-defined measures since the beginning. This strategy fully reflected the Cypriot authorities' fiscal policy intentions, as national proposals largely passed through to the MoU, in a bottom-up fashion. Pension sustainability improvements drew mainly on the link of the statutory retirement age to life expectancy, additional increases in pension contributions from both employers and employees, and an extension of the reference pensionable earnings to life-time service, all of which more socially viable than, for instance, pension benefit cuts. While achieving and exceeding their fiscal sustainability targets, these measures had only limited social impact, thanks to a set of relevant features. Fiscal consolidation measures were detailed, transparent, introduced at once to avoid uncertainty, and targeted higher income groups. In some fiscal-structural areas, measures were prepared well before the programme started, through social consultation and negotiations about reforms. This set of actions increased social trust, gave credibility to the reforms and fostered ownership among Cypriot citizens. In other areas (public administration, privatisation, immovable property tax), the design of the reform steps took much longer than initially expected also linked to social consultations, delaying key plans of the implementation to a period when reform fatigue set in.

EU value added and coherence was ensured through EU policy frameworks that provided guidance on restoring fiscal sustainability. The rules of the Stability and Growth Pact were perfectly integrated in the programme conditionality. Commission - Member States cooperation established in committees at EU level were useful in designing and approving the pension and welfare reform. There was also a clear case of EU value added for fiscal governance reform as the first year of the assistance practically coincided with the national transposition of relevant EU legislation (Budgetary Frameworks Directive, Two-pack Regulation and the intergovernmental Fiscal Compact). Hence, the programme frameworks with its quarterly reviews and detailed negotiations helped to ensure a proper and comprehensive transposition. In areas where the EU did not have a legal prerogative to set policies, such as pensions or healthcare, fiscal sustainability assessment frameworks established by the Commission jointly with Members States provided useful advice in designing the reform.

5. RESTORING COMPETITIVENESS AND BALANCED GROWTH

5.1. PROGRAMME DESIGN AND IMPLEMENTATION

The programme included a broad-ranging set of structural reforms.([53]) Reforms aimed to enhance cost and non-cost competitiveness, improve the functioning of the labour market and return to sustained and balanced growth. Reforms to goods and services markets focused on increasing competition and included specific provisions on housing (including insolvency, foreclosures and the efficiency of civil courts dealing with housing issues), tourism and the energy sector. In parallel, labour market reforms covered two main topics: the wage-setting framework and active labour market policies (ALMPs). This section will focus on those policy areas. Other fiscal-structural reforms (notably privatisations, public administration, education reform, health and property taxation) were part of the fiscal chapter of the MoU. Although the fiscal and structural angles of these policies are present in the programme and are equally important, their assessment is covered in chapter 4 of this report to ensure consistency with the programme documentation.

Labour market reforms

Concerning the wage-setting framework, the programme focused on the effective implementation of the reform of the wage indexation system (COLA, Cost Of Living Allowance) applicable to the broader public sector as determined in the budget of 2013.([54]) In addition, a tripartite agreement was to be pursued for the application of the reformed system also to the private sector by 2014 and, after the fourth review, by 2016. Finally, in order to prevent adverse competitiveness and employment effects, any change to the minimum wage over the programme period was supposed to be in line with economic and labour market developments. After lengthy and, at times, difficult negotiations preceding the signature of the MoU, the authorities implemented a reform of the COLA system and the suspension of wage indexation in the wider public sector until the end of the programme. Social partners also agreed to the suspension of COLA in the private sector for the duration of the programme. After the end of the programme, social partners also agreed on a new way of indexing the COLA in the private sector for the period 2018-2020.([55])

With regard to public assistance and activation policies, the MoU included measures aiming to provide an assessment of current activation policies and to review and enhance the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed. There were also provisions related to the welfare and benefit system reform, notably to ensure synergies and links with activation policies, which are covered in chapter 4.([56]) In line with the relevant provisions in the MoU, activation policies and cooperation between the public employment service (PES) and benefit-paying institutions were assessed by the authorities. This assessment led to the identification of shortcomings and weaknesses.

([53]) This holds only for the EU's MoU while the IMF's Memorandum of Economic and Financial Policies (MEFP) only included those structural reforms that served the objectives of fiscal sustainability and financial stabilisation.

([54]) This reform included a lower frequency of adjustment, automatic suspension and derogation procedures during adverse economic conditions, and a move from full to partial (50%) indexation.

([55]) The agreement foresees that wages will be indexed annually corresponding to half the level of inflation. In addition, wages will not be indexed when negative economic growth is recorded at the end of the second and third quarters of the previous year. In the broader public sector, the same wage indexation mechanism applies on a permanent basis. This mechanism comes in addition to the existing collective agreement with the broader public sector until 2018, which caps payroll growth to nominal GDP growth.

([56]) Additional points were to ensure that the planned reform of public assistance included measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market and reducing disincentives to work and imposing job-search requirements for continued benefit receipt. To this end, the draft reform plan on public assistance was to be submitted to the programme partners by Q2-2013 for review and consultation.

The Cypriot authorities were then requested to submit detailed policy proposals, including (i) the development of a methodology for monitoring and evaluation of activation programmes, (ii) the development of an IT infrastructure for data management, (iii) the centralisation of the administration of all activation programmes, (iv) the enhancement of staff mobility to the benefit of PES([57]) and enhancement of cooperation between these services, social welfare services and benefit-paying institutions.([58]) The Cypriot authorities committed to present a reform plan on public assistance, including measures to activate benefit recipients by facilitating reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements. At the time of the first review (July 2013), the Cypriot authorities committed to present an action plan for youth employment.([59])

Reforms of goods and services markets

Reforms of goods and services markets covered a broad spectrum of policy areas. Those included services and regulated professions, competition and sectoral regulatory authorities, housing, tourism, and energy. Later on, the Cypriot authorities committed to develop a comprehensive growth strategy.

A number of measures aimed at reinforcing competition on goods and services markets. The Cypriot authorities committed to the full implementation of the Services Directive, including in relation to entry, establishment and minimum tariffs. With reference to regulated professions, total bans on advertising and unjustified or disproportional requirements affecting the access to or exercise of an activity were to be eliminated. The programme included enhancing the independent and effective functioning of the competition authority and of the national regulatory authorities (NRA). At the time of the third review (February 2014), the Cypriot authorities also committed to ensuring adequate financial and personnel means for the General Auditor's Office.

To strengthen the competitiveness of the tourism sector, the programme requested studies on how to improve its business model and achieve sufficient air connectivity for Cyprus. The programme requested a concrete action plan towards quantified targets for the tourism sector([60]) and an aero-political strategy leading to the adaptation of Cyprus' external aviation policy. Later on, the programme included the request for a roadmap with milestones to reach the targets set in the tourism strategy and the finalisation of a national tourism strategy. Another measure envisaged already in the original programme was the facilitation of condo hotel projects.([61])

At the time of the third review (February 2014), the Cypriot authorities committed to develop a comprehensive growth strategy based on Cyprus' competitive advantages, which would

([57]) At the time of the third review (February 2014), this measure became wider, referring to the enhancement of the administrative capacity of PES, via increased staff mobility and/or outsourcing of specific tasks. At the time of the sixth review (May 2015), the Cypriot authorities were requested to prepare a detailed description of all actions taken or envisaged in the short term to improve the provision of PES services. In addition, reference is made to the recruitment of additional staff through the European Social Fund (ESF) budget.

([58]) At the time of the sixth review (May 2015), the Cypriot authorities were requested to prepare a comprehensive note on the concrete measures undertaken, covering steps to avoid welfare dependency and links with social welfare services.

([59]) At the time of the third review (February 2014), the Cypriot authorities were requested to prepare a comprehensive note summarising the full list of all active labour market policies (existing and envisaged).

([60]) At the time of the third review (February 2014), an additional measures was included concerning the enhancement of the coordination of the competent authorities with a direct link to tourism. At the time of the fourth review (May 2014), an action plan was supposed to cover coordination of the various tourism stakeholders and relevant authorities. At the time of the fifth review (September 2014), the Cypriot authorities committed to assess the Cyprus Tourism Organisation (CTO) legal framework, in order to identify obstacles to competition. With the sixth review (May 2015), the programme specified that the assessment was supposed to cover the overall regulatory framework (including the CTO law).

([61]) At the time of the first review (July 2013), the Cypriot authorities committed to amend hotel legislation, in order to facilitate mixed-use developments.

help kick-start the economy.([62]) Subsequently, the programme requested an action plan and the assignment to a single body of the task of developing, coordinating and enforcing this growth strategy. This strategy should also aim at improving potential growth, by investing more in R&D and innovating more.

Concerning the housing market and immovable property regulation, the programme included a wide range of measures. Mandatory registration of sales contracts was to be provided for, while addressing the backlog of title deed issuance.([63]) In addition, the Cypriot authorities committed to take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchasers and to implement guaranteed timeframes for the issuance of building certificates and title deeds.([64]) The financial sector and government services were supposed to be given electronic access to registries of title deeds, mortgages, sales contracts and cadastre. The procedure on the forced sale of mortgaged property was to be amended to allow for private auctions. To improve the pace of court case handling, a range of measures, which evolved during the programme period, was included.

The programme requested the full implementation of the Third Energy Package and the formulation of a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy was supposed to include (i) a roll-out plan for the infrastructure required for the exploitation of natural gas;([65]) (ii) an outline of the regulatory regime (CERA) and market organisation for the energy sector and the gas sector;([66]) (iii) a plan to establish the institutional framework for the management of hydrocarbon resources, including a resource fund, which should receive and manage the public revenue from offshore gas exploitation and sales.

5.2. OVERALL OUTCOME AND ASSESSMENT

Labour market reforms

The labour market in Cyprus was performing well before the onset of the crisis but unemployment increased significantly afterwards. The labour market in Cyprus had outperformed most EU member states in the decade preceding the crisis. In 2008, the employment rate was around 76% of total population, among the highest in the EU, while the unemployment rate had hovered around 4% in the previous decade. In spite of significant wage cuts agreed in both the public and the private sector prior and following finalisation of the MoU, the strong deterioration of the labour market in the wake of the double-dip recession, with unemployment doubling from about 8% in 2011 to

([62]) With the fourth review (May 2014) the purpose of the strategy became to "help the economy to move to a sustainable growth path".

([63]) Between 120.000 and 130.000 properties in Cyprus were lacking title deeds. The average time for obtaining a title deed was about 12 years. This created impediments to transactions in the housing market.

([64]) During the programme, progress reviews were to be published of the issuance of building and planning permits, certificates and title deeds, as well as deed transfers and related mortgage operations. At the time of the third review (February 2014), the Cypriot authorities committed to prepare an action plan to streamline the process within the Department of Land Survey (DLS) and between the DLS and the Local and District authorities and the Ministry of Interior Technical Assistance. At the time of the fourth review (May 2014), explicit measures were included about deadlines for the issuance of certificates of completion and certificates of final approval. At the time of the fifth review (September 2014), further commitments were specified in the MoU in view of streamlining all procedures from the planning permit application to the issuance of the title deed.

([65]) At the time of the second review (November 2013), the programme specified that the Cypriot authorities were supposed to undertake a financial and budgetary impact analysis prior to the finalisation of the forthcoming energy sector government agreement between Cyprus and the contracting parties to a production sharing contract. This analysis was supposed to include the evaluation of options with reference to a LNG (Liquefied Natural Gas) project development plan. At the time of the sixth review (May 2015), the Cypriot authorities committed to undertake a financial and budgetary impact analysis of the Field Development Plan of the Aphrodite gas field.

([66]) At the time of the fifth review (September 2014), in this context, the Cypriot authorities committed to include an assessment with a focus on renewable energy sources. At the time of the sixth review (May 2015), based on the outline, the Cypriot were called to make a decision on the preferred option.

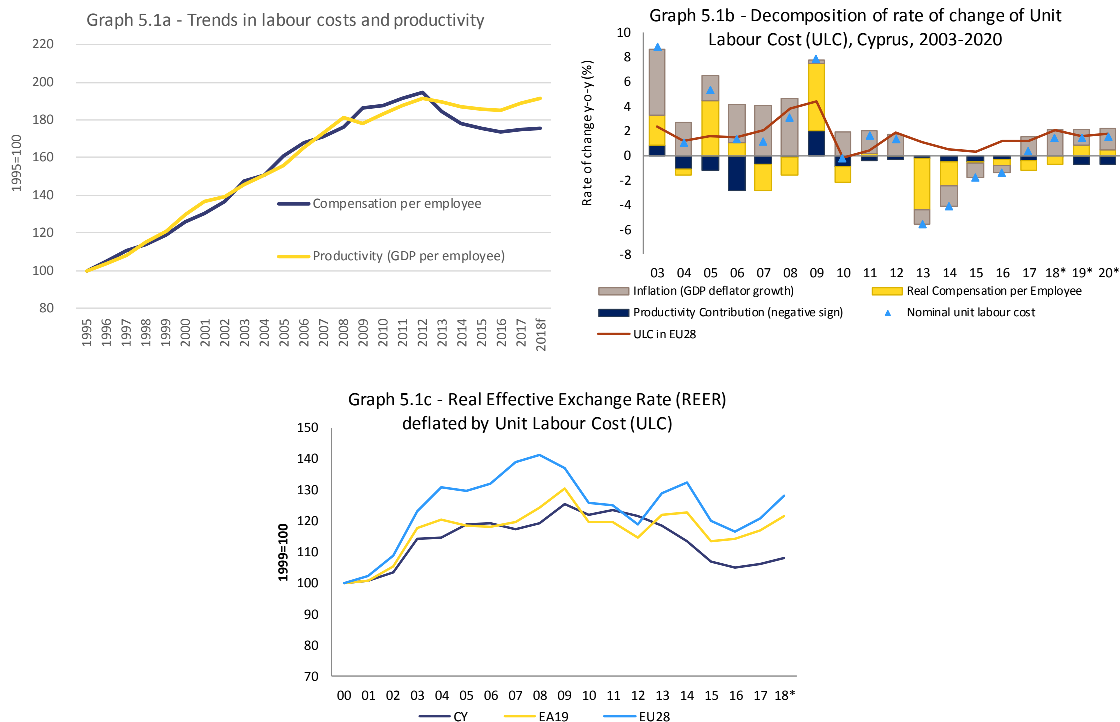
16% in 2014, was interpreted as underscoring the need for greater wage moderation and an overhaul of existing labour and activation policies with a view to preserving cost-competitiveness and employability. In fact, a reform of the wage indexation system had already been discussed for some time, notably in the context of euro accession. The IMF had recommended it in 2009 (IMF Article IV report, 2009) and the Council issued a Country-Specific Recommendation calling for a 'reform of the system of wage bargaining and indexation' in 2011. In a way, the MoU reflected an ongoing policy discussion rather than a new challenge.

Already before the crisis, the labour market was quite flexible and wages had historically evolved broadly in line with productivity (see Graph 5.1**).** The labour market in Cyprus did not suffer from evident rigidities. This was confirmed by various stakeholders interviewed (staff from authorities and programme partners) and the prevailing view in policy reports, and its flexibility was partly proven by the use of part-time work, the facility to implement lay-offs after 2011 and the rapid decline of unemployment when the recovery began. In terms of costs and prices, the situation had worsened in the run-up to the crisis, especially in industry and construction ([67]), but overall there had not been a major divide in terms of wage-productivity dynamics. Over the previous two decades, wages had grown in line with productivity, unit labour cost dynamics and the real effective exchange rate (deflated by unit labour costs) evolved broadly in line with the euro area average. From an institutional perspective, relations among social partners proved quite mature, with trade unions agreeing independently in 2011 – where no programme was under discussion - to nominal pay cuts and to the temporary suspension of COLA within the broader public sector.([68]) Overall, those elements suggest that the major external and internal imbalances, including price and inflation dynamics, were probably mostly related to massive pre-crisis capital inflows feeding into high growth in domestic demand rather than the existing labour market institutions.

([67]) Although the data on the aggregate do not show large losses in competitiveness, data on sectoral unit labour costs developments reveal non-negligible spikes in certain years for industry (excluding construction) and construction, only partly compensated afterwards, pointing to likely excessive labour costs growth in those sectors compared to the rest of the economy.

([68]) For the voluntary extension of such agreement to the private sector, discussions had also already started in 2012 on the basis of a proposal submitted by the Minister of Labour and Social Insurance. In line with the reform for the public sector, the proposal included a provision for the suspension of COLA in the event of negative economic growth rates in the second and third quarter of the preceding year, as well as the disbursement of COLA once instead of twice a year. Although the new metrics was not permanently adopted, the suspension of COLA in the private sector was effectively implemented throughout the full duration of the programme, in line with the extension requested at the time of the fourth review of the MoU.

Graph 5.1: **Trends in productivity, wages, unit labour costs and real effective exchange rates in Cyprus**



Source: Commission services

Despite a good performance in the past, the twin challenge of euro area accession in 2008 and the subsequent unfolding of the financial crisis arguably required giving high attention to competitiveness. There are several theoretical arguments for avoiding strictly automatic wage indexation within an economic and monetary union where the main adjustment mechanism is internal devaluation. This is particularly the case when inflation is persistently higher than in other members of the euro area, when it spirals out of control through secondary effects and feeds into expectations, or at major turning points, as there may be a decoupling between productivity development in year *t* and inflation developments at *t-1*. This latter scenario is clearly visible in 2009, when real compensation of employees increased, despite a drop in productivity. At the time of the signature of the memorandum, it was also believed that increased downward wage stickiness resulting from application of COLA would be an impediment to the economy's ability to respond in a low-growth environment.([69]) Finally, a uniform application of COLA across sectors was seen as introducing an undesirable element of rigidity in the labour market. Although there is both industry and company-level bargaining in Cyprus, it was feared by programme partners that those institutions would not manage to rein in unjustified upward pressures on wages.([70])

([69]) However, the suspension of COLA during the duration of the programme actually prevented a downward nominal adjustment, when inflation was negative.

([70]) Overall, while some rigidity may bring economic advantages in the short-term, notably in cases of temporary short-term shocks, as it helps to preserve purchasing power during a downturn, therefore acting in a countercyclical way; in the long-run, if not accompanied by other adjustment mechanisms or institutions, it may hamper the ability of wages to reflect productivity differences across economic sectors and therefore negatively affect competitiveness and an efficient allocation of resources.

In terms of outcomes, it is difficult – if not impossible - to measure the economic impact of the requested (permanent) COLA reform. As already mentioned, COLA was suspended, in line with the MoU, during the whole programme for both the public and private sector. Furthermore, inflation was negative during the whole duration of the programme. However, even after the end of the programme, inflation was below 1% in 2017 and 2018, meaning that the impact of the reformed formula is quite negligible. On the one hand, the reform may be useful to avoid steep wage increases at the next turning point, since automatic (rather than discretionary) derogations in case of adverse economic conditions have been introduced. On the other hand, trade unions considered COLA a core element of the set of collective agreements that have led to peaceful industrial relations.([71]) This social institution established a peaceful working environment in the country, where discontent over major labour polices was avoided and the right to strike was rarely exercised in practice. Against this background, as it is too early to see the potential benefits of the COLA reform, it is probably also too early to see if the strains over long negotiations may pose a burden on future relations among social partners or negatively impact the perception of European institutions among some of them.

From an efficiency perspective, it is likely that the same outcomes in terms of cost-competitiveness could have been obtained with less prescriptive conditions on wage indexation. Within the time-span of the programme, inflation was forecast to be quite subdued, with deflation actually occurring. In light of the limited magnitude of the previous wage-productivity gap, and as stated by some interviewees from programme partners, the approved suspension of COLA could have been sufficient to keep competitiveness in check (in cases of unexpected bouts of inflation), while saving some 'negotiating capital' for more urgent structural reforms that were left on the back seats (e.g. housing, title deeds, duration of legal disputes, efficiency of the judiciary). From an EU added value point of view, this would have been helpful also because there are no official EU policy frameworks clearly regulating the parameters of wage indexation, and opinions on the optimal elements of a parametric reform may differ. On the other hand, other interviewees from programme partners and stakeholders mentioned that a comprehensive reform of the system had been needed for a long time and the signature of the MoU was the right occasion to put pressure on the authorities and social partners to deliver it. For the reasons mentioned above, and in light of the structural requirements brought by euro area accession, a reform of the COLA was arguably needed and justifiable as part of the programme. However, in view of the long discussions and political capital needed to negotiate its inclusion in the programme, as well as in view of its reversibility post-programme, some of the details could have been negotiated later in the programme so as to increase ownership from social partners and national authorities. For instance, the parametric details could have been negotiated on the basis of the 2012 tripartite agreement, which addressed the key issue of the suspension of indexation in the case of recessions, a lower frequency of adjustment and the introduction of a progressive scale system.([72])

The case of the COLA reform points to the general need to assess carefully ex ante the pros and cons of integrating very detailed policy conditionality in the absence of sufficient ownership. On the one hand, the inclusion of well-specified measures in a programme may allow the

([71]) Traditionally, governments in Cyprus would put draft measures concerning the labour market in Cyprus into consultation with social partners and trade unions (politically affiliated) before submitting them to the Parliament.

([72]) Before the request for financial assistance was formalised, the Government had already tabled a proposal for reform of the COLA following discussion with the social partners in 2012. This included: i) a lower frequency of adjustment (annual rather than biannual); ii) the possibility of suspending the automaticity of wage indexation in periods of recession; and iii) the introduction of a new reverse progressive scale system under which wages would be fully indexed up to a given income threshold, and then at progressively lower rates for income falling within higher income brackets (full application of the COLA for monthly gross salaries up to and including € 2,400, 75% of the COLA applied to monthly gross salaries from € 2,401 to € 3,700, 50% of the COLA applied to monthly gross salaries from € 3,701 to € 5,000, and no application of the COLA for any part of monthly gross salaries exceeding € 5,000).

implementation of a reform that might not happen in a different context. On the other hand, this may come at the expense of ownership and it usually also implies a lack of a thorough consultation process and an assessment of the different options and their impact. Although the trade-offs between prescriptiveness and ownership are not constant across the policy spectrum and have to be continuously re-assessed on a case-by-case basis, in the case of COLA it appears that well-defined overarching objectives and guiding principles of the reform could have been set in the initial MoU and the detailed modalities of their implementation defined later on in the programme. From an EU added value perspective, given the lack of a one-size-fits-all approach, guidelines could draw on commonly agreed principles, as enshrined in relevant EU acquis (e.g. EU Treaties, EU Pillars of Social Rights, etc.), while leaving to the national authorities enough leeway to work towards their achievement following a commonly agreed but country-specific path.

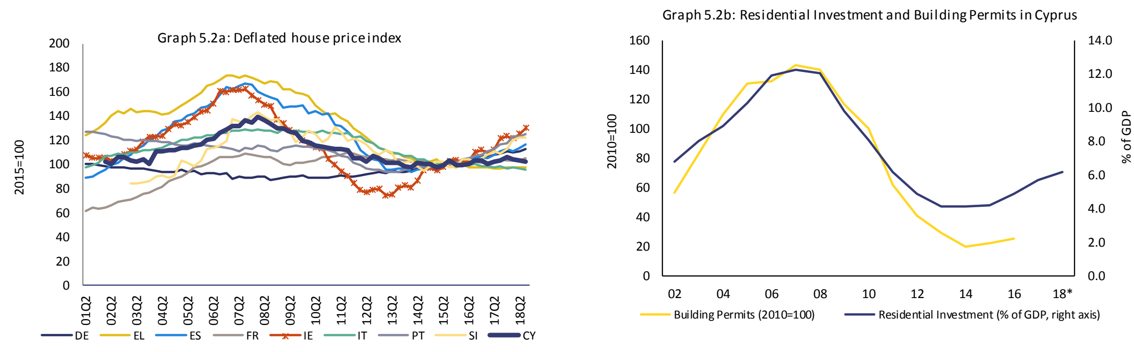
Public assistance and activation policies

The authorities put forward a clear and coherent strategy to integrate the system of activation policies with the broader reform of the social assistance system as defined in the fiscal chapter of the MoU. The envisaged reform of the welfare system, which included, inter alia, the introduction of a guaranteed minimum income (GMI) scheme, promoted 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. Indeed, several stakeholders interviewed mentioned the reform of the social assistance and benefit scheme linked to the introduction of a GMI as a key success of the programme. This was developed in close cooperation with the authorities and based on sound economic analysis using the existing tools (e.g. Euromod simulations) for simulating the distributional impact of different reforms options. The Commission's Support Group for Cyprus also provided useful technical assistance. Throughout the process, the government consulted social partners as customary.

In terms of outcome, participation in active labour policies is increasing but remains below the EU average. In 2015, there were 9.2 participants for every 100 people willing to work, which represents an increase from 2013 (5.6 participants) but it remains significantly lower than the EU average (23.7). Cyprus invested in the administrative capacity of the public employment service (PES) but its effectiveness still remains a challenge. In October 2017, a call for 30 additional PES counsellors was published, with a view to being recruited on the first half of 2018, albeit on a short-term contract (24 months). The long-term sustainability and quality of services, in particular in areas that are lagging behind (e.g. customer segmentation, personalised guidance and activation) and the provision of services to employers, still remain a challenge. Additional initiatives include peer support projects from other PES in the EU and an IT platform for use by both employers and job-seekers to better match labour market demand and supply. Cooperation with the private employment services has also been developed. However, the provision of services to both employers and job-seekers is still sub-optimal.

Given the fragmentation of the system of social assistance and the room for improvements in the design and delivery of ALMPs, the MoU identified relevant bottlenecks. Although it could be reasonably argued that those issues were only marginally related to the emergence of imbalances in the run-up to the crisis in Cyprus, the deterioration of labour market and public finances conditions in its aftermath called for a reassessment of the existing system to make it more efficient and possibly less costly. As for all reforms falling under these politically and distributionally sensitive areas, ownership of national authorities is key for their success. In the case of Cyprus, it was important that preferences between programme partners and the government on those issues were broadly aligned and that reform options were carefully analysed and discussed on the basis of a shared assessment before being implemented.

Graph 5.2: **Deflated house price index, residential investment and building permits in Cyprus**



Source: Eurostat, OECD, BIS, Commission services calculations

Reforms of goods and services markets

The programme included a broad range of structural reforms on the product and service market, but the track record in terms of their implementation is mixed. The services directives were fully transposed, competition in the energy market was to some extent opened in 2014, the backlog of title deeds was eventually reduced, and the tourism strategy was long delayed but then integrated into an Action Plan for Growth. In sum, these reforms may have contributed to improving the overall business environment but do not appear to have acted as catalysts for a permanent, structural change to the growth model.

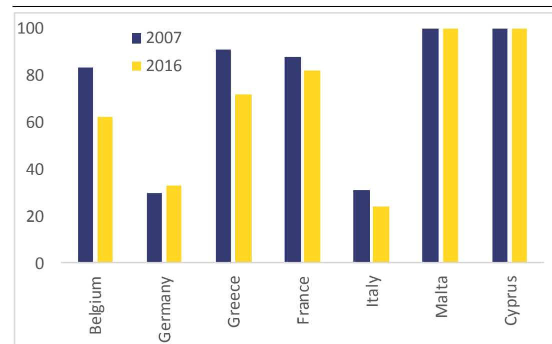
In the housing market, the adoption of the legacy cases law for title deeds (for property sales up to end of 2014) created some momentum and helped resolving legacy issues but more steps are needed to have a new system of swift, safe and automatic transfers of titles. This is essential to ensure that the benefits of the reformed insolvency and foreclosure framework are maximised (see chapter 3). The urgency of the title deeds problem, however, was perhaps fully recognised only in the middle of the programme, thereby hampering the progress made in the areas of insolvency and foreclosure, and in turn negatively affecting the reduction of NPLs and access to credit. In terms of price dynamics, a significant correction has already taken place and the weight of residential construction remains well below pre-crisis levels as a percentage of GDP. Although robust growth in house prices is useful to reinforce the balance sheets of domestic financial institutions, the prices of dwellings remain high compared to households' income. The housing market, however, is also rather segmented. The proportion of foreign holders is important in some areas and may therefore explain strong price dynamics.

Although included as a sub-chapter in the housing market section of the MoU, improving the pace of civil courts case handling is a crucial yet delicate area that – in the full respect of the autonomy of the judiciary - could have deserved more prominence. The long duration of legal disputes and the backlog of pending decisions is an obstacle to the proper implementation of the insolvency and foreclosure frameworks. However, those shortcomings can also deter investment since they delay the enforcement of contracts. Given the relevance of the issue for the economy as a whole, it may have been justified to retain more visibility for the matter. Awareness of its importance has in any case grown over time and, after the programme, the Supreme Court has drafted a reform plan highlighting the priorities in improving the justice system (e.g. introduction of streamlining procedures, hiring of judges, upgrading IT resources, creation of a commercial court). Given the size and scope of the reform, this is likely to take several additional years to come to completion and bear fruits. Although it is not realistic to implement such a comprehensive overhaul of the system in three years, the vast majority of stakeholders reported that the MoU has served the important purpose to start a medium-to-long term reform process in one of the most crucial areas for the business and financial environment.

On the energy market, synergies between structural and fiscal reforms (e.g. privatisations, PPPs) could have been further clarified. The energy market is still extremely concentrated, there are only a few independent power producers and prices are still high (see Graph 5.3). Although in the medium-term the energy market should benefit from higher and fair competition, many of the existing features are linked to geography, market size and legacy issues. On energy matters, technical assistance provided by the European Commission was considered by several interviewees as extremely useful. For instance, the comprehensive study on the possible benefits of the privatisation of the Electricity Authority Cyprus (EAC) showed that the first route to lower operating costs would be to diversify fuel.(73) Since energy prices, especially after the crisis, were regulated at a relatively low rate in relation to production costs, the study showed that the low returns generated by EAC may create problems in financing the necessary upgrade of the capital stock. In the face of low returns, interviewees from the authorities mentioned that they found limited appetite from the private sector, and a pilot survey to identify prospective buyers received no participation, a further indication that privatisation would only be attractive at higher returns for the buyer which in turn may require higher energy prices.

(73) The report showed that the main determinant of energy prices in Cyprus was the high cost of fuel, which accounted for almost two-thirds of production costs in certain years. In this respect, investing in renewable is an area where much more could be done, especially in the medium-term perspective. Importing Liquefied Natural Gas (LNG) also seems a promising route in the short-term and it is currently being implemented. Finally, creating the infrastructure for gas reserves does not seem to be financially viable for Cyprus.

Graph 5.3: **Market share of the largest generator in the electricity market in selected EU Member States**



Source: Commission Services

Several stakeholders argued that, with hindsight, the ambition of the MoU on the energy sector perhaps underestimated the complexity and role played by geographical and geopolitical factors as well as vested interests. For instance, the Law setting up a sovereign wealth fund was only approved in 2019 by the Cypriot Parliament.(74) Overall several interviewees from programme partners and national interviewees pointed to a limited openness from the side of the authorities to privatise SOEs and, even when broader policy objectives were shared (e.g. gas exploitation), to detailed external guidance on the way to implement reforms. This, by and large, explains the limited progress made *de facto* on the reform of the energy sector. In this regard, the approach followed by other programme partners, such as the IMF, was less stringent and did not include detailed language. It is hard to tell if it was more or less appropriate in the context of the programme, however, given the limited results achieved in this field, it was probably more efficient. Although privatisations of network industries did not take place, a more balanced approach could have been reached in the MoU between the objective of generating windfall revenues for the treasury and the objective - usually requiring a medium-term strategy - of introducing "market discipline" by moving from a

(74) The Law introduces provisions on the establishment and operation of the fund and stipulates general principles governing investment and reserves of the fund, among other things. The final version of the Law, however, no longer contains a provision that the public debt will be serviced by fund revenue.

public monopoly in the provision of services to a truly competitive environment.

Structural reforms related to the business environment correctly identified many of the key challenges, but implementation would have benefited from clearer prioritisation. For instance, reforming the laws for ergo-therapists, agriculturists, veterinarians and psychologists – while certainly useful for the business environment – did not seem to be as urgent as reforming and reinforcing the Competition Authority, which was seen by some interviewees from programme partners as a major element of the programme although other interviewees from the authorities considered some parts of it (e.g. staffing and budgetary provisions) as too prescriptive. Surely, a reform of the competition authority was particularly urgent in view of the foreseen liberalisations and privatisations, although in most cases the latter did not take place in the end. Most interviewees and stakeholders considered the inclusion of a chapter on tourism appropriate, as well as its inclusion in the Action Plan for Growth after the creation of the latter. However, deadlines for implementing structural reforms were all equally tight and did not always take into account their urgency, the time necessary to prepare and pass a major reform, or constraints in administrative capacity (for a small administration) in times of a crisis.

The overall outcome of product market reforms is difficult to assess. In some cases, there has been a clear improvement, but it is difficult to disentangle the impact of the programme from overall external developments. The tourism boom in Cyprus in 2016 and 2017 was partly due to efforts to attract tourists by improving air connectivity (with fewer restrictions and more competition), advertising and diversifying tourism products as well as some improvements in cost competitiveness. However, political developments in competing tourism destinations, notably the Arab spring and tensions in Turkey, are also likely to have played a role. In general, efforts remain to be done to diversify the tourist base (UK and Russia being by far the first origin countries).([75])

In terms of innovation, Cyprus has tried to focus on higher added value activities but public and private R&D expenditures levels are among the lowest in the EU. The fact that multinational companies in Cyprus are mostly present for sales representation purposes and carry out their R&I activities elsewhere contributes to this low level. Lastly, interviewees from programme partners and other stakeholders mentioned that there does not seem to be a well-defined and truly shared vision of a medium-term strategy outlining where the authorities would realistically like to see the country in 10 years' time. After the successful completion of the Action Plan for Growth, some steps were taken towards a new long-term growth strategy that will look not only at competitiveness but also at environmental and social sustainability. The Smart Specialisation strategy could also have been a good starting point but suffered from lack of ownership, and the current growth model, heavily relying on housing, construction, tourists and foreigners' inflows and offshore financial services, does not appear too different from the pre-crisis model (see Table 5.1). Ongoing efforts towards a diversification of services include education, touristic attractions (e.g. casino) and the audio-visual industry. Overall, despite the adoption of a broad and comprehensive package of structural reforms that have led to improvements in many areas of the business environment, some of the vulnerabilities of the Cypriot economy are still there and will have to be addressed in the coming years.

Table 5.1: **Sectoral gross value added in % of total, 2008-2018**

	2008	2012	2018
Agriculture, forestry and fishery products	2.4	2.2	2.0
Industry excluding building and construction	8.5	7.2	8.3
Building and construction	12.3	5.6	5.8
Trade, transport and communication (ISIC G_I)	27.5	28.1	30.4
Finance and business services (ISIC J_K)	24.7	30.2	29.9
Other service activities (ISIC L_P)	24.6	26.7	23.6

Source: European Commission, AMECO database

([75]) This should be favoured by the new connections to European regional airports. Other challenges are related to the growing environmental impact of additional accommodation capacity. A new strategy has been launched in 2018 to make Cyprus a premium tourism destination, while emphasising the sustainability aspects of tourism growth.

Overall assessment

Key evaluation questions:

- *Effectiveness: To what extent were structural reforms effectively implemented? To what extent did structural reforms support adjustment, help reduce imbalances and improve competitiveness? To what extent was there an increase in potential growth?*
- *Efficiency: To what extent did structural reforms help achieve the programme objectives at the lowest cost?*
- *Relevance: To what extent were compliance requirements on structural policy conditionality appropriate?*
- *Coherence: To what extent were compliance requirements on structural policy conditionality coherent with other programme measures?*
- *EU added value: Did the framework of the Macroeconomic Imbalances Procedure provide guidance to the programme on addressing imbalances?*

The programme was effective in triggering a broad range of structural reforms that were implemented during and after the programme. These aimed to enhance cost and non-cost competitiveness, improve the functioning of the labour market and return to sustained and balanced growth. Reforms to goods and services markets focused on increasing competition and included specific provisions on housing (including title deeds and the efficiency of civil courts dealing with housing issues), tourism (later included in an 'action plan for growth') and the energy sector. In parallel, labour market reforms covered two main topics: the wage-setting framework and active labour market policies (ALMPs). The programme was also crucial in initiating a comprehensive reform agenda that continued after the programme.

The programme on structural reforms ran quite smoothly, but its implementation would have been more efficient had it been designed with a clearer prioritisation of reforms. Deadlines for implementing structural reforms were all equally tight and did not always take into account their urgency, the time necessary to prepare and pass a major reform, or constraints in administrative capacity (for a small administration) at times of crisis. The urgency of some crucial structural reforms to complement progress made in the areas of insolvency and foreclosure, notably the ones related to the issuance of title deeds and the efficiency of the judiciary, was fully recognised only in the middle of the programme. Earlier attention to these aspects could have contributed to a faster reduction of NPLs and an improved access to credit.

On the labour market, the coherence between activation policies and the welfare reform is a key success of the programme. The welfare reform was fully integrated 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. Indeed, several interviewees from both programme partners and the authorities mentioned the reform of the social assistance and benefit scheme, including its link with activation policies, as a key success of the programme.([76]) Active Labour Market Policies (ALMPs) were also made more targeted and Public Employment Services reinforced, although much of the progress on the ground was made post-programme. In terms of outcomes, there are some positive signs but room for improvement remains, based on a more systematic use of evaluations, as participation in ALMPs is still well below the EU average.

In terms of cost competitiveness, similar outcomes in the labour market could probably have been obtained more efficiently with less prescriptive conditionality. The labour market in Cyprus is quite flexible and, during the decades preceding the crisis, it was among the best performing in the EU in terms of employment and unemployment rates. Although there was a deterioration of cost-competitiveness during the period 2003-09, wage adjustment took place in

([76]) This was developed in close cooperation with the authorities and based on sound economic analysis using the existing tools (e.g. Euromod simulations) for simulating the distributional impact of different reforms options. The Cyprus Support Group also provided useful help for targeted technical assistance. Throughout the process, the Government consulted social partners as customary.

particular in 2013-14. Against this background, it is difficult to assess the effectiveness of the reform of wage indexation by the cost of living allowance (COLA) which was suspended during the whole duration of the programme, when deflation occurred, and applied thereafter, when inflation was below 1%. In a deflationary environment, the impact of the revised formula for the broader public sector is likely to have been quite negligible. In fact, adjustment also came through real variables. Real wages have been growing constantly below productivity from 2013 to 2018, fully offsetting the gap of 2009, and the real effective exchange rate (deflated by unit labour costs) dropped significantly during the same period.

Structural reforms related to product and service markets correctly addressed many of the most relevant challenges. Indeed, improving the product and service markets required a broad set of measures. At the same time, some of the reforms were more relevant than others to meet the objectives of the programme. For instance, reforming the laws for ergo-therapists, agriculturists, veterinarians and psychologists – while certainly useful for the business environment – did not seem to be as urgent as reforming and reinforcing the Competition Authority, which was seen by some interviewees as one of the major successes of the programme. The latter was particularly urgent in view of the foreseen liberalisation and privatisation, even though it did not take place in the end. Moreover, improving the pace of civil courts' case handling – while in full respect of the autonomy of the judiciary - could have deserved more and earlier prominence in the programme. The long duration of legal disputes and backlog of pending decisions is an obstacle to the proper implementation of the insolvency and foreclosure frameworks. Moreover, these shortcomings can deter investment since they delay the enforcement of contracts. Given the relevance of the issue for the business environment in general, it may have been justified to give more and earlier priority to this matter. Awareness of its importance has grown over time and, after the programme, the Supreme Court drafted a reform plan highlighting the priorities in improving the justice system (e.g. introduction of streamlining procedures, hiring of judges, upgrading IT resources, creation of a commercial court). Indeed, the judiciary reform and several other reforms that were part of the conditionality to address some important framework conditions only started towards the end of the programme or well after it had ended.

Despite an overall positive track record in terms of implementation, the programme was less effective in making the country's growth more sustainable and balanced, and some of its underlying vulnerabilities remain to be addressed. Many reforms related to the liberalisation of services, more competition in the energy market, addressing the backlog of title deeds, action plans on tourism and growth were implemented, but they did not induce a permanent, structural change and vulnerabilities in those sectors remain. Ultimately, there does not seem to be a well-defined and truly shared vision of a medium-term strategy outlining where the authorities would realistically like to see the country in 10 years' time. The current growth model, heavily relying on housing, construction, tourists and non-residents' capital inflows and offshore financial services, does not appear too different from the pre-crisis model, although efforts to diversify the services sector are still ongoing.

Coherence between structural and fiscal reforms was clearly achieved in the case of labour market reforms, but less so for product market reforms. The link between a new benefit system by introducing a guaranteed minimum income and labour market activation policies was one of the key achievements of the programme. However, on other fiscal measures, synergies with market reforms could have been more prominent, for example regarding privatisation plans and market regulation.

EU value added was achieved in the identification of relevant structural reforms conditionality in the context of the EU surveillance framework. First, the fiscal and structural challenges of the Cypriot economies had already been analysed and discussed in the context of the European Semester before the start of the programme. There was therefore already a shared analysis for assessing the challenges and reforms

needed, including previous Council recommendations. On the other hand, the implementation of structural reforms that were mostly motivated by the objective of quickly enforcing EU *acquis* implementation and not strictly related to the main programme objectives (e.g. liberalisation of professional services) - could have been achieved at lower costs by making use of the procedures already in place at the EU level. Second, in April 2016, Cyprus was identified as experiencing excessive macroeconomic imbalances. The Macroeconomic Imbalance Procedure (MIP) provided a good governance framework to manage the transition after the programme exit and continue to monitor developments in crucial areas (e.g. NPLs, title deeds, fiscal framework). The policy challenges identified in the context of the MIP and the European Semester were in line with the issues covered by post-programme surveillance.

6. ENSURING SOVEREIGN FINANCING

6.1. PROGRAMME DESIGN AND IMPLEMENTATION

Ahead of the programme, total financing needs including bank recapitalisation were estimated at EUR 17 billion, nearly the size of the Cypriot GDP in 2013.([77]) This amount was considered to be too large for a financial assistance envelope for a number of reasons. First, adding loans of some EUR 17 billion to the Cypriot debt would have led debt reaching unsustainably high levels. Second, this figure included funds for bank recapitalisations which, if funded out of public funds, would have resulted in a huge increase in public debt to bail-out deposit holders. Third, the Cypriot request followed financial assistance programmes in Ireland, Greece, Spain and Portugal and came at a time when some euro area countries were increasingly reluctant to commit further funds for financial assistance. Once agreed, the government of Cyprus signed the Financial Assistance Facility Agreement([78]) setting out the details of the financial assistance under the programme with the European Stability Mechanism (ESM) on 8 May 2013 (for further details on the role of the ESM see Box 6.1 below). This provided up to EUR 10 billion of financing made available until 31 March 2016, subject to the compliance with the reforms set out in the Memorandum of Understanding (MoU), with the proviso that this total included any funding to be provided by the International Monetary Fund (IMF) in any future agreement. On 15 May 2013, the government of Cyprus reached an agreement with the IMF, which would grant assistance of up to EUR 1.032 billion under an Extended Fund Facility.([79]) The ESM and Cyprus amended their financial agreement on 23 September 2013 to reflect this agreement, reducing the maximum financing available via the ESM to EUR 8.968 billion, keeping the overall envelope at EUR 10 billion.([80])

Following the Government of Cyprus' request for financial assistance, and in compliance with Article 7 of Regulation (EU) 472/2013 and Article 13 of the ESM Treaty, the European Commission assessed the financial stability risks posed by Cyprus for euro member states and the euro more broadly. Notwithstanding the small size of the Cypriot economy, the Commission concluded that important indirect effects could undermine financial stability in the euro area, particularly through a confidence channel. A bank run, sovereign default, or bank collapse in one euro area Member State could affect financing conditions in the euro area as a whole. This was particularly relevant to countries with weak access to financial markets or in the process of exiting a programme, such as Ireland and Portugal. Moreover, the very existence of the euro could once again be questioned by financial market actors. Finally, Greece was identified as the economy most exposed to Cyprus, not only due to the close banking linkages between the two, but also given the fragile state of the Greek economy at the time.

([77]) Cf. statement on Cyprus in the European Parliament by Commission Vice-President Olli Rehn on 17 April 2013.

([78]) https://www.esm.europa.eu/sites/default/files/esm_ffa_cyprus_publication_version_final.pdf

([79]) The agreement reached with the IMF was for 891 million in Standard Drawing Rights (SDR), the currency equivalent used by the IMF to grant assistance. According to the exchange rates at the time, this was equivalent to EUR 1.032 billion. https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr13175

([80]) https://www.esm.europa.eu/sites/default/files/cyprusnoticrecital_epublication_version.pdf

The programme financing was estimated to cover the needs of Cyprus over the three programme years. As CPB and BoC had already been intervened and restructured, the financial envelope was not to be used to recapitalise these banks. The total needs for the recapitalisation of the remainder of the banking sector was estimated at EUR 2.5 billion, of which EUR 1.3 billion were a contingency buffer reflecting the uncertainty around the needs of the financial sector. The needs for redemption of medium and long-term debt and the amortisation of government loans were estimated at EUR 4.1 billion. The required fiscal needs to be covered were estimated at EUR 3.4 billion. Of these categories, the redemption needs do not add to the debt, as they replace existing debt with official debt provided by the ESM/IMF.

In addition to the programme financing, the Cypriot authorities committed to cover their overall financing needs from other sources. Already ahead of the programme, there was additional financing through a bail-in of creditors in BoC and CPB (EUR 8.3 billion). CBC profits from gold sales (EUR 0.4 billion) were expected to become available. Marketable debt held by domestic investors was to be rolled over, yielding EUR 1 billion. The programme further contained plans for privatisations to yield EUR 0.7 billion (reaching EUR 1 billion by the end of 2016 – after the end of the programme period) and contained provisions to change the terms of the outstanding

Box 6.1: The euro area framework for financial assistance to a Member State

The euro area framework for financial assistance operations as applied in the case of Cyprus is built on two pillars: a financial pillar based on the European Stability Mechanism (ESM)([1]) and an economic pillar based on the European Union's framework for the economic surveillance of Member States. The financial pillar is codified in the ESM Treaty (TESM) while Regulation (EU) No 472/2013 of the European Parliament and of the Council ([2]) is the key legal act codifying the economic pillar of the framework. The latter lays down provisions for the involvement of EU institutions and the strengthening of the economic and budgetary surveillance of euro area Member States that request or receive financial assistance.

This framework assigns specific roles to the European Commission and the ECB (together with the IMF "the programme partners") and to the ESM:

- According to Article 3 of the TESM, the purpose of the ESM is "to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States".

- According to Article 13 of the TESM and on the basis of Regulation (EU) 472/2013, the decision to grant stability support following a request by the beneficiary member state is made on the basis of three main assessments about (i) the risk to the financial stability of the euro area as a whole or of its Member States, (ii) the sustainability of the public debt, (iii) the actual or potential financing needs.([3]) The Commission assesses the existence of a risk to financial stability, of the sustainability of the public debt and of the financing needs, together with other players. Once stability support is granted in principle, the Commission negotiates the MoU, and the Council adopts the macroeconomic adjustment programme. Thereafter, the Commission signs the MoU on behalf of the ESM, after approval by the ESM Board of Governors. The Commission monitors the implementation of the macroeconomic adjustment programme and periodically sends compliance reports to the Economic and Financial Committee (EFC) and the ESM Board of Directors.

([1]) The ESM is an International Financial Institution, set up through an Intergovernmental Treaty (TESM) among euro area Member States. The TESM was signed by the euro area Member States on 2 February 2012 and entered into force on the 27 September 2012. The ESM started its operations on the 8 October 2012. Its operation has been further codified by rules of procedure, by-laws and detailed guidelines on the modalities for implementing specific financial assistance instruments (ESM Instrument Guidelines) https://www.esm.europa.eu/legal-documents?field_documents_category_tid%5B%5D=275#legal-preselect. At the time of writing of this evaluation report, the TESM was under revision, which could change some of the framework's modalities as described here.
([2]) OJ L 140/1 27.05.2013 https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF
([3]) In addition, the ESM Instrument Guidelines set out complementary eligibility criteria and the modalities of the various instruments.

loan from Russia to generate EUR 0.1 billion. Some of these measures were principally financing measures, while others were more concerned with ensuring debt sustainability.

Table 6.1: Cyprus programme disbursements

Date	€ million	Type	Source
13-05-2013	1000	Cash	ESM
	1000	Cash	ESM
17-05-2013	86	Cash	IMF
26-06-2013	1000	Cash	ESM
16-09-2013	86	Cash	IMF
27-09-2013	750	Cashless	ESM
	750	Cashless	ESM
19-12-2013	100	Cash	ESM
24-12-2013	86	Cash	IMF
2-04-2014	86	Cash	IMF
4-04-2014	150	Cash	ESM
2-07-2014	84	Cash	IMF
9-07-2014	600	Cash	ESM
15-12-2014	350	Cash	ESM
23-06-2015	278	Cash	IMF
15-07-2015	100	Cash	ESM
25-09-2015	126	Cash	IMF
8-10-2015	200	Cash	ESM
	300	Cash	ESM
Total ESM	6300		
Total IMF	832		
Total	7132		

Note: IMF disbursements are made in Standard Drawing Rights. Amounts here are given in euros, according to the exchange rates that applied at the time when the disbursements were made.
Source: ESM, IMF

The programme envelope was set with considerable uncertainty as to the needs of the financial sector. The programme envelope sought to find the right balance between providing sufficient funds to both cover emerging needs and to be seen to be sufficiently large to reassure markets that all needs could be covered, while also limiting the increases to Cyprus's debt from unnecessary disbursements. This balance was not just sought at programme inception, but also during the programme when disbursements were made. As each disbursement needed to be sufficiently large to cover the financing needs over the coming months, the uncertainty coming from the banking sector played a role throughout the programme as it drove the assessment of how large disbursements needed to be.

In the event, Cyprus did not make full use of the financial envelope, drawing just EUR 6.3 billion of the EUR 9 billion made available by the ESM, in addition to most of its IMF allocation. This resulted in total financing of EUR 7.1 billion, Of the EUR 6.3 billion disbursed by the ESM, EUR 4.8 billion were disbursed in cash, while EUR 1.5 billion was disbursed for the recapitalisation of the cooperative banking sector in the form of ESM notes. It drew 792 billion of its 891 billion SDR allocation from the IMF, corresponding to just over EUR 900 million in 2013 exchange rates. Table 6.1 shows the disbursements made during the programme.

Cyprus was successful in returning to financing markets, in part due to overperforming in terms of fiscal and macroeconomic outcomes relative to the programme assumptions. Cyprus did not require the full allocation due to lower fiscal needs than anticipated. Fiscal outcomes benefited from strong consolidation based on determined policy action coupled with a stronger than expected performance on the macro side (see chapter 5). Stakeholders mentioned that the experience of Greece had led to concerns that the macroeconomic assumptions underlying the programme should not be unduly optimistic. However, countervailing opinions were expressed as to whether the resulting macroeconomic outcomes had been anticipated (but worse outcomes planned for in order to set in motion an expected virtuous cycle of good news) or whether lenders had underestimated the Cypriot economy's ability to bounce back. In addition, Cyprus was more successful in accessing financing markets than had been anticipated under the programme financing plans.

There was no explicit provision for a cash buffer in the programme financing. A cash buffer was built up very early on in the programme, and it was sizeable already before the end of 2013. It remained considerable throughout the programme. The initial reason for the build-up of the cash buffer was to reduce fiscal needs early in the programme, following a large initial disbursement to cover debt redemptions and fiscal

needs. Thereafter, the cash buffer was maintained large enough to be able to cover for any forthcoming contingencies during the programme. These included worries about adverse market developments affecting the banking sector coming from Greece. Disbursements were smaller later on in the programme than at the beginning, but they were nevertheless set so that they were sufficient to cover redemption and fiscal needs while maintaining the cash buffer large enough to meet unexpected events. In this sense, the uncertainty around the financial sector drove programme disbursements throughout the programme and contributed to the built-up and maintenance of the cash buffer. Without the ongoing uncertainty, it would have been possible for the ESM to make lower disbursements during the second half of the programme period, leading to a lower cash buffer at the end.

6.2. OVERALL OUTCOME AND ASSESSMENT

Cyprus was able to leave the programme with a sizeable cash buffer and with an average weighted cost of its public debt having fallen from 4.2% in 2012, to 2.3% in 2016. While this was of course partly linked to the fact that official loans under the programme amounted to half of Cypriot debt, the positive impact of the perceived success of the programme is also a reason. It enabled Cyprus to not just borrow at cheaper rates, but also to lock in some of the improvements through its medium-term debt management strategy. The size of the cash buffer was estimated to be around EUR 1 billion, which provided the Cypriot authorities with some breathing space in the immediate post-programme period. However, it also enabled Cyprus to feel less need to comply with the reform programme towards the end of the programme. This incentive effect was considered by the programme partners as the end of the programme drew near. However, worries about the possibility of adverse events emerging within the final months of the programme were compounded by concerns that a cash buffer was desirable in order to reassure markets that fiscal needs would be met in the near future. The incentive effect was therefore counter-balanced by consideration of how programme exit could be achieved.

Graph 6.1: **Spreads of Cyprus (2020) bonds compared to German bonds, 2010-6/2019**

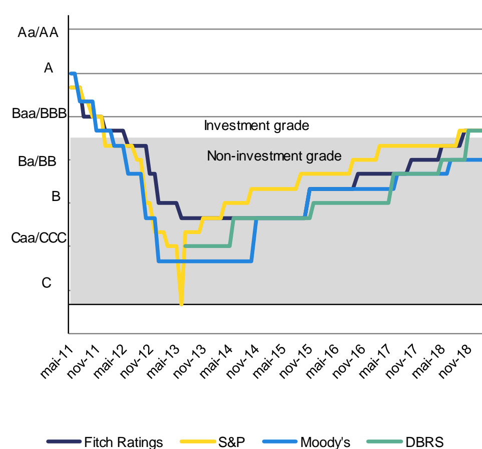
Note: The grey-shaded area indicates the programme period.
Source: Bloomberg; own calculations.

Cyprus was able to return to financial markets in 2014, and able to raise more financing over the course of the programme than was expected. Financial markets started to respond favourably to Cyprus within a few months of the programme agreement and yields then fell steadily over the programme period. Graph 6.1 shows the evolution of yields from 2010 until the end of the programme. It shows that yields began to fall sharply from the end of 2013. Several stakeholders argued that the main driver of increased market confidence was the Cypriot authorities' ownership of the reform agenda – particularly on the fiscal issues –from the early stages of the programme. In parallel, the ECB's unconventional monetary policies and the end of the euro area crisis might have indirectly helped Cyprus improve its sovereign financing conditions. By June 2014, just a year after signing the MoU, Cyprus was able to return to markets, issuing its first 5-year bond at 4.75%. By the end of 2014, international interest in its bonds was strong. Over the course of 2015, the debt management office was able to capitalise on the strong demand and reduced their average coupon from 3.9% to 2.8%. By the end of the programme, yields on Cyprus's foreign-law bonds and T-Bills were at reasonably low levels at around 3.3% and 2.1% respectively in late 2016, despite the pressure from the continued uncertainty in Greece. From July 2016, Cyprus's bonds became eligible for the Eurosystem public sector purchase programme (PSPP).([81]) But Cypriot bonds might have benefited from the PSPP already

([81]) Cyprus had lost access to the PSPP at programme exit, as its bonds were not assessed as being investment grade, which was a necessary condition.

at an earlier stage, as investors' appetite for Cypriot government bonds might have been induced by a search for yield that were relatively attractive in its risk/return profile. Cyprus held regular T-Bill auctions throughout the programme years, which arguably helped the gradual improvement in the T-Bill yield. Cyprus was also able to return to bonds markets quickly.

Graph 6.2: **Sovereign ratings for Cyprus, 2011-2018**



Source: CRAs

The programme years also saw regular increases in the sovereign ratings provided by ratings agencies. Ratings had been downgraded at regular intervals from 2011, as shown in Graph 6.2, which shows the ratings of the four major credit ratings agencies (CRA). By early 2012, investment grade had been lost, following a wave of downgrades, which continued during the adjustment programme negotiations. As the agreement with the international lenders in May 2013 included a provision for the roll-over of EUR 2 billion of domestic debt, this was considered a selective default by CRAs. As a result, the beginning of the programme was characterised by a further downgrade of the Cypriot sovereign. Thereafter, regular increases started, with the result that Cypriot government bonds had regained investment grade with three out of the four major CRAs by September 2019.

A new medium-term public debt management strategy (MTDS) developed by the Debt Management Office (DMO) contributed to Cyprus's return to markets. Under the new strategy, debt issuance was based on a strategy of its own, and could no longer be considered as simply instrumental to fiscal policy. This allowed for a medium-term perspective on costs and risks. More specifically, the new MTDS had as objectives (i) a smoothening of debt maturity profile (including an extension of average maturity), (ii) the accumulation and maintenance of significant cash buffers to avoid liquidity problems, (iii) reduced exposure to currency and interest rate risks, and (iv) building a full sovereign yield curve. As part of the MTDS, the Debt Management Office (DMO) also engaged highly proactively with investors, organising non-transaction roadshows, adopting a wider approach than before the crisis, both in terms of geographical breadth, but also of depth of information shared. This, together with an overall supportive financial environment in the euro area, and better-than-expected macroeconomic outcomes helped the Cypriot government regain market access. Once initial market access was regained, the DMO had to concentrate primarily on foreign investors, as the domestic market was subdued. As the ratings of the sovereign started to improve, the potential investors' pool expanded.

As the expiration of the programme approached, there was concern about whether a follow-up arrangement was needed. As explained by several stakeholders, the Cypriot authorities were keen to signal the success of the programme and the end of conditionality. For this reason, they were not receptive to the idea of some form of follow-up arrangement, such as a precautionary programme. Although Cyprus had not needed all its programme funds – in part due to its greater reliance on financial markets, which was in itself a positive sign for the future – there was still uncertainty as to the needs of the financial sector. The cash buffer provided Cyprus with room to cover its forthcoming needs – which were in any case limited in the immediate post-programme period – and provided it with confidence to exit the programme cleanly. But it was not a given that it would be sufficient in the case of adverse financial sector developments. Arguably, insufficient attention was paid to the impact of the forthcoming increases in the capital requirements for banks, which could have been covered towards the end of the programme period. The clean exit from the

programme was seen as risky, but this risk was counterbalanced by a concern that signalling anything other than confidence in the Cypriot economy and the impact of the reforms would be damaging. On the Cypriot side, forthcoming elections were at the forefront of the policy agenda. On the lenders' side, there was little appetite for requesting the approval of precautionary funds before national parliaments. In addition, the impasse over the final reforms meant that any reform agenda tied to a follow-up arrangement would be very difficult to agree on. In the event, Cyprus's ability to finance itself went from strength to strength, as the regular ratings upgrades showed.

Overall assessment

Key evaluation questions:

- *Effectiveness: To what extent did the programme help in the return to markets? To what extent did other factors (e.g. ECB) help in the return to markets?*
- *Efficiency: To what extent was the financing envelope adequate? To what extent was the time horizon of 3 years adequate? To what extent was the disbursement schedule an adequate balance between upfront needs and sustained ownership? Were all potential financing sources and needs adequately identified?*
- *Relevance: To what extent did ownership/compliance deteriorate as financing needs decreased?*
- *Coherence: To what extent was the programme financing coherent with other EU policies?*
- *EU added value: To what extent was the ESM financing (EUR 9 billion) actually needed? Could there have been other sources to cover the sovereign financing needs?*

The programme was effective in achieving its objectives of providing the Cypriot state with sufficient financial breathing space to restore financial stability. The financing was sufficient to ensure that Cyprus was able to fund its obligations and needs while it embarked on the reforms needed to return to market financing and to sustainable growth. The continued fall in bond spreads during the programme period and thereafter is a testament to the faith that markets placed on its ability to repay its debt over the short and medium term.

In terms of the efficiency and coherence of the financial envelope, the programme financing turned out to be markedly higher than the actual needs, but reflected the objective to ensure that there was sufficient financing even under a worst-case scenario. The size of the financing relative to the actual needs during the programme meant that there was money that went unused and enabled a cash buffer to build up over the programme years, which was much higher than initially expected. This cash buffer enabled Cyprus to feel less need to comply with the reform programme towards the end of the programme. In this respect, it could be argued that the programme would have been more efficient by not providing unnecessary financing. The size of the buffer arguably undermined the coherence with programme conditionality as additional disbursements were not perceived as being as vital in the final months. However, this does not mean that the cash buffer was not justified, nor does it mean that the financing envelope was too large. The cash buffer was a consequence of ongoing uncertainty in the financial sector and the need to prefund any contingencies between disbursements, coupled with a concern that markets should remain reassured at programme exit. The financing envelope was set to provide reassurance that the programme was able to deliver support even under adverse and unknown needs for the financial sector for the whole three years. It would have been much more difficult for market participants to be reassured of Cyprus' ability to cope with unforeseen economic events during the programme with a more limited envelope. In this sense, the large envelope was necessary to provide comfort in the face of uncertainty. The question of efficiency and coherence can therefore only be posed in retrospect, and setting a lower envelope at the start might not have resulted in such good financial results over the programme years.

The financing envelope was clearly a relevant part of the programme. Cyprus was locked out of financial markets in 2011, at a time when financial uncertainty was high in parts of the euro area,

including in neighbouring Greece. In the event, even accounting for the cash buffer, Cyprus needed some EUR 6 billion of budget financing (corresponding to 30% of its GDP) over the programme period. Without the financing envelope it would simply not have been able to find this financing.

Regarding EU value added, no other institution apart from the ESM was able to provide Cyprus with all the financing it needed and at a price it could afford. Prior to the agreement on the programme, the Cypriot authorities had searched extensively for financing, and had agreed a EUR 2.5 billion loan from Russia in late 2011, at an interest rate of 4.5%. By mid-2012, the Cypriot authorities had exhausted the possibilities of receiving more financing from this or comparable sources, leading to the programme request. Providing a financial envelope of the size that the ESM had access to would have been vastly problematic for the IMF.([82]) In addition, the interest rate payable on ESM loans is under 1% for Cyprus; for the IMF the equivalent interest rate was substantially higher.([83])

([82]) The IMF's contribution to the financing envelope was 563% of Cyprus' IMF quota, against a normal lending limit of 145% of quota.

([83]) Because of this, Cyprus paid back pre-emptively 222 SDR of its IMF loan which faced an interest rate of 3½% in 2017 (corresponding to 28% of its loan), following the agreement of the Eurogroup to waive the clause on the right for equitable repayment. Its remaining IMF loans carry an interest rate of 1.6%.

7. INSTITUTIONAL ARRANGEMENTS OF PROGRAMME IMPLEMENTATION

7.1. ARRANGEMENTS AMONG PROGRAMME PARTNERS

The programme partners, represented by staff of the EC, the ESM, the ECB and the IMF, committed to monitor progress in the implementation of policies under the programme through quarterly reviews in staff level missions. Policy conditionality was to some extent operationalised through quantitative performance criteria, structural benchmarks and prior actions. A Technical Memorandum of Understanding defined the reporting requirements of the Cypriot authorities. It was up to the Eurogroup and the IMF Board to decide on the completion of a review and the disbursement of the related financial tranche. To safeguard ownership as much as possible, the consulted stakeholders confirmed that government and programme partners maintained a continuous dialogue with social partners and other stakeholders to consult and inform on the programme.

The programme was effectively coordinated by the Ministry of Finance. Its Directorate General for European Programmes, Coordination and Development (DGEPCD, the former Central Planning Bureau) had a de facto coordinating role in the government (and no formal mandate) and ensured that the different Ministries were aware of what was expected from them in the context of the programme. An Under-Secretary to the Presidency had a more formal coordination role. However, as evidence from stakeholder interviews suggests, they had insufficient powers on the actual enforcement of reforms by line Ministries. As a consequence, the implementation of structural reform objectives showed mixed results. Therefore, the implementation of structural reforms could have benefited from the establishment of a centralised enforcement mechanism within the Cypriot authorities, with appropriate political support. Nevertheless, most of the stakeholders who had worked on the programme generally praised the Cypriot government and the administration for their strong ownership and efficiency, even though this posed a challenge for the small absolute size of the administration (which was still deemed large relative to the size of the country). Technical assistance compensated for some of the administrative capacity constraints. As a result, programme implementation was generally good, as could also be seen from the limited use of prior actions, similar to the programmes for Ireland and Portugal.([84])

Problems of compliance with key conditionality, as most visible in the sixth and the eighth and final reviews, occurred mainly after the government had lost its majority and reform proposals were blocked more frequently in Parliament, and following the gradual return of the Cypriot sovereign to the markets. The completion of the sixth review was delayed from end-2014 to May 2015 because an agreed legislative package on insolvency and foreclosure frameworks was amended in Parliament in a way that could have jeopardised its effective implementation. When the IMF programme ended in March 2016, the eighth - and final - review was not concluded essentially due to non-compliance with a prior action on the privatisation of the Cypriot Telecommunications Authority (CyTA).

7.2. TECHNICAL ASSISTANCE

The Commission decided to set up a Support Group for Cyprus (SGCY)([85]) with the aim of mobilising and coordinating the technical assistance (TA) requested by the Cypriot authorities. Whilst the current ex-post evaluation report of the economic adjustment programme is not an evaluation of the Support Group for Cyprus, this section of the report provides information on

([84]) There was a maximum of three prior actions in the second and third reviews and only one or two in the other reviews.

([85]) On 17 June 2015, the Structural Reform Support Service (SRSS) in the Commission was established (see the related press release at http://europa.eu/rapid/press-release_STATEMENT-15-5218_en.htm). It absorbed the SGCY and, also due to the continuity of staff, provided very useful experience for supporting reforms in other Member States. References to SGCY in this section also include technical assistance activities of the SRSS in Cyprus after 17 June 2015.

the scope of work of the SGCY as relevant for the overall understanding and evaluation of the economic adjustment programme.

After the appointment of its head, the SGCY came into being on 1 July 2013. The purpose was to help the Cypriot authorities on far-reaching reforms with the particular mission to (1) to help alleviate the social consequences of the economic shock by mobilising funds from the EU instruments and by supporting the Cypriot authorities to restore financial, economic and social stability; (2) bringing in further expertise to facilitate the emergence of new sources of economic activity.([86]) Requests received from the Cypriot authorities on 30 September 2013 identified healthcare, the budgetary framework and public financial management, revenue administration, immovable property tax, the welfare system, and renewable energy as priority areas requiring technical assistance. Further assistance was provided in the areas of education, reform of public administration and public revenue administration, improvement of the business environment and, critically, in the area of judiciary reform.

The SGCY, often in cooperation with other international institutions providing technical assistance, worked closely with the Cypriot authorities to support them in achieving the milestones of the economic adjustment programme while adopting a demand-driven approach. Requests submitted by the Cypriot authorities for technical support were assessed by SGCY and discussed with the Cypriot authorities, who were subsequently tasked with identifying specific compelling TA needs on the basis of their relevance, impact, urgency and other criteria if and when relevant. The SGCY's technical assistance was closely co-ordinated with – and at times co-financed – the technical assistance efforts of other international institutions such as the IMF, World Bank and/or specialised organisations, including the World Health Organisation (WHO) in the area of health care and the International Labour Organisation (ILO) on labour issues.

([86]) See minutes of the European Commission of 27 March 2013.

The SGCY did not have its own operational budget for funding assistance for the various reform projects. The technical assistance projects were financed for the most part through contributions from DG REGIO and EMPL from the centrally managed funds under the European Structural and Investment Funds (ESIF). They were also funded to a small extent through a transfer of funds to the SGCY from Cyprus' own technical assistance budget under the ESIF.([87]) The SGCY also relied on policy support and expertise from across the European Commission's line DG's. The SGCY functioned with a very limited staff allocation of initially three full-time equivalents at the start in July 2013 and not going beyond seven full-time equivalents (and two assistants) located in Brussels over the duration of the CYSG's operations. The SGCY was supported by a team in Nicosia, composed of three embedded experts in some of the concerned Ministries. The SGCY organised regular co-ordination meetings with Member States with a view to the mobilisation of expertise from Member States in areas of structural reform in Cyprus. Evidence collected from interviews with staff involved in the SGCY indicates that all viewed the SGCY as a well-functioning cohesive small team. Staff also mention the co-operation between SGCY and the colleagues responsible for the economic adjustment programme as exemplary, noting that clear reporting lines "under the same institutional roof" was very beneficial. Many of the colleagues in SGCY also had prior missions within the core economic adjustment programme itself, as well as joining the inter-institutional missions that took place under the economic adjustment programme, which further enhanced coherence and communication between the adjustment programme and the technical assistance programme.

The general demand-driven mechanism for selecting technical assistance functioned relatively well. Evidence collected from periodic Activity Reports of the Support Group as well as from interviews with officials in the Cypriot

([87]) In line with Article 25 of the common provisions of the ESIF Regulation (EU) no. 1303/2013 for the management of technical assistance of Member States facing temporary budgetary difficulties.

authorities and the European Commission suggests that there were no major diverging views on the identification of priorities and needs for technical assistance. Similar evidence suggests there was a strong ownership of the Cypriot authorities of the technical assistance process. Technical assistance requests were well co-ordinated in Cyprus through the Directorate General for European Programmes, Coordination and Development (DGEPCD, the former Central Planning Bureau). However, the pace of several of the reforms supported by the SGCY was relatively slow, in particular in the health and energy sector. Moreover - and notably in the health sector - policy priorities also changed following electoral calendars.

Looking at particular sector specifics, the following picture emerges as regards the effectiveness of the Cyprus Support Group's contribution to the economic adjustment programme:

- As regards the technical assistance offered in the **health sector**, and with reference to the findings in chapter 4 of this report, assistance of the SGCY consisted in particular of the provision of an embedded expert to the Cypriot Ministry of Health from January 2015 to October 2017. Such expertise was already requested by the Cypriot authorities as early as 2013 with a view to the envisaged transition to a National Health System (NHS). However, half-way through the year 2015, the political priorities in this sector - and the Minister in charge - changed and reform in this sector stalled. In this period, assistance provided by the expert could not properly materialise without the required political support. Political support for the conceptual work and policy advice of the expert and the effective utilisation of technical assistance was therefore found to be somewhat lacking during a certain transitional period. This notwithstanding the fact that, early on in the technical assistance programme, in 2013, SGCY had provided assistance through the Portuguese authorities to prepare technical requirements for a comprehensive IT solution to set up a NHS. Other Member States also provided support (e.g. the UK on scientific and technical training of staff in the healthcare sector, and Belgium on the insurance claims management strategy). Notwithstanding the reservations and delays incurred, eventually the overall reform package was adopted in June 2017, when the economic adjustment programme had actually already been finalised. The general assessment is nonetheless that the economic adjustment programme accelerated the reform and brought the political decisions and legislative changes forward in time.
- Technical assistance on the **budgetary framework and public financial management** included support for the development and monitoring of key performance indicators, implementing public investment guidelines, support for the Fiscal Council and rolling-out an activity-based budget framework. Support from various Member States was also mobilised (e.g. Dutch workshop on indicators, support by the Irish Fiscal Council). The SGCY also secured funding for a public financial management expert embedded in the Ministry of Finance.
- As regards the technical assistance in the area of reforming the **revenue administration**, the Commission and the IMF carried out a number of technical assistance missions; and both assisted the Ministry of Finance in the preparation of an implementation plan for the Domestic Tax Integration Project. Advice was provided on the establishment of an integrated domestic tax department. Expertise and technical support from a number of Member States was mobilised (e.g. Bulgarian tax authorities' support to review of the Cypriot Inland Revenue Department and VAT, and Dutch support on the process of setting up a large taxpayer office in Cyprus).
- In the area of **immovable property tax** reform, SGCY mobilised funds to co-finance IMF-led technical missions as well as missions from Member State experts (e.g. the mission of the Spanish Directorate-General for Cadastre, and Irish TA missions on refining the parameters of the computer-assisted mass-appraisal model (CAMA)).
- In the area of the **insolvency framework**, considerable technical assistance and advice was provided to the Cypriot authorities to develop major reforms of both corporate and

individual insolvency laws in Cyprus with a view to the building-up of an effective insolvency framework, which provided a viable workout plan for financially distressed borrowers. During interviews with relevant staff in the Cypriot authorities and the European Commission emphasised the importance of this piece of structural reform, as it directly addressed some of the root causes of the crisis in the Cypriot economy. The SGCY insisted on this reform, convincing the Cypriot authorities of the urgent need for this reform, and made the warranted expertise available.

- The insolvency framework, NPL issues and others also contributed to increased pressure on the need to reform the **judiciary** itself. The judiciary was seen as shying away from the economic adjustment programme and from accepting dialogue with - and advice from - the programme partners, as it was perceived as possibly impeding on the independence of the courts. Currently, three years after the end of the programme, the judiciary is still receiving technical support from the SGCY and is looking back at more than seven different structural reform projects financed over a number of years. The economic adjustment programme and the SGCY provided the trigger and momentum for the reform of a sector that is perceived as having remained without much change for decades. Following a series of 21 recommendations in an independent experts' report financed with SGCY support, changes in the court system have been gradual but comprehensive, including the setting up of a special commercial court allowing 'fast track' decisions on some commercial cases, and the recruitment of new court of appeal judges.
- On the **welfare system reform**, SGCY placed the required expertise at the disposal of the Cypriot authorities to develop the comprehensive database and IT requirements for the administration of the reformed welfare system and experts offered advice and assistance on the introduction of a Guaranteed Minimum Income Scheme (GMI). Regular exchanges were organised between the Cypriot authorities and Swedish experts (Swedish Ministry of Health and Social Affairs; and the Swedish National Board of Health and Welfare).
- As regards the technical assistance offered in the **energy sector**, SGCY enlisted the assistance of a number of energy experts in a broad range of areas to formulate a comprehensive strategy for the reform and liberalisation of the Cypriot energy sector. This included the provision of an embedded expert to the Ministry of Energy, Commerce, Industry and Tourism (MECIT). This support went hand in hand with the efforts of the Cypriot authorities to comply with the EU's Third Energy Package and to meet EU targets on energy efficiency, renewable energy and carbon emissions. The SGCY was instrumental in facilitating the signing of a Memorandum of Understanding between the Cyprus Regulatory Authority and the Austrian Energy Regulatory Authority E-Control in November 2014, which allowed joint work and exchange of good practice on regulatory matters. Nevertheless, interviews with officials in the European Commission suggest that, throughout the process, there were strong reservations from political actors, economic stakeholders and staff in the Energy Authority of Cyprus against further market liberalisation and an opening up of the energy markets. The successful implementation of reform in this area has been relatively limited. Cyprus has however become more acquis-compliant where energy efficiency is concerned, thanks to advice and expertise offered through the SGCY.
- Technical assistance also included the areas of **public administration reform, competition and the improvement of the business environment.** An embedded expert was provided to the DGEPCD to develop strategies and instruments to provide assistance on improving the business environment. In the field of competition, expertise was mobilised from Competition Authorities in Member States (in particular Ireland and France) to strengthen the independence and effectiveness of the Cypriot Commission for the Protection of Competition (CPC). As regards public administration reform, SGCY technical assistance, and a scoping mission in particular, allowed the start

of a functional review of all Ministries and their subordinate bodies, as well as a horizontal review. Interviews with staff in the Cypriot authorities and in the Commission suggest that a lasting effect of the crisis was that it triggered a process for the reduction of red tape across various segments of the Cypriot administration.

- Finally, in the field of **education**, SGCY technical support concentrated on the supporting the Ministry of Education and Culture (MOEC) in implementing a number of recommendations made in the 2014 World Bank functional review of the Ministry, including the decentralisation of certain policy functions and the reform of the school board system. These actions were not part of the Memorandum of Understanding itself (which concentrated on reduction of numbers of teachers) but can be seen as successful spin-offs.

As an overall conclusion, one can note that the SGCY provided a very useful contribution and fulfilled its purpose. However, some reforms in certain sectors were met with significant resistance in the implementation phase, and repeated requests from the SGCY for a more strategic approach to TA requests failed to produce the desired result from the Cypriot authorities. Nonetheless, opinions expressed during interviews with Cypriot and Commission officials as well as other stakeholders suggest that the SGCY made the economic reform programme more marketable and palatable by mitigating the focus on austerity and belt-tightening. The SGCY provided a "positive agenda" to work on with the Cypriot authorities, but the scope of structural reform projects could possibly have been limited to key sectors, with a stronger emphasis on implementation of reform commitments, with the co-operation of the Cypriot authorities.

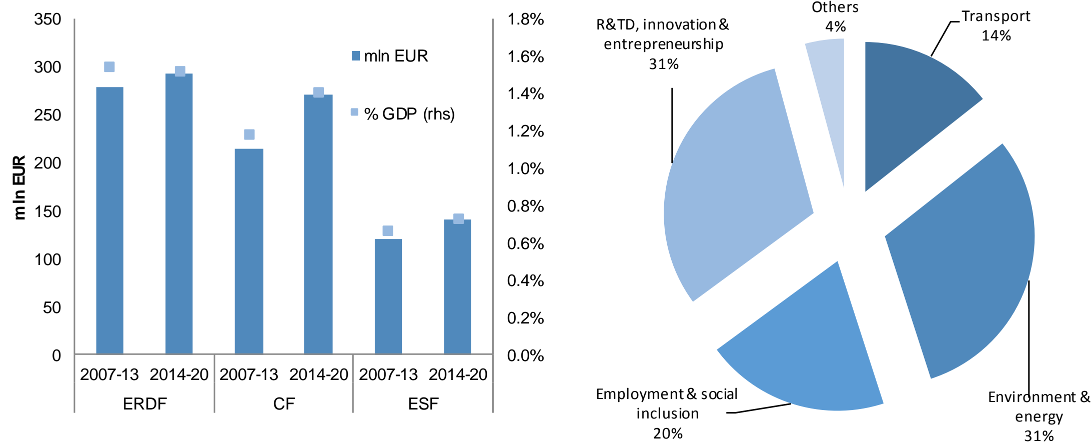
As for the programme itself, technical assistance by the SGCY did not necessarily lead to a very different growth model for Cyprus. Views expressed by staff involved in the Cypriot authorities and the European Commission suggest that the economy still strongly relies on tourism, construction, shipping and banking-related services. An Action Plan on Growth was delivered after some time, but this was considered as a relatively short-term and piecemeal approach. More work on developing a broader medium-term strategy on diversification and competitiveness in the Cypriot economy is currently (2019) supported by the Structural Reform Support Programme (SRSP).

7.3. OTHER EU SUPPORT

During the programme, Cyprus continued to receive substantial financial support through the regular execution of EU Structural and Investment Funds (ESIF) in the context of the previous and current multi-annual financial frameworks (MFF). Those amounted, on average, to about 0.5% of Cyprus' GDP per year (see Graph 7.1). Cyprus has traditionally been able to timely and fully use the Structural Funds and this level of absorption continued during the crisis. This was possible also because a few measures were taken to facilitate the absorption of funds. First, the general part of the MoU included a reference to the importance of safeguarding the resources needed to co-finance EU structural funds. Second, the EU co-financing rate was increased (although overall resources remained unchanged) and a top-up for interim payments was temporarily allowed. ([88]) Third, the definition of strategic priorities for the MFF 2014-20 coincided with the beginning of the programme. The authorities could hence conceive from the start an investment strategy that took the reform priorities of the programme and the necessary flanking measures into account. Finally, the Cypriot authorities continued to benefit not only from the technical assistance available through Structural Funds, but the SGCY was also mandated to assist the Cypriot authorities in making efficient use of the EU funding available through various EU programmes, including the ESIFs to cater for the needs on the ground on the basis of the Cypriot authorities' reform agenda. Overall, these elements, coupled with a traditionally unproblematic management of

([88]) This measure was extraordinarily useful to provide liquidity buffers, especially for municipalities, to finance capital expenditure. On the other hand, since it was accompanied by a sharp reduction in national investment and co-financing, it was not sufficient to prevent a substantial drop in overall public investment.

Graph 7.1: **EU Structural Funds allocated to Cyprus, by main fund and by sectors**



(1) Left-hand chart: The graph indicates the size of the three Cohesion Policy funds for the 2007-2013 and the 2014-2020 programming period. ERDF=European Regional Development Fund, CF=Cohesion Fund, ESF=European Social Fund
(2) Right-hand chart: Overall EU Cohesion policy funds for the period 2014-2020 amount to €14 billion. The graph shows the four largest spending categories of EU funds that were proposed in the partnership agreement by the national government for 2014-2020. "Others" contains Administrative capacity and Technical assistance.
Source: Commission service (DG REGIO)

structural funds before the programme, allowed the authorities both to make use of all funds available and to use them to support the broader reform process spurred by the programme.

Synergies between the Structural Funds and the programme were quite successful in the field of active labour market policies and for the business environment. The reform of active labour market policies made in conjunction with the benefit reform and the introduction of the guaranteed minimum income was largely financed by the European Social Fund. Although according to some stakeholders there are still margins for improvement in terms of monitoring and evaluation, the support received was essential to implement the provisions of the MoU in the field of activation policies. With regard to the business environment, access to credit was another area where some stakeholders interviewed found the structural funds proved quite useful since the entirety of the funds needed to set-up and run JEREMIE, a programme to facilitate access to credit for SMEs, were absorbed. On the other hand, other stakeholders often complained that access to credit was a major issue during the programme and remains to date unresolved. This suggests that the root causes of the problem may go well beyond what can be achieved with Structural Funds and may require additional efforts. Finally, the Structural Funds were crucial for the development and adoption of the 'smart specialisation strategy', which is a pre-condition for receiving the funds. In this case, however, the link with the action plan for growth could have been further exploited and low awareness by stakeholders in the private sector possibly suggest that ownership could have been enhanced by their higher involvement.

7.4. OVERALL ASSESSMENT

Key evaluation questions:

- *Effectiveness: To what extent was the programme management by authorities and institutions conducive to achieving the programme objectives?*
- *Efficiency: To what extent were working relationships between creditor institutions and the authorities conducive to an efficient programme implementation? To what extent were programme reporting and monitoring requirements well designed and implemented? To what extent was the programme administratively burdensome for the Cyprus authorities?*

- *Relevance: To what extent did the Support Group set the right priorities/address the main technical weaknesses as identified in the programme?*
- *Coherence: To what extent did other EU funds and policies support programme objectives?*
- *EU added value: To what extent did the division of labour in technical assistance between the European Commission and others ensure EU added value?*

The programme was generally efficiently managed by the Cypriot administration. Most of those who had worked on the programme generally praised the Cypriot government and the administration for their strong ownership and efficiency, even though this posed a challenge for the small absolute size of the administration (which was still deemed large relative to the size of the country). Technical assistance, largely from the European Commission's Support Group for Cyprus, helped to overcome some of the administrative capacity constraints. The Ministry of Finance had de facto a coordinating role in the government and ensured that the different Ministries were aware of what was expected from them in the context of the programme, even though lacking some enforcement powers vis-à-vis line Ministries. Problems of compliance with key conditionality, as most visible in the 6th and the 8th and final reviews, occurred mainly after the government had lost parliamentary support from some political parties and reform proposals were blocked more frequently in Parliament, and following the gradual return of the Cypriot sovereign to the markets. To safeguard ownership as much as possible, government and programme partners maintained a continuous dialogue with social partners and other stakeholders to consult and inform on the programme.

Technical assistance provided by the Commission during the programme can be considered important and complementary EU value added to the programme. Some of the most important gains were only incurred towards the end of the programme or well after the programme's end, whereas some reforms, which were kick-started by the programme, are still ongoing today. The calendars and timelines of short-term problem-fixing and of looking at the root causes of the problems are different ones. The work of the 'Support Group for Cyprus' (SGCY) - and later the SRSS - was mainly related to structural reforms of which many ultimately got delayed beyond the end of the programme. However, these reforms were and still are addressing some of the framework conditions, which previously allowed the crisis to happen and may now prevent a similar crisis from happening again. There is a general perception that it supported the good collaboration of the Commission with the administration and provided solidarity by helping the Cypriots as much as possible in getting over the crisis. The main achievements were on the reform of the budgetary framework and the guaranteed minimum income, while preparing the ground for other important reforms that got finalised only post-programme in sectors such as healthcare or the judiciary. The Support Group for Cyprus (SGCY) ensured the relevance of its work for programme implementation by working closely with the Cypriot authorities and adopting a demand-driven approach.

Support received through the European Structural and Investment Funds (ESIF) proved effective in supporting investment during the programme and in implementing some of the relevant provisions in the MoU. The definition of strategic priorities for the multi-annual financial framework (MFF) 2014-20 coincided with the beginning of the programme. The authorities could hence conceive from the start an investment strategy that took the reform priorities of the programme and the necessary flanking measures as well as the crisis context into account. Synergies between the ESIF and the programme were quite successful in the field of active labour market policies. Although there remains room for improving monitoring and evaluation systems, the reform of active labour market policies made in conjunction with the benefit reform and the introduction of the guaranteed minimum income was largely financed by the European Social Fund and was useful to provide training opportunities to those who had lost their job during the crisis. The Structural Funds were also an incentive for the development and adoption of the 'smart specialisation strategy', which is a pre-condition for receiving the Funds.

In this case, however, the link with the Action Plan for Growth could have been further exploited and low awareness by stakeholders in the private sector possibly suggests that ownership could have been enhanced by their higher involvement.

8. MAIN OUTCOMES AND REMAINING CHALLENGES

8.1. GROWTH, FISCAL CONSOLIDATION AND SOVEREIGN FINANCING

Economic growth and public finance outcomes turned out visibly better than expected at the beginning of the programme. Real GDP growth turned positive in 2015 and stayed well above the euro area average in subsequent years (see Table 8.1). The Commission's 2019 summer forecast expected the robust GDP expansion to continue at 2.9% in 2019 and 2.6% in 2020. The real effective exchange rate depreciated significantly in the crisis years, in line with the euro area trend, but this is expected to be reversing as wages start to rise and inflation is no longer negative. High growth and strengthened fiscal governance supported the fiscal consolidation marked by budget surpluses during 2016-2017 and a declining public debt (apart from a temporary increase in 2018). A large general government deficit in 2018 was due to the one-off effect of the costs related to the liquidation of the Cooperative Central Bank (CCB, further explained below in section 8.3).

The high government debt burden remains the main source of fiscal risks in the short, medium and long term; fiscal discipline over each of these timeframes is essential to anchor the debt-to-GDP ratio on a sustainable downward path.([89]) Primary surpluses and favourable snowball effects helped reduce the debt ratio in 2016 and 2017, but new state support related to the sale of the government-owned bank CCB led to a spike in gross government debt in 2018 (at 102.5% of GDP). Government debt is expected to decrease in 2019 and steadily over the next decade, but the trajectory is vulnerable to adverse macroeconomic and fiscal shocks, including a sustained increase in interest rates.

Some of the fiscal measures in the public sector agreed during the programme may be reversed, with potential downside risks to public finances. In March 2019, the Administrative Court issued two decisions deeming unconstitutional the payroll and pension cuts in the public sector implemented since the crisis. The government appealed to the Supreme Court and as of September 2019 the case was on-going. A confirmation of the Administrative Court rulings could significantly affect public finances, especially if the ruling is extended to all civil servants. The potential fiscal impact is, however, difficult to gauge at this stage.

In spite of a credit rating below investment grade throughout the programme, the Cypriot sovereign gradually regained access to international markets starting from mid-2014. Having previously exceeded 1000 basis points for 10-year maturities, spreads to the German Bund started declining in late 2013 and reached again levels below 600 basis points in 2014, allowing a gradual return to markets for longer-term financing. Spreads fell to below 400 points in the second half of 2015 and to below 200 points in 2017. In September 2018, Standard & Poor's, in October 2018 Fitch Ratings and in November 2018 DBRS raised Cyprus' sovereign credit rating back to investment grade for the first time since 2012. This allowed the ECB to include Cyprus in its public sector purchase programme. In February 2019, Cyprus issued bonds over 15 years, borrowing EUR 1 billion at 2.76%. It was followed by the issuance of a 30-year bond (worth EUR 750 million at 2.84%) and a 5-year bond (worth EUR 500 million at 2.67%) in April 2019. Using the proceeds from these issuances, the government repaid earlier the outstanding Russian loan (of around EUR 1.6 billion) that was originally due in 2021. In September 2019, Cyprus' 10-year sovereign bond yield in the secondary markets was trading below 1%.

Fiscal-structural reforms started under the programme had a mixed track record after the exit: some were explicitly reversed, some remain to be implemented, while other ones created positive spill-overs. The privatisation plans have essentially been abandoned, the privatisation unit was dismantled, and the separate framework law was abolished. The immovable property tax was first halved for the 2016 tax year, and subsequently fully abolished for the 2017 tax

([89]) Fiscal sustainability risks are currently still assessed to be high in the short term and in the medium and long term - see European Commission, Post-Programme Surveillance Report Cyprus, Spring 2019, *European Economy Institutional Paper*, No. 104/2019 and "Assessment of the 2019 Stability Programme for Cyprus".

Table 8.1: **Key macroeconomic indicators in Cyprus, 2013-2018**

	2013	2014	2015	2016	2017	2018
Real GDP (% change)	-5.8	-1.3	2.0	4.8	4.5	3.9
Unemployment (% of active population)	15.9	16.1	15.0	13.0	11.1	8.4
Budget balance (% of GDP)	-5.1	-9.0	-1.3	0.3	1.8	-4.8
Public debt (% of GDP)	103.1	108.0	108.0	105.5	95.8	102.5
Current Account Balance (% of GDP)	-4.9	-4.3	-1.5	-5.1	-8.4	-7.0
Net International Investment Position (% of GDP)	-138.7	-147.0	-145.0	-123.0	-121.1	-114.7

Source: European Commission, AMECO database

year. In the post-programme period, there has been little progress with the functioning of the public administration and of local governments as well as SOE corporate governance reforms. The national healthcare system started working in 2019, though risks to its implementation still exist (see below). More generally, the Cypriot authorities stated in meetings with the evaluation team that policy advice provided during the programme was very useful and that technical assistance received in this field is being fully utilised. On the other hand, some of the reform avenues in public financial management that opened up during the programme have been rolled out in the post-programme era. Such 'policy spillovers' could be identified in performance-based budgeting (improvement of various aspects of project evaluation) and expenditure control (e.g. secondary legislation adopted in autumn 2016 revamped the procedures for budget preparation and for within-the-year adjustments as well as the responsibilities for commitment control officers). Furthermore, the operation of the main pillars of the revised fiscal framework (domestic numerical rules, medium-term planning, and the Fiscal Council) continued to underpin the solidity of the budgetary stance.

Largely legislated only after the programme ended, the health care reform is a clear example that political will plays a key role determining programme outcomes. There was a national interest to include health care in the programme, which went beyond pure fiscal sustainability considerations (chapter 4). It provided an opportunity for the administration to tackle older issues of the health care system such as spending inefficiency, lack of financial sustainability, low productivity, poor health indicators and dearth access to health care. Yet, the NHS and the hospital autonomy bills were only adopted in June 2017, as a package, thanks to favourable political circumstances. In June 2019, the first phase of the NHS covering out-of-hospital health care was launched, and the second stage is due to come into force in June 2020.

The full implementation of the pension reform will require future decisions. Pension contributions are foreseen to keep rising until 2039 and the first increase in the statutory retirement age is envisaged for 2024, based on the increase in life expectancy (if any) in the 5 years period up till that moment (2018-2023).

8.2. MACROECONOMIC IMBALANCES AND COMPETITIVENESS

Macroeconomic imbalances have been unwinding only slowly and in early 2019 were still considered excessive. The Commission's country report 2019 highlighted the very high levels of NPLs and noted that the ratios of private, government and external debt to GDP remained large, even though they had been gradually declining. A current account deficit of 7.0% of GDP in 2018, inflated by the activities of special purpose entities, prevented a sustainable reduction of net foreign liabilities. While the housing market was recovering, there remained regulatory and administrative inefficiencies in the housing sector. Reforms regarding public administration, the justice system, title deeds and other aspects of the business environment were deemed to be proceeding at a slow pace, while privatisation plans have been in practice abandoned.

Country-specific recommendations addressed to Cyprus in the post-programme years related to many problems already identified during the programme. Summing up, Cyprus was

recommended to (1) improve the efficiency in the public sector, including the performance of State-owned enterprises (2) improve the efficiency of the judicial system and fully operationalise the insolvency and foreclosure frameworks and ensure the issuance of title deeds, (3) accelerate the reduction of non-performing loans, (4) implement the action plan for growth and conditions for investment, and (5) complete reforms of the public employment services, the education and training system and the National Health System.

The post-programme surveillance by the Commission and the ECB has regularly prioritised similar areas of structural reforms to boost potential growth. These include the judicial reform, in particular the specialisation of courts, clearing the high accumulation of cases and revising the outdated civil procedure rules. A reform of the title deeds issuance and transfer system is seen to be long overdue. Improvements in the business environment should in particular take place through the simplification of the procedures to obtain permits to invest in Cyprus, the opening up of the electricity market, and the completion of privatisation projects, also to help diversify investment to sectors other than construction and tourism, currently the key drivers of growth.

8.3. THE BANKING SECTOR

The banking sector remains fragile, as exposure to the state in the sector is significant, profitability is low and the stock of non-performing loans (NPLs) is large, albeit declining. At the end of 2018, NPLs in local operations of local banks still represented 30% of all loans. Furthermore, the Cypriot banks reported the highest NPLs in the EU for their exposure to the construction sector and second highest for their exposure to the real estate sector. This weighs on credit by harming investment and hence the growth potential of the economy. Bank profits were mostly negative for 6 years, essentially due to impairments and risk provisioning, and turned moderately positive only in 2018.

In 2018, the financial situation of the Cyprus Cooperative Bank (CCB) raised concerns. Contrary to expectations in 2014-2015, when the CCB received restructuring aid, it was unable to return to viability as it failed to recover sufficient money from its very significant portfolio of non-performing loans. This was partially due to the bank's own governance failures and partly because of obstacles created by the Cypriot legal framework to work out non-performing loans. As the restructuring of CCB started on the basis of national law before EU bank recovery and resolution rules (namely the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation) entered into force, the process was managed by the Cypriot authorities, which considered public support necessary to mitigate the effects of the bank's market exit. Thus, on the basis of EU state aid rules a state aid of EUR 3.5 billion (around 18% of the Cypriot GDP) was approved to facilitate the orderly market exit of CCB while retail deposits remained fully protected. The liquidation involved the sale of some CCB assets and deposits to the private Hellenic Bank, while the non-performing loans were kept in a 'Residual entity' (KEDIPES) owned by the state. This transaction removed about 25-30% of NPLs from the banking sector. In this context, to facilitate the reduction of NPLs in the banking system, the government committed to introduce significant amendments in the insolvency, foreclosure and sale of loans legislations and to reform the judicial system.

Cyprus recently made progress in reducing non-performing loans (NPLs) held by banks. They declined markedly in 2018 mainly on account of two one-off transactions, i.e. the transfer of the non-performing CCB assets to the state-owned asset management company KEDIPES and the sale of a large NPL portfolio by Bank of Cyprus. Notwithstanding this progress, the NPL ratio in the Cypriot banking sector continues to be the second highest in the euro area. Moreover, the NPLs transferred to KEDIPES continue to weigh on the economy, awaiting an efficient workout based on commercial principles to maximise the recovery value for the state and reduce the burden to the taxpayers. The establishment of KEDIPES as an asset management company in line with the corresponding EU state aid decision further requires setting up an effective governance framework, ensuring operational independence

from the State, and having an adequate supervisory framework. In addition, a legislative package was adopted in 2018 that included amendments to the foreclosure and insolvency frameworks and the sale of loans law as well as the adoption of a securitisation law. The new foreclosure law since July 2018 is seen by the Cypriot authorities and banks as bearing fruit in the sense that foreclosure is slowly becoming a credible threat and more defaulted borrowers return to the negotiating table to restructure their loans.([90]) Whether this – together with improving judiciary procedures – will enhance the credibility of the collateral enforcement remains an open question. Finally, the so-called ESTIA scheme - launched in September 2019 - will give support to vulnerable debtors having NPLs collateralised with their primary residences who want to resume their debt service subject to specified eligibility criteria, while triggering foreclosure procedures in the case of re-defaults.

8.4. SOCIAL OUTCOMES

Social conditions deteriorated before and during the programme, but more recently they have begun to improve because of the labour market recovery and some policy reforms. Following strong employment losses in 2012 and 2013, total employment continued to decline modestly during 2014 and recovered thereafter. The unemployment rate, which had been rising steeply before and during the programme, has been declining since 2015 (see Table 8.1) and was projected to continue falling in 2019 and 2020. The labour market situation, including wage cuts, may have been among factors behind an observed increase in emigration during 2012-2014.([91]) The share of young people not in employment, education, or training (NEET) remained high until mid-2017, but since then has started to decline more visibly. Gross household disposable income fell more steeply than GDP in 2010-2015, and income inequality was increasing until 2013. However, despite a reduction in expenditure on social protection benefits that was particularly visible in 2014, income inequality started to fall already in the same year, and has been on a declining path since then (Graph 8.1). By 2016, inequality indicators largely fell to levels from around 2011. At the same time, wealth inequality remains among the highest in the euro area.

There is insufficient data to assess more precisely the difference in burden of labour market adjustment among various categories of workers. Many stakeholders believe that the burden of adjustment has not been evenly shared in the Cypriot society and in particular that private sector employees were particularly strongly affected (see Annex 1). National accounts data point to a slightly more nuanced picture. During 2013-2014, employment reduction in the private sector was stronger than in the public sector, while the opposite is true for the compensation per employee.([92]) More recently, especially in 2017-2018, employment gains were stronger in the private sector, while compensation per employee stagnated there, in contrast to compensation increases in the public sector. The compensation data based on the records of the Social Insurance Services reported by the Cyprus Statistical Service do not indicate a large difference in the dynamics of earning between public and private sectors.([93]) Yet, another source of data - the Structure of Earnings Survey of Eurostat carried out once every four years - suggests that between October 2010 and October 2014 average hourly earnings declined much more in sectors such as public administration and defence, compulsory social security or education than for the economy as a whole.

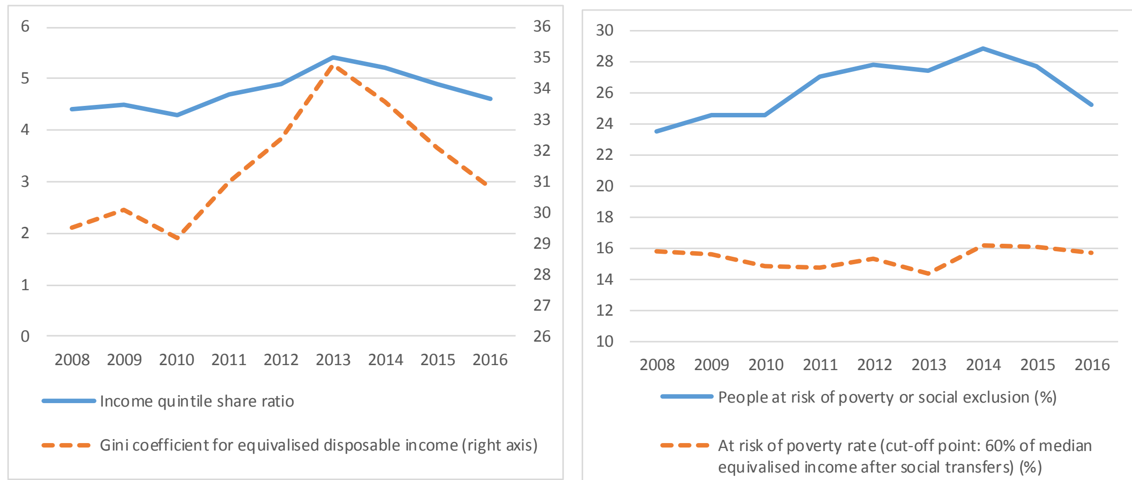
([90]) However, amendments to the foreclosure framework approved by the Parliament in August 2019 implied a dilution of some of its key elements, notably regarding primary residences. The President of the Republic referred these amendments to the Constitutional Court.

([91]) Eurostat data suggest an increase of emigration of Cypriot citizens (from below 300 per year during 2009-2011 to a peak of above 3,000 in 2013) and more significant emigration of citizens of other EU and non-EU countries (peaking in 2013-2014 at above 20,000 per year).

([92]) For these comparisons the public sector is proxied by NACE category “Public administration, defence, education, human health and social work activities”.

([93]) The distinction between sectors is done in the same way as for national accounts data.

Graph 8.1: **Selected inequality and poverty indicators in Cyprus, 2008-2016**



Source: Eurostat, EU SILC data.

Social transfers and pensions in particular helped to minimise adverse social effects of the crisis, and most inequality and poverty indicators actually improved after 2013/14. The poverty rate after social transfers changed little during and after completion of the programme (Graph 8.1). However, poverty indicators not taking into account social transfers point to a substantial increase in poverty in the years until 2014 and a broad stabilisation of poverty levels since then until 2016 (the most recent year for which income data is currently available). This appears to be driven predominantly by a significantly increased poverty-reducing role of pensions, which, however, do not appear to be linked to changes introduced during the programme. On the other hand, given the decrease in total expenditure on social protection benefits during 2013-2014, this suggests an improvement in targeting of benefits that may be in part attributed to the reform of social assistance with the introduction of GMI scheme in 2014. This would be also consistent with the observed decline in income inequality.

8.5. OVERALL ASSESSMENT

Positive macroeconomic and fiscal developments that had started during the programme continued thereafter. Real GDP growth, which had turned positive in 2015, remained above euro area average in subsequent years. Unemployment continued to decrease and social conditions improved. Public debt has been on a descending path (except for 2018 due to the one-off banking support measures related to the resolution of the Cyprus Cooperative Bank), and the costs of sovereign financing decreased to historic lows in summer 2019. Some of the fiscal-structural reforms envisaged under the programme, such as a national health system, were nearing completion in 2019.

While the programme had contributed to the stabilisation of the banking sector and the economy at large, their underlying structural weaknesses have not yet been fully addressed. The Commission's Country Reports, country-specific recommendations and post-programme surveillance reports document the extent to which the Cypriot banks and the economy continue to be challenged by structural legacy problems that were already identified during the programme. The economy continues to rely on few sources of income, related to tourism, construction and housing, and foreign capital inflows. It is important to remember though that a small open economy will always face limits in terms of possible economic diversification.

With the benefit of hindsight, this raises legitimate questions as to whether programme conditionality and its implementation had always been sufficiently complete and rigorous

in addressing the deeper structural problems in the Cypriot economy. However, as could also be seen in other euro area adjustment programmes, it is clear that not all vulnerabilities can be addressed within a 3-year programme and that some of the structural problems can only be expected to be solved in the medium term. One option to address this general problem could be to consider extending the length of adjustment programmes from three to, say, five or six years. However, this would not solve the fundamental problem of programme ownership and implementation that tend to deteriorate once the sovereign financing constraints are easing, as could also be seen in the case of Cyprus. Another option could be to have an adjustment programme accompanied by a medium-term economic and social strategy that would include all policy elements that are not immediately contributing to the programme's objectives or unlikely to be accomplished during the programme period. It would provide linkages to the programme's macro-fiscal framework as well as to its policy conditionality with a view to preparing and starting medium-term reforms. Such a document could also include a public investment strategy, and the contribution of EU funding, also to avoid that public investment unduly falls victim to fiscal consolidation. Ideally, such a medium-term strategy should be supported by a broad political and social consensus to avoid significant disruptions in its implementation over time.

A tighter surveillance regime right after the end of the Cyprus programme could have been considered to reinforce and accelerate key reforms that address legacy problems, such as the non-performing loans in Cyprus' banks. Options would have been enhanced surveillance or corrective action under post-programme surveillance and/or the Macroeconomic Imbalances Procedure, as is possible under current EU legislation. This would have allowed specifying conditionality-like actions to be taken within a given timeframe, something that is not foreseen under standard EU surveillance procedures.

The crisis and the adjustment process had less of a social impact than could be expected. In spite of the high unemployment, poverty and inequality started to improve already in 2014 despite a fall in expenditures on social protection in that year. This suggests an improvement in the targeting of social protection that could be partly explained by the introduction of the reforms implemented in the programme, notably the guaranteed minimum income scheme.

9. CONCLUSIONS

The main purpose of this ex post evaluation was to assess the adjustment programme for Cyprus in order to draw lessons to inform the policy debate. This should help to improve future policy-making when designing and implementing adjustment programmes or similar interventions, whether in the euro area or elsewhere. The lessons learned, presented below, strive to achieve that purpose.

The main findings of this evaluation are detailed in the overall assessments of Chapters 2 to 8 and enable the identification of conclusions and some general lessons learned. Conclusions and lessons learned are considered in the framework of the evaluation criteria of effectiveness, efficiency, relevance, coherence and EU value added. In many instances the lessons learned coincide with those mentioned by stakeholders in interviews with the evaluation team when explicitly asked about their main lessons from the Cyprus programme (see Annex 1, section A1.8).

Effectiveness

While the programme objectives of stabilising the financial sector, restoring fiscal sustainability, and implementing structural reforms were largely achieved, allowing Cyprus to regain market access, external factors such as government action ahead of the programme, the euro area recovery and a buoyant tourism sector also contributed. The programme was overall successful in restoring fiscal sustainability and stabilising the financial sector while providing the Cypriot state with sufficient financial breathing space. This helped re-establish a gradual access to sovereign markets already during the programme. Positive macroeconomic and fiscal developments that had started during the programme continued thereafter.

Despite an overall positive track record in terms of implementation, the programme was less effective in making the banks' business model and the country's growth more sustainable and balanced, and some of the underlying vulnerabilities remain to be addressed. With the benefit of hindsight, this raises legitimate questions as to whether the programme design and its implementation had always been sufficiently complete and rigorous in addressing the deeper structural problems in the Cypriot economy, while acknowledging that a programme can only start such changes that go beyond the 3-year time horizon of a programme.

The overall situation of the Cypriot financial sector gradually improved after its stabilisation was achieved at the beginning of the programme. Yet, the Cypriot banking sector remained subject to high risks at the end of the programme. In particular, the programme could have pursued a more comprehensive approach to address the problem of NPLs. Risks also remained in the cooperative banking system. The programme was largely ineffective in reducing the private sector debt overhang, which persisted post-programme, despite some deleveraging starting from 2016.

Due to cautious macroeconomic projections and a prudent fiscal consolidation path, surprises were always on the upside. Fiscal-structural measures varied in their implementation and contribution to fiscal consolidation during the programme horizon.

The programme was effective in triggering a broad range of structural reforms that were implemented during - and continued after - the programme. Support received through technical assistance and the European Structural and Investment Funds (ESIF) helped in implementing some of the relevant provisions in the programme.

From the outset, the programme was committed to minimise the impact of the programme on vulnerable groups, including through programme measures to improve the targeting of social spending achieved by introducing the Guaranteed Minimum Income (GMI). While the social impact of the programme itself is difficult to assess, the crisis and the adjustment process had less of a negative social impact than could be expected.

Against this background, the main lessons learned from the adjustment programme for Cyprus on effectiveness are the following:

1. It is not possible to attribute all – positive or negative – effects to an adjustment

programme, given that a lot depends on general economic developments, which in turn are related to the broader European and global economic context.

2. The distributional and social implications of a programme are difficult to distinguish from the social costs of an economic crisis and the subsequent adjustment. While making a detailed social impact assessment when the programme is at its design phase is practically impossible, there should be a more systematic monitoring and reporting of the main social developments in programme documents. Methodological tools to assess the social impact of key programme measures should be further developed and applied.

3. Programme measures should be shaped to take equity and social considerations into account, aiming at progressive burden-sharing and protection of the most vulnerable. A well-designed safety net, such as the GMI scheme in Cyprus, integrated with activation policies, is necessary to minimise the social implications of the adjustment process and the programme.

Efficiency

The efficiency of the programme's policy conditionality and its implementation varied in the different areas. Following the initial stabilisation of the financial sector, with the benefit of hindsight, the programme could have been more efficient by pursuing a more comprehensive strategy on NPLs and a more determined approach on the cooperative banking system, which however met political resistance from the Cypriot side. The overall policy approach to fiscal consolidation, pension and welfare reform, and the revamp of fiscal governance was efficient, as it more than delivered on the fiscal sustainability objectives set while avoiding the harshest measures in a reformer's toolbox. The programme on structural reforms ran quite smoothly, but its conditionality could have been more efficient had it been designed with a clearer prioritisation. In terms of cost competitiveness, similar outcomes in the labour market could have been obtained with less prescriptive conditionality. Programme financing turned out to be markedly higher than the actual needs, but reflected the objective of programme design to ensure that there was sufficient financing even under a worst-case scenario.

Overall, the programme was efficiently managed by the Cypriot administration that was highly committed to implementation and benefitted from technical support provided by the Commission and other institutions. However, the delayed start of the programme increased the financing needs and aggravated the problems in the banks. At the end of the programme, the authorities did not seriously consider alternatives to its exit strategy.

Against this background, the main lessons learned from the adjustment programme for Cyprus on efficiency are the following:

4. A delayed start of a programme may increase the economic and social costs of a crisis and thereby increase the size and risks of the programme. The euro area could further reflect on how to accelerate the request for a programme by a Member State in crisis, including by making use of a Council recommendation for an adjustment programme as foreseen in Article 3.7 of Regulation (EU) 472/2013 of 21 May 2013.

5. To avoid a delayed recourse to programme financing, the use of bilateral loans – such as the one from Russia to Cyprus in late 2011 – should be avoided. Euro area procedures on restricting access to such loans in a crisis could be further developed.

6. Programme conditionality and its sequencing should be commensurate to the administrative capacity of a country and the time horizon of the programme, notably in a small country like Cyprus. Over-burdening a programme with conditionality that is unlikely to be achieved can negatively affect a programme's credibility and economic confidence.

7. The time needed for reforms to be implemented and to show results raise questions about what can reasonably be expected to be implemented during the limited

period of an adjustment programme. The trade-off between ownership and the objective of a swift return to the market – as witnessed also in Cyprus - must be recognised by a frontloading of the most important measures, being aware that there can be administrative capacity constraints when trying to do everything at the same time.

8. Policies aimed at addressing the weaknesses of a banking sector in a country subject to a macroeconomic adjustment should be implemented promptly and forcefully, in particular to avoid a delayed and costly tackling of problems, as could be seen in the case of the cooperative banking system in Cyprus.

9. Temporary administrative restrictions and capital controls, as applied in Cyprus, can be an important tool for protecting banks' liquidity position after major shocks to depositor confidence. A clear strategy on the conditions to lift such administrative restrictions and capital controls should be set and communicated upfront to rebuild trust in the financial system, while avoiding risks arising from lifting them too soon and having to reintroduce them again.

10. While macroeconomic and fiscal projections should generally be made with an appropriate balance of upside and downside risks, it may be prudent in a financial crisis - with many unknowns - to be on the cautious side. However, excessively pessimistic projections may bear risks of negatively affecting confidence and requiring a steep fiscal adjustment that could turn the economy into a negative downward spiral.

11. A frontloaded fiscal consolidation strategy, as it was implemented in Cyprus, needs to adequately assess the expected benefits of ensuring debt sustainability and boosting confidence and credibility against the possible negative effects on economic growth and employment and the risks of reform fatigue in a backloaded strategy.

12. Reforming poorly targeted social benefit schemes, as was done with the GMI scheme in Cyprus, can serve at the same time both objectives of fiscal consolidation and of providing better social protection in times of an economic and social crisis.

13. High levels of political and social sensitivity and strong vested interests can contribute to delays and a weak implementation of structural reforms. This was the case with the privatisation of state-owned enterprises in Cyprus. Strong prioritisation on what is economically sound and effectively achievable within the short time of a programme and clear communication are necessary for maintaining country-wide ownership of the reform process, overcoming resistance and achieving implementation of fair and efficient reforms.

14. Programme objectives related to growth and competitiveness, and their link with structural reforms, need to be realistic. As structural reforms usually require thorough economic, legal and political preparations, they are difficult to frontload in a programme, while ownership tends to diminish at some time in the programme as reform fatigue sets in and sovereign market access is gradually regained. Furthermore, for more comprehensive reforms, such as changes to the growth model aimed at in Cyprus, a three-year time horizon of a programme can be insufficient to ensure their full implementation on the ground, and even less so to see their results. For these reasons, overly ambitious structural reforms often remain unfinished business at the end of a programme.

15. Assumptions about financing needs should be prudent to reflect the uncertainties prevailing at the time, such as in Cyprus prior to the programme, taking into account contingent liabilities of the public sector and market access developments, while preserving debt sustainability. The size of the financial envelope should add credibility to the programme's overall objective of facilitating a return to the sovereign debt markets.

16. Transparency and a good flow of information are essential for working relationships between programme partners and the authorities that are committed to an efficient programme implementation, as was mostly the case in Cyprus. Programme reporting and monitoring requirements should be well designed and implemented, while avoiding being administratively burdensome for the authorities.

17. Strong and sustained programme ownership by the national authorities and key stakeholders is crucial for programme success. Ownership can be negatively affected by several factors, including the lack of prioritisation of the most important reforms, insufficient communication on the reforms' long-term benefits, as well as the relaxation of the financial constraints once the country returns to the market. A shared diagnosis of the main challenges and a continuous dialogue between programme partners, national authorities and key stakeholders can strengthen programme ownership and help ensuring that programme measures are implemented in cooperation.

18. A good administrative capacity and a powerful coordinating body within the government are essential elements of a good programme implementation. When a government loses its political majority in the Parliament policy conditionality must be set in a manner that ensures the full implementation and application of measures, including the use of prior actions.

19. For an exit strategy without a successor programme ('clean exit'), a tight surveillance regime right after the end of a programme should be considered to reinforce and accelerate key reforms that address legacy problems at the end of the programme, such as the non-performing loans in Cyprus' banks. Options include enhanced surveillance or corrective action under post-programme surveillance and/or the Macroeconomic Imbalances Procedure.

Relevance

The overall programme strategy and its main objectives were relevant in addressing the main challenges. Financial stabilisation was necessary to avoid an even deeper banking crisis. In retrospect, the specific fiscal targets may appear ambitious, but they were relevant in effectively containing debt at the time and signalling to the markets that the government was capable to deliver fiscal discipline. The programme was also very relevant in improving the long-term sustainability of Cypriot public finances. Structural reforms related to product and service markets correctly identified many important challenges, even though not all of them were relevant to achieving the programme objectives. The financing envelope was clearly an indispensable part of the programme.

Against this background, the main lessons learned from the adjustment programme for Cyprus on relevance are the following:

20. Fiscal-structural policy conditionality can help ensure that gains in fiscal consolidation become more permanent and the efficiency of the public sector is improved. Politically more controversial measures, such as pension reforms or privatisations, need to be well prepared, communicated and consulted to strengthen ownership in the society and political support.

21. Programmes should limit their structural reforms to what is clearly needed to achieve the programme objectives and to support the adjustment process, embedded in a clear strategy that allows a focus on the most critical weaknesses affecting the functioning of the economy. Even with full initial programme ownership, including too many reforms with tight deadlines risks overstretching the administrative capacity and the available political capital of a government, thus damaging the credibility of the programme.

22. Structural policy conditionality may also be needed to support the achievement of financial stability and fiscal sustainability objectives, such as housing market measures to reduce

NPLs or regulatory measures before restructuring or privatising state-owned enterprises. Although coherence with EU acquis and principles has to be ensured throughout programme implementation, conditionality linked to the implementation of EU acquis pursuing mainly non-programme objectives should be avoided.

23. Labour cost adjustments are often required in a crisis, especially if the nominal exchange rate is not an available adjustment mechanism. As part of a broader set of measures to support productivity and competitiveness, this is necessary to avoid even deeper job losses and to enhance competitiveness in a monetary union. Where labour markets are sufficiently flexible to bring about the necessary adjustments, as was largely the case in Cyprus, programme conditionality should limit itself to the key reforms in this respect, following a substantive consultation of social partners.

24. A specified target for cash buffer developments should be part of the programme envelope design, which was not done for Cyprus. This contributes to market access and the exit from the programme, but can reduce the incentives for reform over time.

25. Earmarking a financial envelope for the banking sector helps prevent its use for other needs and enhance confidence in the banking system, especially in the presence of a delayed adjustment of banks' balance sheets.

Coherence

The programme generally ensured coherence between its different objectives, although in some parts the coherence was initially insufficient. At the start of the programme, the responsibility for the supervision and resolution of banks in the EU was located at the national level, which presented a difficulty for preventing, assessing and addressing coherently the problems of banks in Cyprus. The EU's fiscal policy framework provided guidance on restoring fiscal sustainability. Coherence between structural and fiscal reforms was clearly achieved in the case of labour market reforms, but less so for product market reforms and privatisation.

Against this background, the main lessons learned from the adjustment programme for Cyprus on coherence are the following:

26. The restoration of banks' viability and of market confidence go hand in hand, in a mutually reinforcing process as could be seen in Cyprus. Strengthening and cleaning the banking sector is therefore a crucial part of addressing a financial crisis. This also requires other policy measures, including fostering private debt restructuring and maintaining an adequate level of credit to viable firms.

27. Taking into account the complexity and interlinkages between different areas and avoiding working in departmental 'silos' is essential to ensure a coherent programme strategy. A comprehensive diagnosis about the main causes of non-performing loans (NPLs), which was to some extent lacking in the Cyprus programme, is necessary to understand the complexity of the matter and to develop the most adequate strategy to pursue. Reducing NPLs may require the parallel implementation of a balanced and broad combination of different policies, including improving the insolvency and foreclosure procedures, making the judiciary more efficient, ensuring a functioning housing market, enhancing supervision, developing distressed debt markets and setting up an asset management company.

28. Reforms started during the programme but going beyond its time horizon need to be followed up after the end of the programme. Economic surveillance in the context of the European Semester and technical assistance provided by the Commission can ensure the time-consistency of the reform process.

EU value added

There was a clear value added of the EU engagement in that adequate financing was

provided at low costs and in that the credibility of policies was boosted. No other institution apart from the ESM was able to provide Cyprus with all the financing it needed and at a price it could afford. The identification of relevant fiscal policies and structural reforms in the programme was supported by the EU surveillance framework. Technical assistance provided by the Commission during the programme enhanced the administrative capacity needed for programme implementation.

Against this background, the main lessons learned from the adjustment programme for Cyprus on EU value added are the following:

29. When the sovereign has market access only at unsustainable costs, an EU intervention provides for an adequate financing envelope at very low costs. Apart from financing, the intervention at EU level also adds significant value in terms of credibility, expertise and coherence with other EU policies.

30. A well-defined EU framework for dealing with bank recovery and resolution is essential for avoiding perceptions of unequal treatment and unfair burden-sharing. It can also help overcome problems with banks that benefit from political protection and that are difficult to address without putting the programme altogether at risk. Progress made towards an EU-wide Banking Union already provides a better framework to deal with banks' contingent risks.

31. The EU fiscal policy framework, including the Stability and Growth Pact, the Budgetary Frameworks Directive, the Two-pack Regulation and the intergovernmental Fiscal Compact, provides relevant guidance and coherence to a programme strategy on strengthening fiscal sustainability.

32. Technical assistance, as provided by the Commission's Support Group for Cyprus, can support the implementation of selected programme measures. It is also an important act of solidarity and willingness to help a country in crisis in a tangible manner. To deliver results and be well integrated with the overall programme work, a demand-driven approach can ensure that the right priorities and technical weaknesses are addressed.

33. Other EU funds and policies should support the programme objectives and avoid inconsistencies, which was largely the case in Cyprus. To do so, a medium-term economic and social strategy accompanying the programme could take up all policy elements that go beyond the reach of the programme in time and scope. It would provide linkages to the programme's macro-fiscal framework as well as to its policy conditionality with a view to preparing and starting reforms with a medium-term time horizon. Such a document could include a public investment strategy, and the contribution of EU funding, also to avoid that public investment unduly falls victim to fiscal consolidation. Ideally, such a medium-term strategy should be supported by a broad political and social consensus to avoid significant disruptions in its implementation over time.

ANNEX 1
Evaluation process and methods

A1.1. GENERAL APPROACH

This evaluation aims at striking an adequate balance between providing an understanding of the context of the intervention and a judgement benefitting from hindsight. As time passes after the end of a programme it usually becomes clearer which parts of the programme worked well and which parts did less so. However, in the middle of a programme, decisions have to be taken under uncertainty and in the face of imminent stability risks as well as a significant number of constraints of a political, economic, social or legal nature. The evaluation aims at assessing whether programme decisions taken were adequate given the information available at the time, even though *ex post* they might have turned out to be not entirely adequate. In this way, lessons can best be learnt for making more adequate decisions in future programmes.

Judgements made in the evaluation are strictly evidence-based. Assessments in the evaluation are made by drawing on the available empirical literature and evidence. Quantitative research, whenever relevant and feasible, is complemented by qualitative analysis. Publicly available data is used, including Eurostat and Ameco, and relevant Commission, ECB, ESM and IMF reports, as well as documents published by the Cypriot authorities, other international organisations, and private sector and academic research. As the evaluation took place about three years after Cyprus exited the programme, the analysis focuses on the short-term results rather than on the medium to long-term impact of the intervention that cannot yet be fully observed.

While an ideal evaluation would assess in quantitative terms the action taken compared to viable alternatives at the time, the assessment could not be based on building counter-factual scenarios. The use of a macroeconomic model is not appropriate in the context of an ex-post evaluation of such a multi-faceted programme due to the exceptional nature of the crisis (especially in the euro area context of the time) and the importance of the political context and other unobservable and/or exogenous factors. For these reasons, it would not have been practical to use DG ECFIN's QUEST model for this ex-post evaluation. The approach taken allows a much wider range of factors to be taken into account, which can deliver conclusions that are more relevant in terms of institutional learning. Nevertheless, some partial analysis was used, such as the Debt Sustainability Assessment (DSA) toolkit, which is not a general equilibrium model but can incorporate feedback effects.

Targeted stakeholder consultation is an important element of the evaluation. Its aim is to facilitate an open and wide understanding of issues surrounding the programme and to get specific insights on the key evaluation questions. Information, including data and assessments from key stakeholders, was collected using a variety of methods including interviews, written questionnaires, a workshop and desk research.

The structure of the evaluation report follows the programme objectives. This ensures a better coherence of the report and enhances its dissemination once finalised. The structure also facilitated the division of labour among the authors according to their specific expertise. The main chapters assessing the programme design and implementation are on preserving financial stability, ensuring fiscal sustainability, restoring competitiveness and balanced growth, and ensuring sovereign financing. In addition, there is an assessment of the institutional arrangements of programme implementation, in particular those of the Cypriot authorities, the programme partners, technical assistance, and other EU support. Each of these chapters aim to answer questions oriented at the evaluation criteria of the Commission's Better Regulation framework, notably effectiveness, efficiency, coherence, relevance and EU added value of the programme. Finally, a chapter summarises the main outcomes, provides an overview of the current situation and highlights remaining post-programme challenges.

A1.2. THE EVALUATION QUESTIONS

The evaluation examines the following overarching issues:

- **Effectiveness:** To what extent has the programme achieved its objectives? What have been the qualitative and quantitative

effects of the programme? What was the social impact of the programme? What have been the unintended effects of the programme?

- **Efficiency:** Could there have been a different programme strategy to achieve the objectives at lower economic and social costs? To what extent were the focus, timing and flexibility of conditionality appropriate? To what extent was the implementation of the programme efficient? How proportionate were the costs and benefits of the intervention borne by different stakeholder groups? Was the programme's exit strategy appropriate?
- **Relevance:** To what extent was the design of the programme appropriate in relation to the outputs to be produced and the objectives to be achieved?
- **Coherence:** To what extent was the programme strategy coherent across its different areas and with other EU policies?
- **EU added value:** What was the rationale of an EU level intervention? To what extent was the EU surveillance framework helpful for programme entry, implementation and exit? How did the EU level intervention interact with other approaches adopted by the Cypriot government?

Key evaluation questions were formulated that corresponded to the two dimensions of the five evaluation criteria (see above) and the main objectives of the programme. The evaluation team defined these specific evaluation questions at the beginning of its evaluation work and ahead of the gathering of evidence. They are presented at the beginning of the 'overall assessments' in chapters 2 to 7.

A1.3. INTER-SERVICE STEERING GROUP

The Director General of the European Commission's Directorate General of Economic and Financial Affairs (DG ECFIN) appointed an Inter-service Steering Group (ISG) to oversee the evaluation. Chaired by the (acting) Deputy Director-General of DG ECFIN, it was composed of officials from DG ECFIN, DG Competition (DG COMP), DG Financial Stability, Financial Services and Capital Markets Union (DG FISMA), DG Employment, Social Affairs and Inclusion (DG EMPL) and the Secretariat General (SECGEN) as well as the Structural Reforms Support Service (SRSS). The ISG provided guidance, ensured impartial supervision during the overall process and assessed the quality and usefulness of the final outcome of the evaluation carried out by a team of economists from DGs ECFIN, FISMA, COMP and SRSS and not by the operational unit in DG ECFIN in charge of the Cypriot economy. None of the members of the evaluation team or of the ISG has been involved in the work of the adjustment programme for Cyprus.

A1.4. KEY DELIVERABLES

In line with the EU Commission Better Regulation guidelines an evaluation roadmap was published online from 8th October to 5th November 2018.([94]) The roadmap summarised the context, purpose and scope of the evaluation. Publication of the roadmap provided EU citizens and stakeholders an opportunity to provide feedback on the planned evaluation. During the feedback period two responses were received, which have been noted by the evaluation team.([95])

The evaluation inception report was submitted to the ISG who discussed and approved it in November/December 2018. The inception report laid the groundwork for the subsequent data collection and analytical tasks. It outlined the economic background to the request for financial assistance from the Cypriot authorities, presented the main elements of the programme, set out the evaluation methodology and put forward a tentative timetable for each of the steps of the evaluation process. Following the approval of the inception report, the evaluation team proceeded with the collection of data on which to base a comprehensive assessment of the programme.

After the data collection had been nearly finalised, the ISG discussed the interim report on the 8th of April 2019. It provided a summary of

([94]) In the Commission's planning procedure the Decide reference of this evaluation on the Cyprus programme is PLAN/2018/2854.

([95]) https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2930792_en

the evidence gathered during the desk and field research that had been undertaken. The interim report also presented some preliminary elements of assessment. The ISG supported the general approach of the evaluation and provided further guidance on the way forward.

On the 27th of May 2019, the ISG discussed the draft final report and approved a revised version on 2 July 2019. It was covering all the relevant evaluation issues with proper analysis and was assessed to be a good basis for the finalisation of the report. This draft version was subject to an inter-service consultation where some Commission services provided comments. The Cypriot authorities were called to express their views on the draft report, which are published in Annex 2 of this report.

In October 2019, the ISG approved the final report.

A1.5. DATA COLLECTION AND STAKEHOLDER CONSULTATION

This evaluation is centred on a data-based economic analysis. It uses publicly available data, Commission, ECB and IMF reports, documents published by the Cypriot authorities and other international organisations as well as private sector and academic research. While the numbers tell the story in terms of economic impact, being able to draw conclusions requires a good understanding of both the rationale and the context behind the programme. This is the role of the consultation process.

A wide and representative stakeholder consultation was undertaken to provide economically informed programme-specific input and context to the economic analysis. The consultation strategy was part of a focussed economic evaluation of the measures contained within a reform programme. Therefore, given the precise economic and financial nature of the intervention, the stakeholder consultation element of the evaluation was targeted and organised at three levels, applying Chatham House rules:

1. A wide and representative stakeholder consultation of bodies with an informed understanding of the economic adjustment programme – or the context in which it was implemented – was undertaken. The objective was to collect a broad and multi-dimensional understanding of issues surrounding of the programmes.

2. Individuals and organisations directly involved in the development and implementation of the programme were consulted to enable the evaluation to benefit from their experience and knowledge. In order to maximise the quality and usefulness of the information obtained from these interactions, it is necessary to ensure the confidentiality of the exchanges.

3. A workshop with senior officials involved in the programmes and independent academics took place, to discuss the preliminary findings of the evaluation.

To cover the relevant stakeholder groups and to collect a triangulated picture of the economic and financial issues surrounding the programme, the following specific stakeholders were consulted through written questionnaires:

Industry/business/employers' organisations:

- Employers and Industrialists Federation (OEB)
- Cyprus Chamber of Commerce and Industry (CCCI)
- Cyprus Confederation of Professional Craftsmen and Shopkeepers (POVEK)
- Cyprus Hotel Organisation

Workers' organisations:

- Cyprus Workers' Confederation (SEK)
- Pancyprian Federation of Labour (PEO)
- Democratic Labour Federation of Cyprus (DEOK)

Banking sector:

- Association of Cyprus Banks (ACB)

Consumers:

- Cyprus Consumers Association

Public Authorities:

- Superintendent for Insurance Control (SI)
- Cyprus Securities and Exchange Commission (CySEC)
- Union of Municipalities
- Cyprus Tourism Organisation
- Cyprus Energy Regulator Authority
- Competition protection commission
- Office of the Commissioner of Electronic Communications and Postal Services
- Health Insurance Organisation
- Financial Ombudsman
- Commissioner for Administration and Protection of Human Rights (ombudsman)
- Further information from other Cypriot public authorities and agencies was collected through meetings in Nicosia in March and April 2019.

Charitable organisations/NGOs:

- Association for Social Reform (OPEK)
- Pancyprian Volunteerism Coordinative Council
- Association of Cancer Patients and Friends (PASYKAF)
- Cyprus Patient and Friends Federation (POSFP)
- Cyprus Confederation of Associations of Disabled (KISOA)

Research/academia:

- The University of Cyprus: Economics department
- Cyprus Economics Society

Euro area Member States:

- Members of the Eurogroup Working Group (EWG, members representing the national Ministries of Finance).

The targeted consultation by written questionnaires took place in February and March 2019. The two different questionnaires for Cypriot stakeholders and the euro area Member States' Ministries of Finance were presented in a letter by the chairman of the Inter-service Steering Group (transmitted by e-mail) to explain the nature of the evaluation. While individual replies to the questionnaire are not published, a succinct summary is included in this annex to the report (see section A1.7).

In parallel, the evaluation team conducted a consultation of experts through interviews/meetings from January to April 2019. Interviews with individuals and organisations directly involved in the development and implementation of the programme were carried out to get insights on specific key economic issues as they emerged during the analysis, as guided by the key evaluation questions. These more than 40 interviews covered:

- A number of Cypriot authorities and agencies who were involved in designing and implementing the programme (e.g. the Central Bank of Cyprus, the Ministry of Finance, other Ministries);
- Relevant staff of programme partners: European Commission, EWG/EFC, IMF, ECB, ESM;
- Other organisations/persons/academics who can provide information on specific issues that emerged during the analysis.

Finally, when the report was nearing completion, an experts workshop was organised to test and validate the analysis and provisional findings of the evaluation. On the 21st of June 2019, the preliminary findings of the evaluation were discussed during a workshop with academics and experts. It was organised by the evaluation team under the guidance of the ISG. The final outcome of the evaluation benefited from the resulting open exchange of views.

A1.6. STRENGTHS AND LIMITATIONS

The evaluation process has been robust and the data gathered has been reliable. The process has benefitted from the input of a wide range of relevant skills, expertise and experience – both in the team of Commission economists undertaking the evaluation and in the ISG overseeing the process. In addition, the evaluation has benefitted from the input of academics and experts who have stress-tested and validated the analysis and provisional findings. A significant volume of

relevant and reliable data was available on which to base the evaluation, including form a wide range of informed stakeholders.

Economic adjustment programmes must be flexible in order to react to both internal and external changes of economic circumstances, which are bound to be substantial in countries that have requested external assistance. Uncertainty is also very high and structural changes need to occur in countries experiencing crises. The quarterly reviews allow close monitoring of the implementation and prompt adaptation of the different sets of measures to evolving circumstances. There is a continuous loop between design and implementation, which makes a programme a "living body". In this context, considerations about design and implementation are difficult to disentangle and do not necessarily allow useful conclusions to be reached.

This evaluation focuses on the initial design of the programme, how conditionality evolved during time, programme implementation and achieved results. The analysis in the different chapters of the report is distinguishing, to the extent possible, between the original design and the implementation of the programme. In assessing the original design, the evaluation compares the initial programme with the key challenges faced by Cyprus. In assessing the implementation, the results achieved through the implementation of specific conditionality – as it has been adapted over the course of the programme – are analysed. Each chapter also includes an overall assessment with respect to the objectives of the programme, while chapter 2 assesses the intervention logic of the programme against the background of the economic context and chapter 7 its institutional arrangements. These assessments are complemented by chapter 8 where the macroeconomic outcomes and remaining challenges, including social developments, are analysed. Drawing on the previous chapters, the overall conclusions (chapter 9) provide the main lessons learned in view of the effectiveness, efficiency, relevance, coherence and EU added value.

The evaluation encountered some limitations, particularly with respect to the non-availability of some individuals involved in programme design/implementation and the relatively short time since the end of the programme as well as the limited response by stakeholders to the written questionnaires. This hampers the ability to draw strong conclusions on the sustainability of some programme's achievements. As the programme dates back to 2013, in some cases officials who were directly involved in its design or in the early stages of its implementation were no longer working for the Cypriot authorities, the Commission or the other programme partners. Whenever possible these officials were interviewed, despite having moved to other assignments. The low response to the written questionnaires may also reflect to some extent many stakeholders' diminishing interest in the topic.

The fact that this ex post evaluation was undertaken about three years after the end of the programme represents a limitation for making a definitive assessment about the medium to long-term objective of a return to sustainable growth. A number of structural reforms that are crucial on a medium to long-term perspective and that started under the programme have not yet been finalised, making it difficult to reach concrete conclusions on their longer-term impacts.

In spite of these limitations, the different sources of evidence converged sufficiently well to provide reassurance to the assessments made in this report. While each of the individual sources of evidence (data, literature, stakeholder consultation) may be subject to specific weaknesses, the fact that they all pointed in the same direction and revealed hardly any contradictions underscores the reliability of the main findings. Therefore, the limitations encountered do not impair the robustness or reliability of the evaluation.

A1.7. SUMMARY OF THE TARGETED STAKEHOLDER CONSULTATION (RESPONSES TO WRITTEN QUESTIONNAIRES)

A non-exhaustive and non-specific summary from the replies to the written questionnaires is

reported below. The reference to 'respondents' or 'stakeholders', 'MoFs' or similar references must not be interpreted as majority, tendency, unanimity or necessarily 'more than one'. This summary aims at providing an overview of the main controversial assessments mentioned in at least one reply. This is not a statistical exercise based on sampling, representativeness and questions with closed answers. Of course, not all opinions could be reported, but they have been duly taken into consideration in the analysis.

The response rate to the written questionnaire was low,([96]) but received responses covered a broad spectrum of stakeholders. The Member States' Ministries of Finance that replied represent Member States accounting for nearly 60% of the euro area's GDP. Responding Cypriot stakeholders include associations representing the business sector, the banking sector and a university.

General assessment

The Member States' Ministries of Finance assess the programme very positively. All MoFs agree that the overall focus of the economic adjustment programme was appropriate for achieving its main objectives. Additional explanations to support this view mention that there was a clear link between the measures agreed in the MoU and the vulnerabilities and risks detected in the Cypriot financial sector and economy, the support from a recovering euro area when the programme started, as well as a successful exit in 2016. With one exception, no MoF believes that measures non-relevant for the above-mentioned programme objectives were included in the programme or that important measures relevant for achieving the above-mentioned objectives were missing. Those who believe that a number of important measures that had been included in the programme have not been implemented while they should have been referred to the high NPLs and the underlying reasons, the cooperative banking sector, state-owned enterprises' governance and privatisations, public administration reform, and local government reform. All MoFs agree that the programme was detailed and flexible enough in relation to unexpected developments and/or results significantly differing from the projections. MoFs also support the view that the programme had a significant impact on alleviating market concerns about Cyprus' solvency and restoring confidence in the Cypriot economy. They relate this in particular to the authorities' strong ownership and commitment to programme conditionality, successful fiscal consolidation, and banking sector stabilisation including the reduction of banks' exposure to Greece, money-laundering prevention measures, and growth above expectations. Almost all MoFs believe that the EU value added consisted in particular in the European/international perspective to programme design, the credibility of the adjustment, coherence with other EU policies, a bigger financial envelope, and lower costs of financing.

Cypriot stakeholders also have a generally positive assessment of the programme. They all agree that the overall focus of the economic adjustment programme was appropriate given the challenges that brought Cyprus to request financial assistance and that measures were well designed and had the intended consequences. However, they also believe that important relevant measures were implemented later than they should have been or were not implemented at all, notably referring to NPLs and the insolvency and foreclosure framework, the restructuring of the cooperative banks, structural reforms including the judiciary, privatisation, public administration reform, healthcare reform and support to SMEs. Cypriot stakeholders agree that the programme went into the right amount of detail and was flexible enough in relation to unexpected developments. Among the main factors that contributed to the improvement in the investors' confidence and Cyprus' return to financial markets they mention the good programme ownership, banking sector stabilisation, fiscal consolidation, and the faster-than-expected return to growth. All agree that the programme had a significant impact in this respect.

Financial stability

MoFs do not have strong views on the effects that the programme had on financial stability. Most respondents were neutral, and only two

([96]) There were replies from six Member States' Ministries of Finance and from seven Cypriot stakeholders.

agreed on the statement that the programme restored the health and viability of the financial sector. Programme design and implementation on the financial sector is also assessed neutral by most, and only one MoF agrees that conditionality was appropriate. Additional explanations refer to the success in restoring the capital base and resizing the banking sector, but also to the failures as seen in high NPLs and the liquidation of the Cyprus Cooperative Bank in 2018. MoFs are either neutral or (strongly) against the idea that the recapitalisation of commercial banks should have been done through programme financing, stressing the precedent value of the Cyprus bail-in, the fact that bank recapitalisation is an issue to be dealt with up-front by supervisory authorities, as well as the risks to debt sustainability of a bail-out.

Cypriot stakeholders have split views on the financial sector part of the programme. Half of them agree and half of them disagree that the health and viability of the financial sector was restored. Four versus two agree/disagree that the recapitalisation of commercial banks should have been done through programme financing. Those agreeing additionally express the views that (i) the bail-in has resulted in rising unemployment, a household poverty surge and the upswing of companies liquidating or ceasing operations; (ii) governance implications of getting new shareholders were ignored; and (iii) the bail-in was counterproductive due to its vast impact on confidence and trust of depositors and investors, which also exacerbated the problem of NPLs and private indebtedness. Those supporting the bail-in recall that Laiki Bank and the Bank of Cyprus created their own problems, hence it was not the European institutions' role to pay for their correction and that it would have taken a longer time to bring public debt down to manageable levels. All stakeholders believe that the correction of the cooperative banking structure was not appropriately designed and implemented. The problems in asset quality were underestimated, as well as the governance and culture problems faced by cooperatives. There should have been a more direct involvement by European institutions in the implementation of the restructuring plan. Stakeholders further agree that the measures on lifting the administrative restrictions and capital controls were fully adequate. Responses were divided on the appropriateness of measures on NPLs, referring to both shortcomings during the programme and recent progress. There is also agreement on improvements in banking supervision and AML, but it is also mentioned that AML requirements may now have become too strict.

Fiscal policy

MoFs' evaluation of the fiscal and fiscal structural measures is very favourable. They believe that fiscal consolidation and more generally the timely adoption of programme measures were amongst the factors that most helped improve investors' confidence during the course of 2015 and 2016. MoFs deem that the fiscal consolidation required during the programme was appropriate to the programme's objectives ([97]) (all respondents agree), and so were the pace, sequencing (most respondents agree, two are neutral) and composition of fiscal consolidation (half of the respondents agree, half are neutral). One MoF deems that MoU measures to enhance revenue collection, increase the quality of public spending and efficiency of the public sector were appropriate, considering Cyprus' excessive government deficit and high public debt. Half of MoFs believe that the composition of fiscal consolidation (revenue-increasing vs expenditure-reducing consolidation, capital vs current expenditure, composition of revenue-based consolidation) was appropriate. The other half are neutral, arguing that the corporate tax rate remained low compared to the euro area average, and that around three quarters of the increase in total tax revenues observed in recent years was down to VAT and income taxes. They recognise though that corporate income tax revenue is inherently volatile, subject to relocation decisions by (large) companies, while the sizeable VAT receipts such as those of 2017 largely benefitted from the buoyant construction sector and, to a lesser extent, from wholesale and retail trade. Fiscal-structural measures are believed to have adequately flanked fiscal consolidation, although implementation issues arose in some politically

([97]) Preserving financial stability, ensuring fiscal sustainability, restoring competitiveness and balanced growth, and ensuring sovereign financing.

thorny areas such as privatisation of SOEs, welfare reform, immovable property tax. One MoF emphasises that further efforts are needed on the appraisal of public investment projects and that only individual privatisation projects remain active after the privatisation unit was dismantled and the legal framework for privatisation abolished.

Cypriot stakeholders largely share the views above. They concur in that fiscal discipline was amongst the key factors for regaining investors' confidence and helping Cyprus' return to financial markets. They deem that the time profile and composition of fiscal consolidation, with the ratio between revenue-increasing and expenditure-reducing measures, appropriate. However, their views differ regarding the split between capital and current expenditure cuts, as well as regarding the appropriateness of revenue measures, with roughly half of respondents deeming these appropriate, while the other half not. All stakeholders believe the design and timing of the measures appropriately ensured the long-term viability of the pension system, although they see risks from population ageing and the implementation side. Inversely, all but one stakeholder estimate that programme measures have not been effective in improving the overall efficiency of the health sector, highlighting delays in the implementation of budgetary autonomy of public hospitals and universal access/ the NHS, as well as a deterioration of public health services. Stakeholders generally agree with the inclusion of conditionality on privatisation and state-owned enterprises, but they also point to the disappointing implementation record of these reform plans.

Structural reforms

The Member States that responded to the survey have an overall positive view of the structural reforms included in the programme, but some note that progress in implementation was mixed. They consider that they addressed the most relevant challenges and, with hindsight, would not suggest additional ones. On the other hand, in terms of implementation some Member States note that a number of reforms have not been implemented or have been implemented only partially. Those include privatisations (of telecommunications operator CyTa and of energy provider EAC), public sector reforms regarding the functioning of public administration, governance of State-owned entities and local governments, the insolvency and foreclosure frameworks, creation of a reliable and swift system for the issuance of title deeds and the transfer of immovable property rights. Overall, the main concern of Member States is that it took too long to set up a proper legal framework to deal with NPLs that is now in place but its effectiveness is still to be tested.

The stakeholders that responded to the survey also consider the structural reforms to be appropriate and do not identify significant gaps. On the implementation, however, they generally see a mixed track record in line with the opinion expressed by some Member States. Examples mentioned include that no privatisations have taken place, the reform of the legal system has started only recently, and the reform of insolvency took too long. Among the main factors contributing to the success of the programme, indeed, rarely are structural reforms mentioned. On the positive side, the reform of welfare and public assistance is considered a key success story. The guaranteed minimum income was successfully introduced, including a centralised information and payments system for streamlined and rationalised social benefits. However, it is also noted that public spending for social protection remains low by European standards and more could be done in this area to provide more support to needy groups. This is particularly relevant since the majority of stakeholders consider that the burden of the structural adjustment has not been fairly distributed among Cypriots and has mostly affected vulnerable groups of the population. Stakeholders agree that the private sector (less so for the financial sector) saw the largest drop in wages and employment. The public sector was also heavily impacted, but much less in comparison. The measures on the labour market are considered to have been effectively implemented but one stakeholder notes that there should have been more initiatives from the Commission to promote effective social dialogue on the needs of economic adjustment. However, the role played by EU Structural Funds was seen as very positive in promoting economic activity, especially thanks to their front-loading at the beginning of the programme. In terms of sectoral reforms, energy

conditionalities are generally seen as positive by stakeholders but they note that natural gas has not yet been introduced. This development is seen as responsible for keeping the cost of energy high. In addition, there have not been any significant measures to increase renewable energy sources. The Action Plan for Growth is generally seen positively, but one stakeholder notes that Cyprus' growth is once again reliant on construction and property, therefore it cannot be considered either balanced or sustainable.

Sovereign financing

All MoFs believe that the implementation of the programme had a significant impact in alleviating market concerns about Cyprus' solvency and in restoring confidence in the Cypriot economy. They attribute the successful return to markets to a range of factors with the two most cited being the strong fiscal consolidation and results it yielded, and the successful implementation of the reform measures overall, supported by government ownership and decisive action. Strong GDP growth is cited as important – particularly given that it exceeded expectations, as was decisive action in the financial sector. In this respect, the reduction in banks' exposure to Greece, measures taken to prevent money-laundering and the positive assessment by the ECB of banks' capital adequacy following the Europe-wide comprehensive assessment are mentioned. The role of the Eurogroup in providing clear messages of financial support is seen as important. In terms of programme measures that would have contributed on the financing side, the failure to privatise the telecoms operator is the only issue cited that had a bearing on financing.

The Cypriot stakeholders who replied all agree that the implementation of the programme had a significant impact in alleviating market concerns about Cyprus' solvency and in restoring confidence in the Cypriot economy. They attribute the return to markets to a combination of factors, with fiscal discipline and the reduction of deficits being the most cited reason but one respondent also regrets that success in this area may have undermined the pressure to introduce needed structural reforms. Respondents also mentioned the return to growth as being significant. They also consider that the ownership of the programme by the authorities – which they contrast to the situation in Greece – had a positive impact, as did the return to financial stability through measures in the financial sector, particularly once NPLs started to fall. The quick abolition of capital controls is seen as important. In terms of programme measures that would have contributed on the financing side, the failure to privatise public enterprises is very widely cited.

Institutional arrangements

While MoFs generally see a good ownership of the programme by the authorities, views are mixed regarding the administrative capacity and the importance of technical assistance for programme implementation. With one exception ("no opinion"), all MoFs agree that the level of ownership of the programme by the authorities and their level of commitment to effective programme implementation were satisfactory. Only two of the respondents disagree (and three are neutral/no opinion) that shortcomings in the administrative capacity of the Cypriot authorities were an obstacle to the speedy implementation of the measures in the programme. One respondent specifies that the administrative capacity of the Cypriot authorities was quite good while they requested technical assistance in some areas. Three MoFs agree, the others being neutral/no opinion, that the Commission's Support Group for Cyprus provided technical assistance that was important for achieving the programme objectives. One respondent who sees shortcomings in the administrative capacity and agrees to the importance of the Support Group mentions as example the area of tax administration.

Stakeholders believe that programme implementation could have benefitted from more determination by programme partners and better communication, and they acknowledge the usefulness of the Commission's technical assistance and EU structural funds. Replies to the question what the Cypriot authorities or the programme partners should have done differently to improve programme implementation essentially go into two directions: (1) programme partners should have insisted more on a full programme

implementation, and (2) there should have been more information and public debate on the need for the programme and the implementation of specific measures. About half of the stakeholders agree partly (and the remainder are neutral/no opinion) that shortcomings in administrative capacity were an obstacle to the timely implementation of the measures in the programme. One respondent points to the political constraint of finding a majority in the Parliament to pass unpopular measures, while another respondent mentions quantitative and qualitative limits in the administration as a real constraint. There is broad agreement that the technical assistance provided by the Commission's Support Group for Cyprus was important for achieving the programme objectives. Other EU policies or EU funds helpful in achieving the programme objectives are generally seen as partly or very helpful. Specific references are made to EU structural funds and the accommodating monetary policy pursued by the European Central Bank.

Social impact

The Member States' Ministries of Finance do not have strong views on the social impact of the programme. The assessment of reforms of the welfare system does not feature prominently in the questionnaire for the Member States' MoFs and the issues related to the social impact have not been taken up by respondents.

Cypriot stakeholders generally consider the reform of the welfare system to have been appropriate, although they believe that the burden of adjustment has not been evenly shared across the society. The large majority of Cypriot stakeholders positively assess the welfare system reforms, although several of them also highlight remaining weaknesses and some believe that an overall assessment would be needed. The respondents believe that the targeting of social support has improved. At the same time, the clear majority disagrees with the statement that the burden of adjustment has been evenly shared across the Cypriot society. Several stakeholders consider that private sector employees (possibly with the exception of those working in the financial sector) have been hit stronger than public sector employees. Some voices also point to relatively strong negative effects for vulnerable groups of the population.

A1.8. SUMMARY OF THE TARGETED STAKEHOLDER CONSULTATION (REPLIES GIVEN IN INTERVIEWS AND MEETINGS)

The evaluation team conducted more than 40 interviews or meetings between January and April 2019. Interviews with individuals and organisations directly involved in the development and implementation of the programme were carried out to get insights on specific key economic issues as they emerged during the analysis, as guided by the key evaluation questions. These interviews covered staff from the Cypriot authorities involved in designing and implementing the programme (e.g. the Central Bank of Cyprus, the Ministry of Finance, other Ministries), staff working in programme partner institutions (European Commission, EWG/EFC, IMF, ECB, ESM), and other persons who could provide relevant information on specific issues.

Below is a non-exhaustive and non-specific summary from the replies given in the interviews and meetings. As participants in these interviews and meetings were assured respect of the Chatham House Rule, it implies that this summary can only use the information received without referring to their identity or affiliation. There was a common set of questions to those who had a more general perspective on the programme (e.g. mission chiefs, resident staff, or meetings with staff covering all parts of the programme) while interviews/meetings with staff responsible only for a specific part of the programme were based on specific and technical questions according to the main information needs. This summary mainly reflects the replies given to the former, i.e. the common set of questions.

Regarding the design of the programme, there was a broad consensus about its strong and weak points. The main achievements of the programme were seen in swiftly restoring fiscal sustainability and stabilising the financial sector, which supported confidence and a better-than-expected macroeconomic performance. This also helped re-establish a gradual access to sovereign markets already during the programme. As main

shortcomings interviewees pointed to the failure to address the underlying structural weaknesses of financial institutions and the Cypriot economy in general. At the end of the programme, the Cypriot banking sector was still having significant contingent liabilities, several fiscal-structural and structural reforms remained incomplete, and the Cypriot economy's growth model did not change fundamentally. All interviewees agreed that the delayed start of the programme made problems become bigger, notably with a view to the increasing risks in the banking sector and the financing costs for the sovereign. While most found that the overall programme strategy was adequate on matters of financial stability and fiscal sustainability, there were more critical views on structural conditionality which some believed to have been excessive and overburdening the programme. All believed that the Cyprus programme compared favourable to other EU/IMF adjustment programmes. The clean exit was seen as a feasible strategy, as there was no political appetite to seriously explore any alternative.

On the financial stabilisation part of the programme, the prevailing view was that it would have been difficult to pursue a different strategy even though some elements could have been done better. With few exceptions, all agreed that the recapitalisation/resolution of the Bank of Cyprus and the Cyprus Popular (Laiki) Banks should not have been done as a bail-out with programme financing, mainly for reasons of debt sustainability and a fair burden-sharing. Capital controls were deemed unavoidable to avoid any further draining of bank liquidity, and the authorities were given credit for a successful strategy of regaining depositors' trust to lift the capital controls faster than expected. While there was agreement that, with the benefit of hindsight, the programme should have done more about the cooperative banking system, there were doubts on what exactly the programme could have asked for without putting the programme as a whole at risk, given the high political sensitivity of the matter. Not everybody agreed that the complexity of non-performing loans were initially underestimated by focussing on the insolvency and foreclosure framework, as dealing with other aspects such as the housing market or the judiciary in parallel upfront could have overburdened the authorities. There was consensus about the presence of strategic default in non-performing loans, while there was less clarity on its size and the underlying reasons.

With a view to macroeconomic and fiscal policies, there was a recognition that the overachievement of prudent programme projections was a successful strategy to follow. Interviewees explained that the rather pessimistic projections were both the result of uncertainty about the macroeconomic effects of the restructuring in the banking sector and a deliberate strategy to surprise on the positive side to build up confidence. It was confirmed that there was no disagreement between programme partners and the Cypriot authorities on the successive tightening of the fiscal consolidation path that could otherwise have been less tight and more supportive to growth. Interviewees did not have strong views on the social impact of the programme, recognising that it is generally difficult to distinguish between the social effects of a crisis in general and those of programme measures.

The mixed implementation record of fiscal-structural and structural reforms was generally acknowledged, but there were varying views on the main underlying reasons. While some insisted on the importance of the structural reforms agenda in the programme, others made the point that this was overburdening the programme – also in view of administrative and political capacity constraints of a small country – often without adding much to achieving the main programme objectives. There were also varying views on the main reasons for the weak implementation record of some of the fiscal-structural and structural reforms. While most mentioned the loss of the government's majority in the Parliament, possibly reflecting a diminishing society-wide ownership of the programme, others also saw reasons in vested interests and the complexity of some of the reforms that required thorough preparation and communication. Interviewees mentioned as main fiscal-structural achievements the budgetary framework, the reform of the revenue administration and the pensions reform, and as shortcomings the public administration reform, restructuring of state-owned enterprises and their privatisation. Main structural achievements were

seen in the labour market reforms, while it was felt that reforms were overall insufficient to fundamentally change the economy's growth model.

Institutional arrangements for programme implementation were mostly seen positively. Many interviewees pointed to the good programme ownership by the government and the efficiency of the administration. This was even though the loss of the majority in the Parliament later in the programme implied some difficulties for its implementation, most visibly in the 6th and 8th programme reviews. Technical assistance, including that by the Commission's Support Group for Cyprus, was seen as being an important and complementary support for programme implementation and the reform agenda, including after the end of the programme.

Interviewees mentioned a number of lessons learned from the Cypriot programme. A lesson often mentioned was that the delayed start of a programme is costly when prompt action is needed. This included the observation that an earlier bail-in enables fairer burden-sharing, as those with better information tend to withdraw their capital early on. Some regretted that the lead-time to the programme was insufficiently used to better design the programme. There was also a recognition that more streamlined and better-prioritised conditionality would have been preferable, notably on structural reforms, but then programme partners should also insist more on the full implementation of such streamlined conditionality. Many emphasised the key importance of good programme ownership, communication and social dialogue. To support this, programme partners need to be open-minded to what the authorities and stakeholders have to say and to learn along the way of a programme. On the other hand, it was recognised that vested interests are difficult to overcome when trying to implement reforms. Several mentioned that more frontloading of conditionality should be done in view of the diminishing ownership over the programme horizon. More generally, some also said that the Cypriot crisis showed how the EU needs to make further progress towards financial regulation and the Banking Union. Finally, the importance of prudent policies for avoiding the need for an adjustment programme was mentioned as a key lesson.

ANNEX 2
The Cypriot authorities' views on the ex post evaluation

The Cypriot authorities are broadly in agreement with the main findings of the ex-post evaluation report, which has been prepared with a view to drawing lessons for the future.

The Report acknowledges that **overall the Cyprus programme was successful**, as exhibited by the strong resumption of economic growth, fiscal over performance, normalisation of the banking sector and smooth return to the markets already during the programme. Even though it is not possible to attribute all positive or negative effects to an adjustment programme, given that a lot depends on general economic developments (as noted by the Report), nevertheless the main driving force behind economic developments in the Cyprus economy during the programme period was undoubtedly the programme itself and the determination of the Government to implement it.

In particular, **the programme was very effective and relevant in improving the long-term sustainability of public finances**. The fiscal consolidation strategy was mostly expenditure-driven and frontloaded on purpose, which helped to put public finances on a sustainable path early on, with limited impact on economic growth. In this way, the risks associated with reform fatigue in a backloaded strategy were significantly reduced. Moreover, the frontloading strategy provided more clarity and certainty to investors and consumers.

The programme also included a wide range of structural reforms, most of which have been fully implemented. However, the lack of clear prioritisation and the insufficient time provided for the implementation of some of them, resulted in delays. In this regard, **prioritising structural reforms and allowing the necessary time to implement them is an important lesson for the future. A 3-year period is unlikely to be sufficient to implement reforms in such a wide spectrum as an adjustment programme entails.** As the Report notes, the experience with other euro area adjustment programmes shows that it is very challenging to address deeply-rooted structural problems within such time horizon. This is even more so the case for small administrations (in absolute terms) like the one in Cyprus.

As regards the banking sector, the Report notes that the progress in reducing the high level of non-performing loans was rather limited during the programme. However, it should be stressed that according to the literature and past experiences, banking crises are most often resolved over a number of years, sometimes extending over a decade**.** Therefore, **even though it is true that domestic private sector deleveraging could be characterised as rather slow during the programme period (for a number of reasons such as the inadequate legal framework), it was known from the beginning that this would be a rather lengthy procedure.** Still, more decisive measures to address the NPLs issue at system level at the beginning of the programme could have also supported an even greater progress in reducing further the size of the banking sector and a more robust banking system going forward.

The Report highlights the fact that **the ownership of the Programme by the Cyprus authorities has been strong and instrumental in its success**, which was indeed the case. The level of ownership can be a decisive factor (or even the most important factor) of whether or not an adjustment programme would be successful. Having a coordinating agency/body with a leading role in the implementation of the adjustment programme (as in the case of Cyprus) is also helpful in this respect.

The Report correctly points out that the delayed start of the programme increased the financing needs and aggravated the problems in the banks, thus highlighting **how critical the timing of entering into an adjustment programme is.** Having said that, **the unintended consequences as well as the confidence impact of the chosen type of burden-sharing implemented in Cyprus, including the bail-in of unsecured depositors, could be better foreseen**.

The Report also notes that while the need for an adjustment programme in Cyprus was triggered by a banking crisis, it was preceded by imbalances (fiscal and structural) that created a very challenging economic environment for the authorities to handle, including the need to impose capital controls. This is also an important lesson, i.e. **creating enough fiscal space to cater for**

unforeseen negative circumstances that might occur in the future.

The technical assistance provided by the European Commission, and by other institutions, during the programme was indeed very helpful and instrumental in implementing a number of difficult-to-implement structural reforms.

Another lesson to be drawn is **how pessimistic or optimistic macroeconomic projections should be**. Even though the merits of being on the cautious side are obvious (overachieving targets and positive surprises which can strengthen the market confidence in the programme later on), it is also true that by being overly pessimistic (as in the case of Cyprus), the debt sustainability analysis is unduly affected. This entailed an unnecessarily strict fiscal adjustment from the outset and created negative expectations from investors and Rating Agencies. Moreover, the lasting impact of market-sensitive actions such as Cyprus' distressed debt exchange, a consequence of pessimistic macroeconomic projections, could be better assessed a priori, not least because of the long-term consideration of such events by Rating Agencies.

The Report states that despite an overall positive track record in terms of implementation, the programme was less effective in making the country's growth model more sustainable and balanced. However, while acknowledging the need for more diversified investments, it should be stressed that **the economic model of Cyprus has always been based on services (including the banking sector), given its competitive advantages in this area**. Therefore, even though there are efforts to further diversify the economy through the Action Plan for Growth (for which its implementation started within the programme and continues post programme), the growth model of Cyprus will essentially continue to rely on services, with Cyprus being a significant financial and business services centre. In any case, as the Report correctly notes, a small open economy like Cyprus will always face limits in terms of possible economic diversification.

The Report also correctly points out that **difficult measures were implemented in Cyprus without any particular social unrest, suggesting that society was mature enough to acknowledge the necessity of these measures.** It could also be inferred that the communication strategy of the Government and the programme partners was effective in conveying the reasons and the potential benefits from the implementation of those difficult measures. In this regard, the **communication policy of the programme is essential in maintaining social cohesion in a programme country.**

A programme should also be flexible enough, taking into account the characteristics of the programme country. As the Report correctly notes, a degree of flexibility is required to ensure its policies are able to adjust to complex circumstances and that, although core objectives such as growth and debt sustainability are central, each country is unique and a one-size-fits-all approach should not be utilised.

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