EXECUTIVE SUMMARY

From April 2013 until March 2016, Cyprus implemented an economic adjustment programme supported by financial assistance from the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). 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 a few activities. It provided financial assistance of up to EUR 10 billion, subject to favourable assessments of compliance with the agreed policy conditionality. This Staff Working Document presents the findings of the ex-post evaluation of the adjustment programme for Cyprus, which was carried out by a team of Commission economists who have not been involved in the Cyprus economic adjustment programme. Main sources of evidence consisted of a general literature review of the Cypriot economy, programme document analysis, data-based economic analysis, and a targeted stakeholder consultation. The evaluation was guided by the Commission's Better Regulation framework and its evaluation criteria of effectiveness, efficiency, relevance, coherence and EU added value.

The programme was largely effective in achieving its objectives of stabilising the financial sector, restoring fiscal sustainability, and implementing structural reforms, while external factors also contributed favourably, thus allowing Cyprus to regain market access. However, the programme was less effective in changing fundamentally the banks' business model and in making the country's growth more sustainable and balanced. While the overall situation of the Cypriot financial sector gradually improved after its stabilisation was achieved at the beginning of the programme, the Cypriot banking sector remained subject to high risks at the end of the programme. Since then further progress was made in reducing these risks. Due to cautious macroeconomic projections and a prudent fiscal consolidation path, surprises were always on the upside. A broad range of fiscal-structural and structural reforms was implemented. The crisis and the adjustment process had less of a negative social impact than could be expected, also because of programme measures to improve the targeting of social spending and to minimise the effects on vulnerable groups.

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. On structural reforms, conditionality could have been more efficient had it been designed with a clearer prioritisation of reforms. Programme financing turned out to be markedly higher than the actual needs, but it ensured that it was sufficient even under a worst-case scenario. However, the delayed start of the programme increased the financing needs and aggravated the problems in the banks. 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.

The overall programme strategy and its main objectives were relevant in addressing the main challenges. Restoring financial stability was necessary to avoid an even deeper economic crisis. In retrospect, the specific fiscal targets may appear ambitious, but they were relevant in signalling to the markets that the government was capable of ensuring the sustainability of its public finances. Structural reforms correctly addressed many important challenges, even though not all of them were relevant to achieving the programme objectives and for some of them the 3-years time horizon of the programme was too short.

The programme generally ensured coherence between its different objectives (financial, fiscal and structural policies), 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.

There was a clear value added of the EU engagement in that adequate financing from the ESM was provided at low costs. 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.

Finally, the findings of this evaluation enable the identification of general lessons learned to improve future policy-making. In doing so, it is important to bear in mind that the economic and social effects of a programme are generally difficult to distinguish from those of an economic crisis and the subsequent adjustment as well as external developments. An important lesson from Cyprus is that delaying the start of a programme by recourse to other financing sources, e.g. bilateral loans, should be avoided as it may increase the costs of a crisis and the risks of a programme. 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. Strong and sustained programme ownership by the national authorities and key stakeholders is crucial for programme success.