

European Department

The Cyprus Economy as Viewed by International Institutions

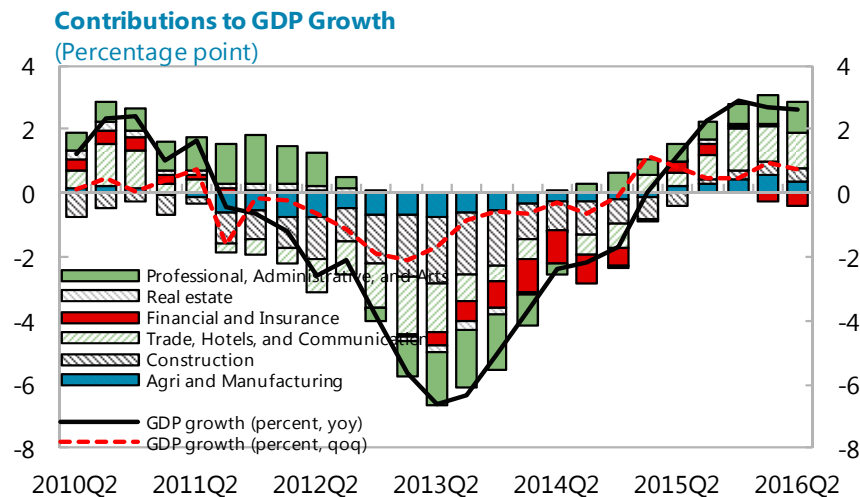


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Resident Representative in Cyprus

Cyprus: a success story

- ❑ The economic adjustment program has delivered an impressive turnaround of the economy during the past three years. The economy returned to positive growth last year and accelerated further in 2016, beyond expectations
- ❑ The banking system is on a much more solid footing and workouts of nonperforming loans are accelerating, opening space for new productive lending
- ❑ The fiscal position has been restored to a sustainable path, and public debt is now firmly on a downward trajectory. In addition, Cyprus regained access to international capital markets and successfully issued four Eurobonds during the past two years
- ❑ Clearly, there are still challenges (as laid out in this presentation), but the authorities' commitment to maintain prudent macroeconomic and fiscal policies and to continue promoting structural reforms is encouraging

Cyprus continues to recover from the crisis



Sources: Cystat; and IMF staff estimates

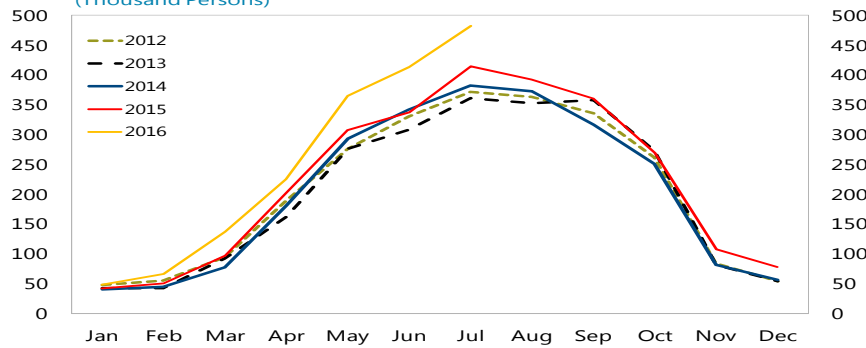
□ In 2015, GDP grew by 1.5 percent, after a cumulative contraction of 10.9 percentage points over the previous three years

□ In H1/16, growth accelerated to 2.7 percent yoy, much stronger than expected

□ The recovery in economic activity is broad-based, with tourism and professional services still being the main contributors to growth

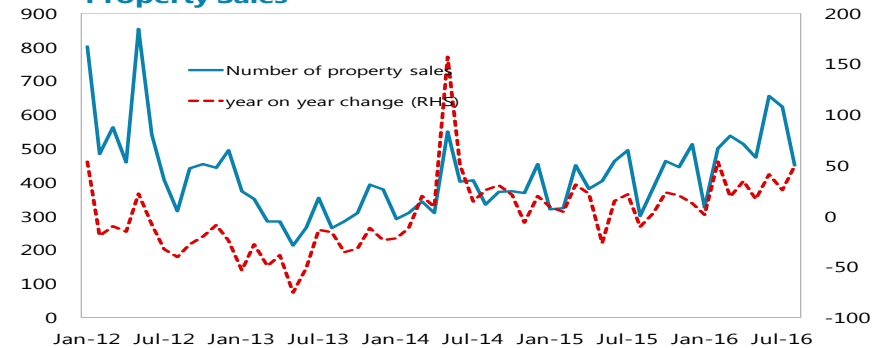
The recovery is broad-based

Tourist arrivals
(Thousand Persons)



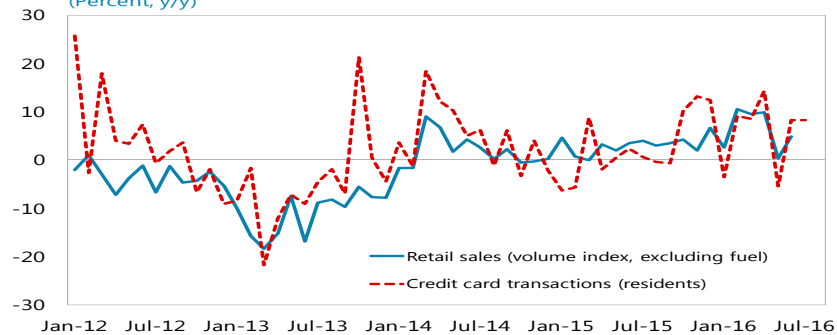
Source: Cystat.

Property Sales



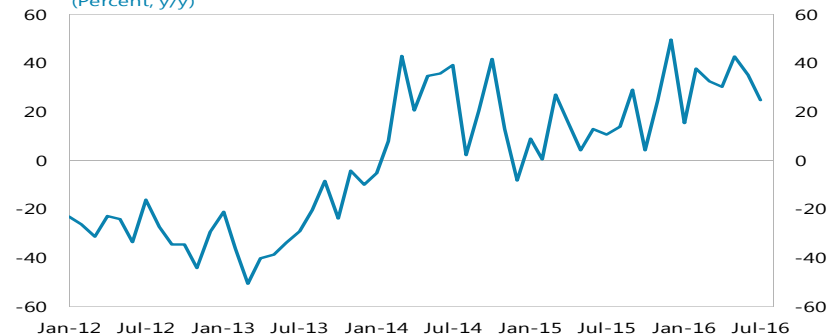
Sources: Land registry; and IMF staff estimates.

Retail sales and credit card transactions
(Percent, y/y)



Sources: Cystat; JCC payments; and IMF staff estimates.

Registration of motor vehicles
(Percent, y/y)

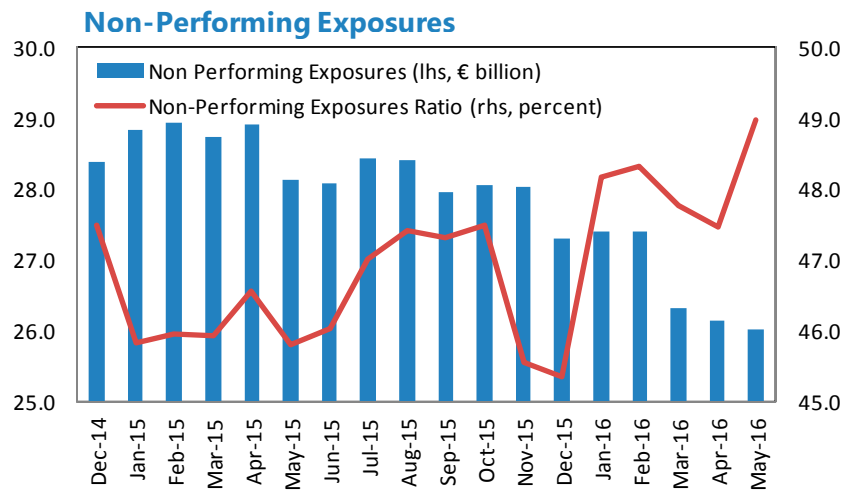


Source: Cystat.

Expansion is expected to continue

- ❑ According to current IMF staff projections, the economy is expected to grow at around 2 percent during 2017-2020
- ❑ This would be far better than the nearly -2 percent recorded in the crisis years 2009-2014, although below the average growth rate of 5 percent seen during 1988-2008
- ❑ What challenges does the Cypriot economy face? What policy responses are being developed? What opportunities are being seized to allow a return to stronger and, most importantly, long-lasting growth?

Challenge #1: NPLs are high



Source: Central Bank of Cyprus

- ❑ At around €26 billion, non-performing exposures are still close to 150 percent of GDP
- ❑ The NPE ratio for the total banking system is 49 percent, up slightly from a year earlier
- ❑ On a positive note, over €14 billion of loans have been restructured, €6.8 billion of which from early 2015

Policy response #1: the infrastructure to clean banks' balance sheets is largely in place

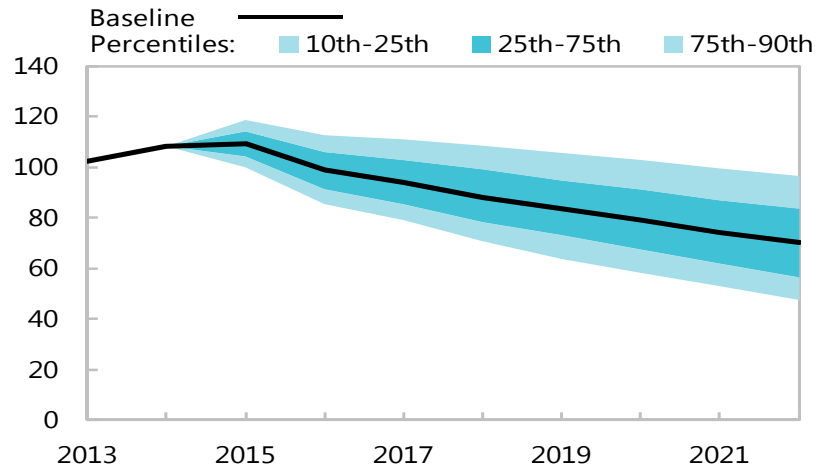
- ❑ Banks have set up loan restructuring operations and refining policies and practices on the basis of experience to date
- ❑ Legal framework for foreclosure and insolvency, along with relevant institutions and processes, have been established and are starting to operate
- ❑ A law allowing banks to sell their loans has been adopted
- ❑ The Central Bank of Cyprus, in its financial stability function, is taking an increasingly active role in encouraging and monitoring progress with reducing NPLs

Opportunity #1: lower NPLs imply stronger growth

- ❑ Dealing with the NPL problem effectively not only has an impact on the balance sheet and the capital of the banks, but it also has broader implications for the economy
- ❑ By lowering NPLs, banks can increasingly extend new (targeted) credit to families and corporations, and do that on better terms, thus supporting investment and jobs
- ❑ In turn, stronger growth increases borrowers' ability to repay, thus reinforcing the case for further reduction in NPLs
- ❑ Banks' improved lending capacity affects especially SMEs that are more dependent on bank financing. This is very important for Cyprus, where SMEs play a critical role in the economy

Challenge #2: public sector debt is high

Public Debt Sustainability Analysis (Percent of GDP)



Source: IMF staff estimates

❑ At nearly 109 percent of GDP in 2015, public sector debt is still high

❑ Primary surplus will have to be kept at around 3 percent of GDP to maintain public debt on a sustained downward path

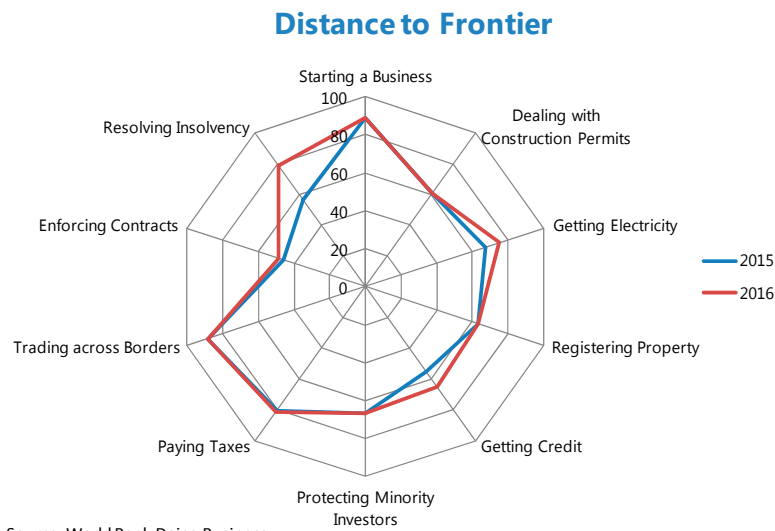
Policy response #2: so far fiscal performance has consistently exceeded targets

- ❑ This reflects the positive impact on tax revenue of the better than expected economic performance and lower than expected primary spending owing to prudent budget execution
- ❑ For the fourth time since the 2013 financial crisis, the government accessed the market and used part of the proceeds to build cash buffers
- ❑ Bank government-guaranteed bonds issued during the crisis were canceled, reducing the stock of government guarantees by nearly a third
- ❑ Loss of eligibility for ECB financing facilities due Cyprus's sub-investment grade has not appreciably impacted secondary market yields on government bonds

Opportunity #2: sustainable public debt implies more fiscal space

- ❑ Ensuring sustainable public debt allows adequate fiscal space for productive public investment spending, which in turn would support long-lasting growth
- ❑ Controlling the growth of the public sector wage bill and increasing the efficiency of the public sector through promotions and mobility across the civil service is a critical step in this direction
- ❑ Completing the reform of the revenue administration through the integration of the tax departments supports revenue collection over time and contributes to creating adequate fiscal space
- ❑ Overcoming vested interests and strengthening the functioning, oversight and governance of state-owned enterprises further improves fiscal sustainability and contributes to ensuring a more dynamic and just society

Challenge #3: Cyprus is taking steps towards improving the business environment



Source: World Bank Doing Business

❑ Cyprus' ranking in the World Bank Doing Business Index has moved to 47 in 2016 from 60 a year earlier

❑ Cyprus' distance to frontier score in the same index has risen to 72 from 67, with 100 representing the frontier

Policy response #3: ambitious reform agenda is being developed and implemented

- ❑ Legal framework for Fiscal Responsibility and Budget Systems was adopted
- ❑ Inland revenue and VAT were integrated in a single Department of Taxation
- ❑ Amendments to foreclosure law were enacted and insolvency framework reformed
- ❑ Privatization of the commercial activities of Limassol port was completed; legal unbundling of the public electricity utility into two separate companies will become effective in December
- ❑ An extensive “action plan for growth” aimed at improving the business environment has been developed

Opportunity #3: more business-friendly environment implies more investment

- ❑ Continuing to privatize state-owned enterprises i) allows better and less expensive services for the population and ii) attracts foreign direct investment, which again can bring jobs and increase liquidity in the economy
- ❑ Favoring deeper capital markets and encouraging the development of an investment fund industry, within an appropriate regulatory framework, helps channel capital towards productive investment and reduce over-reliance on bank credit
- ❑ i) Reducing labor market redundancy costs; ii) opening up closed professions by streamlining licensing restrictions; iii) removing barriers to competition, including protection of firms and price controls; iv) reducing red tape; v) strengthening the legal system and vi) fostering innovation would all have a significant impact on medium-term growth

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Thank you