INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/375

CYPRUS

December 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its December 13, 2017 consideration of the staff report that concluded the Article IV consultation with Cyprus.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 13, 2017, following discussions that ended on October 4, 2017, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 28, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Cyprus.

The documents listed below have been or will be separately released.

Selected Issues

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INTERNATIONAL MONETARY FUND

COM COMMUNICATIONS DEPARTMENT

Press Release No. 17/494
FOR IMMEDIATE RELEASE
December 14, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Cyprus

On December 13, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Cyprus.

The Cypriot economy has achieved an impressive turnaround since the 2012–13 banking crisis. GDP growth has been accelerating for three consecutive years on strong foreign demand, reaching 3.8 percent (year-on-year) during the first nine months of 2017. Rising labor demand has sharply lowered the unemployment rate to 10.3 percent as of September. Emergency liquidity assistance to banks has been fully repaid. Gains in cost competitiveness and strong foreign demand have narrowed the underlying current account deficit (excluding large one-off imports). The fiscal primary balance has swung from a large deficit to a surplus of 3.0 percent of GDP in 2016, supported by earlier reforms and revenue from the robust recovery, and is expected to increase further this year. However, crisis legacies in the form of extremely high private sector debt and nonperforming loans (NPLs) and elevated public debt have yet to be eliminated.

The current strong growth momentum is expected to persist for the next several years, underpinned by ongoing large construction projects and (albeit undesirable) weak payment discipline alongside slow progress with NPLs that will support consumption. Rising import intensity of activity is expected to rewiden the current account deficit, while output is forecast to grow above capacity and give rise to a positive output gap. Continued primary surpluses will help to reduce public debt.

This strong growth cycle could be threatened by excessive concentration of activity into construction and real estate and by potentially-volatile capital flows. Persistently slow resolution of NPLs would keep financial sector vulnerabilities elevated. Growth prospects could be significantly boosted if development of offshore hydrocarbon deposits proves financially viable.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors commended the authorities for the Cypriot economy's impressive recovery from the 2012–13 banking crisis, facilitated by prudent macroeconomic policies and progress on structural reforms, together with strong foreign demand. Directors observed, however, that progress on reducing nonperforming loans has been tepid, and that private and public debt remain high. They urged the authorities to take advantage of the current strong growth momentum to resolve legacy problems and generate a broader basis for future growth.

Directors urged the prompt implementation of a comprehensive deleveraging plan, supported by measures to improve payment discipline. Simultaneously reducing excessive private debt and banks' weak loan portfolios would help protect macro-financial stability. Directors recommended using an array of restructuring tools, in combination with burden-sharing, to limit the short-term dampening effect on GDP growth. They also called for improving payment discipline through a strengthening of the legal framework for resolving problem loans.

Directors stressed the need for banks to adopt ambitious and credible strategies to reduce nonperforming loans, underpinned by long-term capital plans and realistic assumptions on recovery rates and the required provisioning. They cautioned banks against warehousing properties on their balance sheets that were acquired through debt-to-asset swaps, and underscored the need to preserve prudent standards for new lending and loan classification.

Directors welcomed the significantly improved fiscal position and urged safeguarding these gains to achieve a rapid reduction in public debt. They agreed that the authorities' plan to set a ceiling on fiscal spending that increases in step with medium-term GDP growth would help contain spending pressures and limit the risk that cyclical or one-off revenue is spent. To help keep spending within the ceiling, Directors recommended adopting the civil service reform law and closely monitoring the cost of the planned National Health Scheme. Completing pending revenue administration and public expenditure reforms would also create space for growth-enhancing spending.

Directors called for reinvigorating the structural reform agenda. They advised a tightening of lending standards to avoid excessive concentration of economic activity and to protect financial stability. They stressed in this context the need to safeguard the integrity of the citizenship-by-investment program by ensuring compliance with AML/CFT standards. Directors also called for strengthening competition and productivity to attract investment and help diversify the economy. Restarting the privatization program and undertaking governance reforms in the public and private sectors will also be important. In this regard, Directors recommended establishing a dedicated commercial court to strengthen the enforcement of commercial claims.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Cyprus: Selected Economic Indicators, 2014–18

				Projections	
	2014	2015	2016	2017	2018
	(Percent change, unless otherwise indicated)				
Output/Demand					
Real GDP	-1.4	2.0	3.0	3.8	3.6
Domestic demand	-1.5	3.3	4.8	4.4	3.6
Consumption	-1.2	1.8	2.6	3.5	2.9
Private consumption	0.7	2.6	3.3	3.4	3.2
Public consumption	-7.2	-2.8	-0.4	3.8	2.0
Gross capital formation	-3.2	12.4	17.2	8.8	6.8
Foreign balance 1/	-0.1	-0.9	-1.7	-0.5	0.0
Exports of goods and services	4.2	6.3	3.9	0.0	2.4
Imports of goods and services	4.6	8.1	6.6	0.8	2.4
Potential GDP growth	0.4	0.8	1.1	1.5	1.8
Output gap (percent of potential GDP)	-7.2	-6.0	-4.3	-2.0	-0.3
Prices					
HICP (period average, percent)	-0.3	-1.5	-1.2	0.8	0.7
HICP (end of period, percent)	-0.9	-0.5	0.1	0.8	0.7
Employment					
Unemployment rate (EU standard, percent)	16.1	14.9	13.0	11.3	10.0
Employment growth (percent)	-0.6	-1.3	2.5	3.2	2.7
	(Percent of GDP)				
Public Finance					
General government balance	-0.8	-0.1	0.5	1.0	1.1
Revenue	39.3	38.8	38.8	39.7	39.7
Expenditure	40.1	38.9	38.3	38.7	38.6
Primary Fiscal Balance	2.6	2.7	3.0	3.4	3.5
General government debt	107.5	107.5	107.1	99.7	95.5
Balance of Payments					
Current account balance	-4.3	-1.5	-4.9	-4.9	-4.2
Trade Balance (goods and services)	2.0	0.8	-0.8	-2.2	-1.6
Nominal GDP (billions of euros)	17.6	17.7	18.1	18.8	19.9

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth (percentage points).

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

November 28, 2017

KEY ISSUES

Context and outlook

Cyprus has achieved an impressive turnaround since its banking crisis. Output growth has been accelerating for three consecutive years and is now strong, while unemployment is on a rapidly-declining path. The fiscal primary balance has swung from a large deficit to a moderate surplus. Emergency liquidity assistance to banks has been fully repaid and their deposit bases are growing. House prices have corrected. Yet private sector debt and nonperforming loans (NPLs)—key legacies of the previous boom-bust cycle—remain extremely large. Also, the pace of NPL reduction has been slow despite several years of robust GDP growth. Public debt is also elevated.

Dynamic growth is set to persist for the next few years, underpinned by ongoing large construction projects and (albeit undesirable) continued weak payment discipline alongside slow progress with NPLs. Elevated financial sector vulnerabilities and the potential for a new construction boom, supported by possibly-volatile capital flows, pose risks to this outlook.

Policy priorities

- Significantly reducing both private sector debt and NPLs is essential. A comprehensive and ambitious plan that incentivizes borrowers and creditors to cooperate, relies on a broad set of tools and includes burden-sharing is needed. Banks should remain well provisioned and capitalized.
- Improving payment discipline is essential for sustainable deleveraging and a well-functioning market economy. To better serve as a deterrent against strategic default, strengthening the foreclosure framework, greater use of the new insolvency tools and introducing a credit scoring system are needed.
- Capping increases in fiscal spending to the rate of medium-term GDP growth would protect against undue spending pressure and the risk that temporary or cyclical revenue is perceived to be permanent.
- Ensuring balanced and sustainable growth requires policies to protect against excessive concentration of activity in construction, strengthen the efficiency of the courts and civil procedures, and improve the investment climate in innovative sectors.

Approved By
Philip Gerson and Kevin Fletcher

Discussions took place in Nicosia during Sept 20–Oct 4, 2017. The mission team comprised Ms. Rachel van Elkan (head), Messrs. Hajime Takizawa and Seung Mo Choi (all EUR), Mmes. Nadia Rendak (LEG) and Greta Mitchell Casselle (MCM), Messrs. Futoshi Narita (SPR) and Vincenzo Guzzo, and Ms. Maria Heracleous (both Resident Representative office). Ms. Jeske de Lint (office of the Executive Director) joined some of the meetings. Mmes. Hiroko Oura (SPR), Tingyun Chen and Dilcia Noren (both EUR) supported the mission from headquarters. Part of the mission was conducted jointly with the European Commission, European Central Bank and European Stability Mechanism, in the context of their Third Post-Program Surveillance with Cyprus.

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ANNEXES

CONTEXT[1]

1. **The Cypriot economy has achieved an impressive turnaround since the 2012–13 banking crisis.** GDP growth has accelerated for three consecutive years; unemployment is falling; the underlying current account deficit has narrowed alongside improved external price competitiveness; the fiscal balance has swung from a large deficit to a small surplus; emergency bank liquidity has been fully repaid and bank deposits are rising; and property prices have begun to edge up following a large correction. These results were underpinned by generally prudent macroeconomic and financial policies and progress on structural reforms that enabled the sovereign to access capital markets on increasingly favorable terms, accompanied by a series of upgrades to the credit rating, which now stands close to investment grade (Annex I).

2. **Important legacies from the earlier boom-bust cycle have yet to be erased, however.** Private sector debt remains extremely high, with banks' nonperforming loans (NPLs) relative to both total loans and GDP among the highest in the world. Although several years of robust GDP growth has improved the repayment capacity of many borrowers, progress on reducing NPLs remains slow. Public debt also remains elevated. High debt and NPLs renders the economy more vulnerable to adverse shocks, including a tightening of global financial conditions.

RECENT DEVELOPMENTS

A Strengthening Recovery with External Rebalancing

3. **The economic recovery has gathered speed on robust external demand.** GDP grew by 3.8 percent (year-on-year) in the first nine months of 2017, accelerating from 3 percent in 2016. This lifted output to 4 percent below its pre-crisis peak and narrowed the output gap to about 2 percent. Strong foreign demand propelled tourism, construction and professional services, while contracting financial intermediation—reflecting banks' contracting loan books—was a drag on growth. On the expenditure side, rising disposable incomes and employment, together with tourist spending and (albeit undesirable) strategic non-servicing of debt by a large fraction of borrowers, is fueling consumption. While still well-below pre-crisis levels, construction of dwellings grew by more than 15 percent in 2016, supported by a range of tax and other incentives, and has since gained momentum.

4. **The recovery is reflected in price and labor market developments.** Following protracted deflation, core inflation has gradually returned to (low) positive territory alongside the narrowing output gap. Rising labor demand has pushed down unemployment to 10.3 percent as of September 2017, from a peak of 16.8 percent, but it remains well-above the pre-crisis rate of 4 percent. Labor force participation is also rising gradually. Remaining labor market slack has so far held down wage growth in the private sector, although compensation per employee in the public sector rose sharply in Q2:2017.[2]

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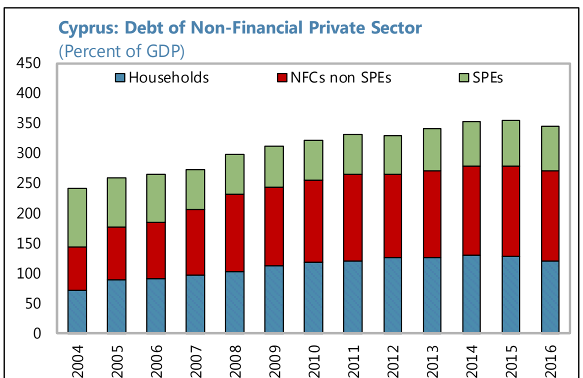
[1] This report does not cover areas of Cyprus not under the effective control of the Republic of Cyprus and assumes no change in the status quo.

[2] Disposable incomes also benefited in 2017 from the roll back of the temporary solidarity levy on wages that was introduced during the crisis.

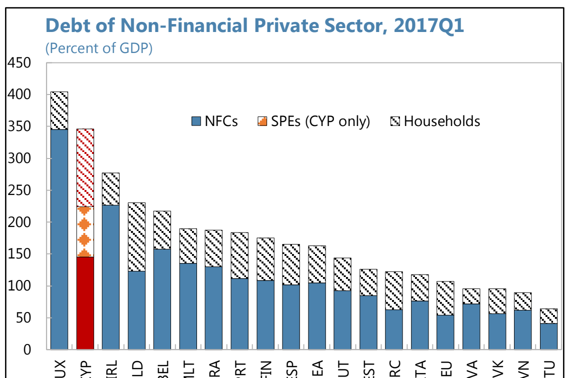
5. Improved cost competitiveness helped narrow the underlying current account deficit. Reductions in wages and prices and rising productivity during and after the crisis lowered the unit labor cost- and CPI-based real effective exchange rates (REERs) by 20 and 10 percent, respectively, where they have stabilized for the past two years. This, together with security concerns elsewhere in the region, helped to boost net exports of tourism and other services by more than 3 percentage points of GDP in recent years. The current account deficit widened sharply to 4.9 percent of GDP in 2016, but excluding lumpy imports/exports from registration/deregistration of ships and interest on foreign debt of special purpose entities (SPEs) (Annex II), it dropped to 0.2 percent of GDP. Private net financial inflows have been strong, at more than 30 percent of GDP per year in 2014–16, likely attracted by relatively high interest rates and the citizenship-by-investment (CbI) program.[3]

But Legacy Stock Imbalances Remain

6. Despite some deleveraging, the private sector debt overhang persists, although deposits are also sizable. At 259 percent of GDP in Q2:2017, gross debt of Cyprus's nonfinancial private sector (mostly loans from local banks) is extremely large.[4] Household gross debt equals 119 percent of GDP, with nonfinancial corporates accounting for the remaining 140 percent of GDP. Gross debt has declined by nearly €1 billion since end-2014, with bank loans having decreased by more than €3 billion, mainly on write-downs, but with limited net repayments (which include debt-to-asset (D-A) swaps). The debt ratio has decreased by 18 percentage points of GDP since end-2014, supported by the pick-up in nominal GDP. Notwithstanding high gross debt, bank loans net of deposits are considerably lower at 49 percent of GDP as of Q3:2017 owing to large deposit holdings. In particular, households' deposits are on aggregate almost 20 percent larger than their loan obligations, although deposits may be distributed differently than loans.



Sources: Central Bank of Cyprus; CYSTAT; IMF staff calculations.

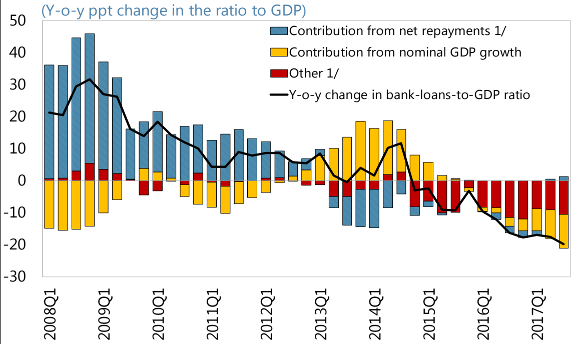


Sources: Central Bank of Cyprus and Haver Analytics.

[3] The current scheme requires a minimum own-equity investment of €2 million, held for at least three years, and purchase of a residence with a minimum price of €500,000, to be held indefinitely. While there are no sectoral requirements on eligible investment, much of the investment is focused in real estate.

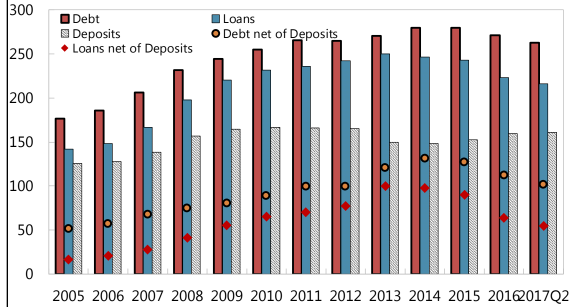
[4] This excludes debt of nonfinancial SPEs, amounting to 81 percent of GDP, which is mostly external.

Bank Loans to Resident Non-Financial Private Sector
(Y-o-y ppt change in the ratio to GDP)



Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ "Net repayments" include debt-to-asset swaps. "Other" includes write-offs.

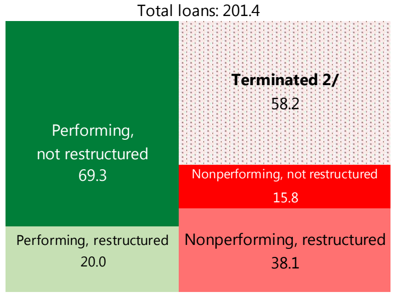
Debt, Loans, and Deposits of Resident Non-Financial Private Sector[1] (Percent of GDP)



Sources: Central Bank of Cyprus and IMF staff calculations.
1/ Loans and deposits are with Cypriot banks only. Debt includes loans owed to nonbank financial institutions and nonresidents.

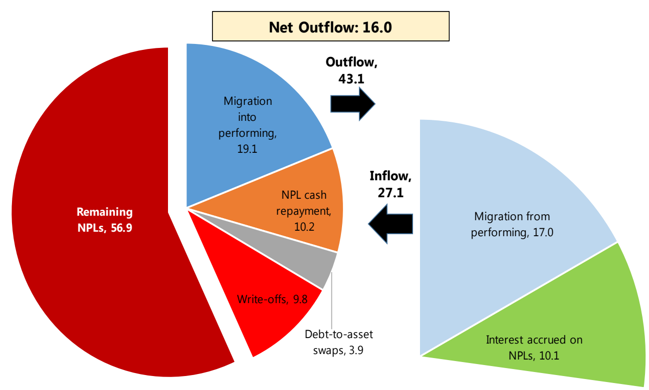
7. High private sector debt has contributed to the poor quality of banks' loan books. NPLs in the three large domestic banks stand at about 55 percent of loans and more than 100 percent of GDP, as of March 2017.[5] NPL reduction has been slow and uneven, with progress focused on the limited number of larger-corporates, leaving banks with smaller-value, more-difficult-to-recover NPLs owed by households and SMEs, which comprise (by value) over 90 percent of the total (Annex III). Some previously-restructured NPLs and formerly-performing loans continue to default despite robust GDP growth. Given shrinking credit and growing deposits, banks are placing excess liquidity (some 15 percent of assets) at the central bank. Capital exceeds regulatory requirements and provisioning was raised to nearly 47 percent of NPLs as of Q2:2017 (which is close to the European average). Profits remain under pressure from periodic provisioning adjustments, narrowing interest margins and limited rationalization of operational expenses despite significant overbanking.

Cyprus: Loans by Classification 1/
(Percent of GDP, 2017Q2)
Total loans: 201.4



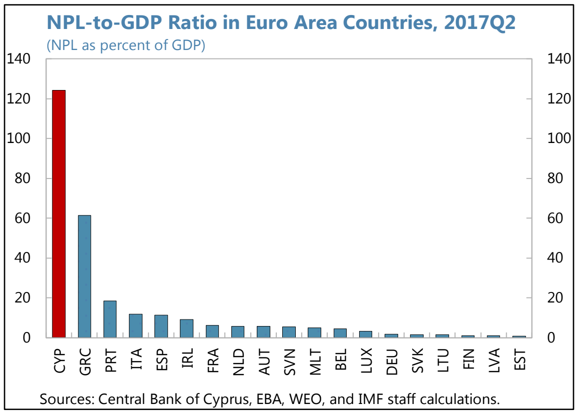
Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Fixed-term loans. Local operations only. Excluding RCB bank.
2/ An account is considered terminated if the outstanding balance has been called in.

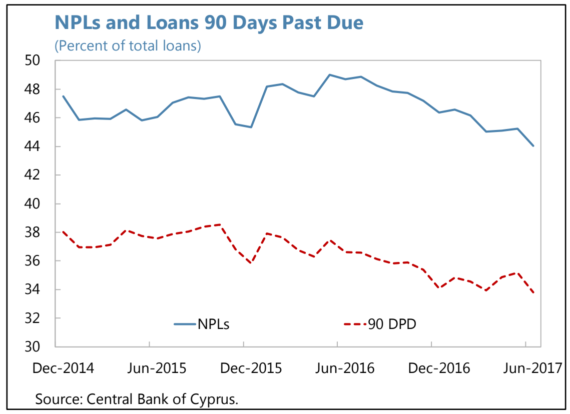
Cyprus: Flows of Non-Performing Loans 1/
(Q4:2015-Q2:2017. Stock at the beginning of the period normalized to 100.)



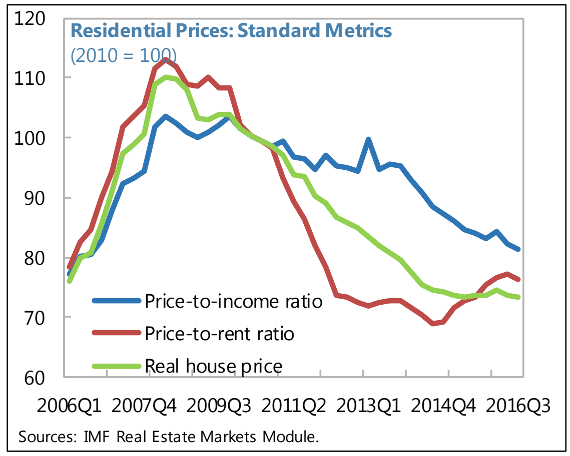
Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Data cover fixed-term loans owned by locally active banks. Two banks, RCB and Astro, are excluded.

[5] Economy wide, NPLs were 44 percent of total loans and 124 percent of GDP as of Q2:2017.





8. After falling sharply, property prices are now rising marginally while transactions are recovering, especially in the luxury segment. Prices declined 30 percent (residential) and 50 percent (retail) relative to the 2008–09 peak, stabilized in 2015, and rose moderately since mid-2016. Price-to-rent and price-to-income ratios have returned to historical levels.[6] With at least two-thirds of loans collateralized with real estate, moderate price growth will increase banks' NPL cover and borrowers' net worth. However, prices have also benefited from the limited number of foreclosures, while turnover is more active in the luxury market owing in part to the CbI scheme.



9. The approaching presidential elections are widely perceived as having delayed essential reforms. The pace of reform had already waned since the end of the IMF-ESM program in March 2016 and with the greater fragmentation of parliament following the May 2016 elections. The two-year negotiations to reunify the island—which were suspended in July 2017—and the presidential elections, scheduled for January–February 2018, have also diverted attention from the macro-financial policy agenda.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

10. In staff's baseline scenario, current dynamic growth momentum is expected to persist for the next several years, before gradually easing. This forecast is underpinned by two forces: the existing pipeline of large, mainly foreign-financed construction projects that will take several years to complete, and continued weak payment discipline that avoids the need to curtail spending

[6] Data for the period prior to 2006 are not available. The short length of historical data could lead to significant uncertainty regarding the appropriate level of house prices.

to service debt, and hence allows private consumption to grow broadly in line with income. Thus, growth is expected to average 3¾ percent during 2017–18, and to moderate gradually thereafter to around 2½ percent by 2022 as investments are completed. The high import intensity of investment will cause some re-widening of the current account deficit despite further expansion of tourism. Notwithstanding sustained growth in income and employment, NPL reduction is expected to remain subdued in the absence of more effective measures to strengthen payment discipline.

11. While ongoing investment will help to raise potential growth, the negative output gap is expected to close in the next few years. Part of ongoing construction will alleviate capacity constraints in tourism, although slow structural reform momentum, together with continued excessive debt and weak payment discipline, would hold down potential growth, keeping it to around 2¼ percent.[7] However, while unemployment is expected to remain above pre-crisis levels, the natural rate is likely to have also risen reflecting (i) greater structural mismatch between jobseekers, who tend to be university graduates, and job openings, which are concentrated in construction and tourism, and (ii) erosion of skills due to sustained unemployment. Thus, output is expected to temporarily overshoot potential within the next few years, exerting some upward pressure on prices and productivity-adjusted wages, before falling back to potential over the longer run.

12. Further moderate upside growth surprises are possible, but downside risks could be sizable (Annex IV). Growth could remain elevated for longer if the current momentum in foreign-financed construction activity were sustained. However, this could intensify resource shortages, putting pressure on prices and wages. It would also further skew growth toward construction, making the economy more prone to a new boom-bust cycle if external financing were to slow suddenly—possibly in response to risk-off sentiment triggered by faster-than-expected policy tightening by major central banks—or if the supply of new properties was to significantly outstrip final demand. Continued slow resolution of NPLs could keep financial sector vulnerabilities elevated. If fiscal discipline were eroded, higher financing costs could weaken growth. Cyprus's role as a business and financial hub could be adversely affected by any new international initiatives on corporate taxation or by retrenchment of cross-border financial intermediation by foreign correspondent banks. On the other hand, growth prospects could be significantly boosted if development of offshore hydrocarbon deposits proves financially viable.

Authorities' Views

13. Recent positive macroeconomic trends are expected to continue over the medium term, albeit at a moderating pace. Growth is expected to be near 3¾ percent this year, then to ease slightly during 2018–19, and stabilize at around 2¾ percent during 2019–20. Domestic demand will remain the main growth driver, although at a less-vigorous pace than at present. Private consumption will be supported by growing employment and wages, with only a modest dampening effect from reducing NPLs. Investment would remain active, benefiting from the current stream of projects in tourism, energy and other business services, among others. The current account deficit is

[7] This rate also reflects Cyprus's already moderately-high level of per capita income, which limits scope for faster convergence-driven growth.

likely to remain sustainable at around 4 percent of GDP. Potential growth is projected to increase to just below 2½ percent, falling-short of growth outturns over the forecast horizon. The negative output gap is closing and a positive gap will open.

14. Growth has shifted to a more durable model, but risks remain. In contrast to the previous economic cycle, growth no longer depends on fiscal deficit spending or an unsustainable expansion in credit. Indeed, growth may well exceed near- to medium-term forecasts if the current momentum in tourism and investment continues. Ongoing construction projects are partly funded through foreign direct investment and therefore less volatile. Owing to the elastic supply of foreign workers, together with the segmented nature of the property market, strong construction activity in the luxury market is not expected to push up wages or prices across the economy. In fact, rather than a source of "Dutch disease," increased construction activity could alleviate such pressures by adding to tourism capacity. Delayed implementation of banks' plans to reduce NPLs would hinder their ability to support growth through new lending. On the upside, prospects in the energy sector could yield a positive growth surprise.

B. Policy Priority: Achieving Sustainable Deleveraging and NPL Reduction

Macroeconomic Effects of Deleveraging

15. Eliminating the private sector debt overhang and banks' excessive NPLs is essential to support balanced and sustainable growth. High debt and NPLs have not so far prevented the economy—even previously credit-dependent and high-NPL sectors—from growing, owing to alternative funding sources from foreign financing and current profits, as well as strategic nonpayment of debt service obligations. However, these sources could be finite or unreliable. Moreover, the status quo of high debt and NPLs is not sustainable as financial stability risks would fester and potential borrowers who depend on bank loans—especially SMEs—could be ineligible for new credit. In addition, limited opportunities for prudent new lending would curtail banks' profit potential, and further concentrate investment and growth into those few sectors that are self-funded or appeal to foreign investors. Gradually lowering nonfinancial private-sector debt net of deposits by 40 percentage points of GDP—bringing it close to its early post-EU accession ratio—over a period of five years is an appropriate target. Hoping to achieve this target by growing out of debt—either by increasing the capacity to service the existing stock or by mechanically raising the denominator—is unlikely to be feasible given the very rapid growth rates that would be needed and the potential for volatility amid high debt and NPLs.[8] There is also no assurance that higher incomes would automatically improve payment discipline.

16. The current period of strong externally-driven growth provides a window to initiate a comprehensive and ambitious strategy for sizable deleveraging. Reducing both private debt and NPLs is needed because cleaning up banks' portfolios while leaving borrowers saddled with excessive debt would not be sustainable for banks or the economy. Banks should remain adequately

[8] See accompanying Selected Issues Paper "Too Much of a Good Thing? Cyprus's Private Sector Debt and a Path to Deleveraging."

provisioned and capitalized, and borrowers should be incentivized to engage with banks by strengthening legal and other restructuring measures. Adopting a broad set of tools—including debt-assets (D-A) swaps, use of banks' provisions, borrowers' own funds and current income—in combination with burden-sharing, could deliver a sizable reduction in private debt and NPLs within a five-year period. The current conjuncture of strong external demand provides an auspicious opportunity for delivering on this goal.

17. Given the need for deleveraging, the external sector is overly weak. Notwithstanding the sizable reduction in the current account deficit and REER in recent years, unwinding the excessive level of private debt will require further strengthening of the external sector. According to the EBA-lite methodologies (Annex V), the external sector was weaker than warranted by fundamentals and desired policy settings in 2017 reflecting, in particular, the need to eliminate the remaining net credit gap. Such deleveraging would decrease domestic absorption, raise the current account and lower net IIP liabilities (e.g., by lowering foreign funding used by Cypriot banks to support domestic credit).

Summary of EBA-lite Results

	CA Norm (percent of GDP) (1)	Underlying CA (percent of GDP) (2)	CA gap (percent of GDP) (2) – (1)	REER gap (percent) (elasticity: -0.47)	Assessment[1/]
CA	0.1	-2.3	-2.4	5.2	Weaker
ES	-0.3	-2.3	-2.0	4.2	Weaker
REER	…	…	…	15.0	Weaker

Sources: IMF staff estimates.
Note: See Annex V for details. The assessment is based on the "Methodological Note on EBA-lite" https://www.imf.org/external/np/pp/eng/2016/020516.pdf).
[1/] A CA gap within [-4, -2] percent of GDP or [10, 20] percent for the REER gap corresponds to an external position that is weaker than implied by fundamentals and desirable policy settings.

Authorities' Views

18. A strategy that heals both banks and borrowers, relies on burden sharing and takes account of macroeconomic effects is appropriate. NPL reduction is not merely an end, but a means to ensure sustainable, robust growth. While ample scope exists for banks to accelerate NPL reduction, the appropriate pace should be determined by the extent of negative feedback on economic growth and society, and also considering market conditions for banks' capital-raising. Moving too aggressively could have unwarranted consequences for financial stability and put the economic recovery at risk. Therefore, an optimal approach would be balanced in terms of tools and burden sharing, and set a realistic timeframe, taking into account bank funding conditions.

Financial sector policies

19. Cypriot banks with large legacy-NPLs face a challenging operating environment. Progress has been made in reducing NPLs of larger corporates, but performance across the three large banks has been uneven, reflecting differences in their loan portfolios. Shrinking interest margins amid excess liquidity and strong competition, limited opportunities for healthy new lending, together with little reduction in operating expenses despite decreasing loan books, is weighing on profits, which—in some cases—include interest accrued-but-not-paid. Increased provisioning in Q2:2017 raised provisioning cover to the EU-bank average of 45 percent but further pulled down profits. In this environment, supervisors should closely monitor new lending and loan classification to ensure that banks uphold prudent standards, and encourage banks to strengthen capital buffers by curtailing operating costs and raising capital as market conditions allow.

20. New approaches are needed to achieve a decisive and durable reduction in NPLs. The CBC's current bank-specific NPL restructuring targets are no longer encouraging performance. However, the planned shift to targets on NPLs could, in the near term, encourage overreliance by banks on balance-sheet operations that unnecessarily consume provisions, rather than promote viable loan workouts. To protect against this risk, NPL targets should be calibrated based on ambitious and credible medium-term strategies—embedded in realistic capital plans—prepared by each bank and approved by the supervisor. These plans should utilize a range of tools and incentivize viable borrowers to agree to sustainable loan workouts:

- ***Small borrowers.*** Accelerating the reduction of household and SME NPLs could be supported by: (i) effective outsourcing of NPL management to third parties with specialized debt recovery and restructuring skills and an arm's length relationship with borrowers; and (ii) segmenting the portfolio according to characteristics of the loan, and offering standardized restructuring packages to viable borrowers within each category in order to discourage them from holding out for better deals, including through re-restructurings. Assumptions underpinning provisioning requirements should be updated frequently to reflect recent time-to-liquidation and collateral recovery-rate performance.

- ***Real estate portfolio.*** Voluntary D-A swaps are a useful tool that avoid the added cost of a forced sale. However, banks may be tempted to use them excessively to show progress on NPL reduction, even if onboarded properties cannot subsequently be sold without depressing property prices. In those circumstances, banks would be replacing credit risk with real estate risk. To preserve prospects for upside price gains and discourage warehousing of onboarded property, (i) banks should engage in D-A swaps only when prospects for upside value-extraction are favorable (using plausible assumptions for maintenance and depreciation costs) or as part of a larger restructuring deal; (ii) properties should be onboarded at a forced-sale discount such that any loss is incurred upfront; and (iii) a cap on real estate holdings, together with a capital surcharge that escalates with the share of real estate in a bank's assets and length of holding period, should be imposed.

- ***Portfolio divestment.*** Divesting part of banks' portfolios of problem loans would allow banks to refocus on their core activities and transfer assets to parties better placed to resolve NPLs. This could be achieved under the new sale of loans law or through securitization, once the enabling legislation—which has been pending for several years—has been approved. However, large price discounts relative to book value may be needed, consistent with deficiencies in the frameworks for private debt restructuring.

Authorities' Views

21. While progress has been made on reducing NPLs, greater effort by banks is needed. Banks' business models and capital levels are being affected by their nonperforming loans, the negative interest rate environment and intensified market competition. Progress with reducing NPLs has been uneven, and some banks have made considerably more progress and effective use of available tools, while for others, efforts to date have been insufficiently ambitious. The recent increase in provisioning was a necessary step, and the supervisor will continue to review frequently the adequacy of banks' provisions to ensure that NPL reduction plans remain feasible. The continuing inflow of NPLs from new defaults and re-defaults and the gradual shift to provisioning on an expected-loss basis (IFRS9) could lead to further calls for provisioning. Some banks are exploring options for selling or securitizing loans, and the needed legal frameworks and capital safeguards to support these strategies should be put in place. External NPL-servicing platforms can be effective if they bring appropriate skills, experience and functional changes to restructuring processes. Given the prevalence of loans collateralized with real estate and the frequent use of D-A swaps, onboarding and holding periods should be monitored, with prudent limits to prevent excessive onboarding if the properties cannot be sold. However, D-A swaps bypass difficulties with foreclosure, relieve borrowers of part of their debt burden, are booked at a conservative 25–30 percent discount on the lowest current market valuation, and are typically used in combination with cash repayment and other measures. Close oversight will be maintained on adherence to loan classification requirements and credit standards for new lending.

22. The CBC is revamping its targeting framework to focus directly on NPLs. The CBC is planning to shift from targeting performance indicators based on restructurings to targeting NPLs. The setting of these new bank-specific NPL targets, which are expected to be rolled out by end-year, would be embedded within a comprehensive sector strategy that adopts a broad macroprudential perspective. The CBC is also in the process of proposing solutions to remedy impediments to effective NPL resolution and recommending enhanced monitoring of NPLs.

Strengthening Claims Enforcement

23. Improved payment discipline is essential for sustainable deleveraging and a well-functioning market economy. While previously-weak lending practices and the crisis and its aftermath have undoubtedly contributed to the high rate of distressed loans, the robust recovery has not produced the expected reduction in NPLs, likely reflecting in part weak payment discipline.[9] Strategic default is enabled by still-lengthy and inefficient procedures for commercial claims enforcement and foreclosure, the perceived blanket protection of primary residences and competing claims on individual properties from failing to issue or transfer title deeds. Delays in addressing NPLs also discourage payment discipline. Strategic default imposes a heavy social and economic cost by limiting banks' ability to extend healthy credit and perpetuating financial sector vulnerabilities.

[9] See Selected Issues Paper "Economic Effects of Weak Claims Enforcement—International Evidence and Implications for Cyprus."

24. Modifying borrowers' incentives is therefore needed. To better serve as a deterrent to strategic default, the foreclosure framework should be further strengthened, including by (i) lowering or eliminating minimum reserve prices and introducing virtual auctions; (ii) allowing more flexible procedures for notifying borrowers; (iii) clarifying the applicability of the new foreclosure procedures to legacy cases; and (iv) reviewing and clarifying existing protections for primary residences and guarantors. Utilization of the new debt restructuring tools for individuals and corporates should be more-widely promoted and transfer of property titles to eligible trapped buyers should continue.[10] The planned introduction of a credit scoring system is welcome. More generally, enforcement of commercial claims should be strengthened to enhance collection and provide incentives for creditors and debtors to find mutually-agreeable restructuring solutions. Court and civil procedure reforms should move forward on an expedited basis.

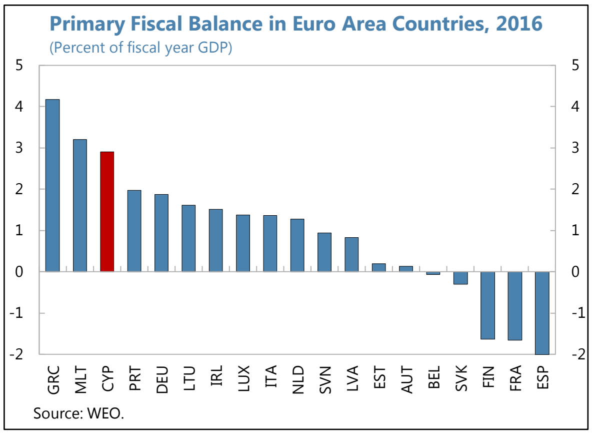
Authorities' Views

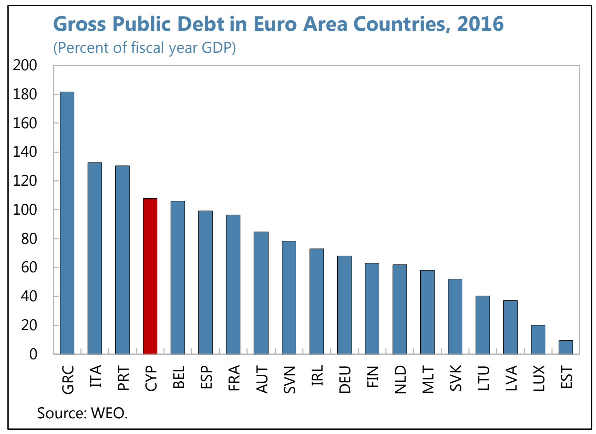
25. While the economic recovery is expected to deliver some gradual reduction in NPLs, more proactive use of available tools is needed. Some delay between the improvement in economic conditions and faster NPL reduction is to be expected as it takes time for banks to ramp-up their restructuring capacity and for cured NPLs to migrate into the performing category. In addition, some borrowers remain affected by job losses and bail-in of deposits that were intended to fund their retirement or were precautionary buffers in the face of limited social safety nets. Nonetheless, the incidence of strategic default seems not to be insignificant, as evidenced by the rise in household and firm deposits, signaling their increased debt-servicing capacity. Moreover, some sectors benefitting significantly from the ongoing recovery have not seen a faster-than-average reduction in their NPLs. In the legal sphere, the introduction of foreclosure and insolvency laws has increased incentives for lenders and borrowers to come to the negotiating table and try to find solutions based on consensual arrangements; nevertheless, targeted amendments could be pursued to enhance the functionality of the legislation. On the other hand, inefficient court procedures—which allow for repeated and protracted appeals—are a concern. Significant progress is being achieved on the issuance and transfer of legacy title deeds. Overall, banks should enhance their efforts to use all existing instruments in the law. Debtors' demand for new credit and the fact that properties cannot be sold or bequeathed unless the mortgagor agrees provides banks leverage in their negotiations with borrowers. However, political commitment to strengthen the payment culture is needed.

[10] The 2015 "trapped buyers" law allows transfer of the property title to a buyer who has fulfilled his financial commitments. This is done by shifting the mortgage encumbrance to another property of the developer. The constitutionality of the law was recently challenged by the banks, which are concerned the law undermines their leverage over developers and that existing loans to developers would become unsecured and require additional provisions. Of the original 14 thousand applications for compulsory transfer of property title, eight thousand cases remain outstanding (See accompanying Selected Issues Paper "Reforming the Legal Framework to Support Private Debt Restructuring").

C. Policy Priority: Ensuring Fiscal Sustainability without Procyclicality

26. Fiscal performance has improved markedly in recent years, with primary surpluses among the highest in Europe. Headline and primary balances reached 0.5 percent and 3.0 percent of GDP, respectively, in 2016, and are each expected to increase by a further ½ percentage point in 2017. These favorable outturns reflect strong revenue collection brought by the robust recovery—especially in construction[11]—and several one-off revenues (from gas exploration rights, temporary tax relief and arrears collection), despite 1½ percentage points of GDP of loosening measures adopted during 2015–17, and backloaded to this year.[12] Gross public debt declined below 100 percent of GDP in late 2017 (Annex VI).





27. Current plans imply a further increase in fiscal balances and a faster decline in public debt over the medium term, although policy would turn somewhat procyclical. According to the 2018 draft budget and medium-term fiscal plans, and which assume low revenue buoyancy, the authorities expect the overall surplus to increase to 1.3 percent of GDP next year (while staff expects 1.1 percent based on its macroeconomic forecasts and somewhat less-restrained spending growth reflecting higher wage growth than envisaged in the draft budget and some pick-up in spending pledges in the context of the election), after which it would remain broadly stable (staff expects some further improvement over the medium term).[13] However, with the output gap already positive and projected to widen further in the authorities' scenario (expected to turn positive in 2019 and then widen through 2022 in staff's forecasts), a growing share of revenue would be sourced from

[11] The growth rate of real construction is high, and with the shift to higher-end, more complex construction projects, the price deflator for construction is likely to rise faster than the CPI or GDP deflator. In addition, the composition of economic activity might have shifted toward sectors that are taxed more heavily, and real GDP growth during the first three quarters of 2017 might faster than official data indicate.

[12] The main loosening measures (and associated costs in percent of GDP) are: (i) elimination of the tax on immovable property, with full effect from 2017 (0.5 percent); (ii) expiration in 2017—as envisaged under the program—of the temporary solidarity levy on wages introduced during the crisis (0.4 percent); and (iii) hiring additional military personnel in 2016 (0.2 percent).

[13] The forecasts include a 0.4 percentage point permanent increase in revenue from an already-legislated increase in social security contribution rates in 2019.

above-potential output. With spending growing faster than cyclically-adjusted revenue (in both the authorities' and staff's forecasts), some erosion of the structural balance is expected, which contributes to the economy's overheating. Nonetheless, public debt is forecast to decline to 82 percent of GDP by 2020 (86 percent of GDP in staff's forecasts and 75 percent of GDP by 2022).

Cyprus: Fiscal Targets, 2015–22 [1/]

(Percent of GDP, unless otherwise noted)

	2015	2016	2017	2018	2019	2020	2021	2022
Draft Budget Plan 2018 (DBP2018)								
Overall balance 2/	-0.1	0.5	1.0	1.3	1.4	1.4	...	...
Primary balance 2/	2.7	3.0	3.5	3.8	...	...	...	...
Structural overall balance 3/	1.2	1.1	0.7	0.5	0.4	0.2	...	...
Gross public debt 2/	107.5	107.1	99.0	92.4	86.5	81.8	...	...
Memorandum								
Output gap (percent of potential GDP) 3/	-3.7	-1.5	0.5	1.5	2.0	2.3	...	...
DBP2018 with staff's macroeconomic projections								
Overall balance 2/	-0.1	0.5	1.0	1.3	1.4	1.4	...	...
Primary balance 2/	2.7	3.0	3.5	3.7	...	...	...	...
Structural overall balance 4/	1.9	1.7	1.6	1.4	1.3	1.1	...	...
Gross public debt 2/	107.5	107.1	98.8	91.0	85.2	80.3	...	...
Memorandum								
Output gap (percent of potential GDP)	-6.0	-4.3	-2.0	-0.3	0.6	1.1	1.4	1.7
Staff projections								
Overall balance	-0.1	0.5	1.0	1.1	1.4	1.4	1.4	1.4
Primary balance	2.7	3.0	3.4	3.5	3.8	3.8	3.7	3.7
Structural overall balance	3.3	1.8	1.8	1.1	1.0	1.0	0.9	0.8
Gross public debt	107.5	107.1	99.7	95.5	90.9	85.8	81.7	75.0
Memorandum								
Output gap (percent of potential GDP)	-6.0	-4.3	-2.0	-0.3	0.6	1.1	1.4	1.7
Staff recommendation								
Primary balance	2.7	3.0	3.4	3.8	4.3	4.3	4.2	4.2

1/ Accrual basis.
2/ Since the DBP 2018 was prepared, historical fiscal and national accounts have been revised.
3/ Estimates for 2015 and 2016 are from the authorities' March 2017 "Stability and Growth Program (SGP) 2017-2020."
4/ Derived by adjusting for staff's estimate of output gap.

28. **To protect against undue spending pressure and the risk that temporary or cyclical revenue is perceived as permanent, increases in fiscal spending should be capped by medium-term GDP growth.** Setting an annual ceiling for nominal spending that increases in line with medium-term growth (with downward adjustment to compensate for any future cuts to tax rates or narrowing of tax bases) would avoid procyclical policies and help prevent a structural loosening. Such a policy would also accelerate the downward path of debt, thereby helping to rebuild fiscal space to absorb any contingent fiscal liabilities. To underpin this spending cap, while making room for growth-enhancing spending, a more durable mechanism to keep the public-sector wage bill in check should be instituted. Close monitoring of the costs—including arrears—of the National Health Service (NHS) that will be rolled out in June 2019 should be undertaken to ensure public finances are not put at risk (Annex VII).

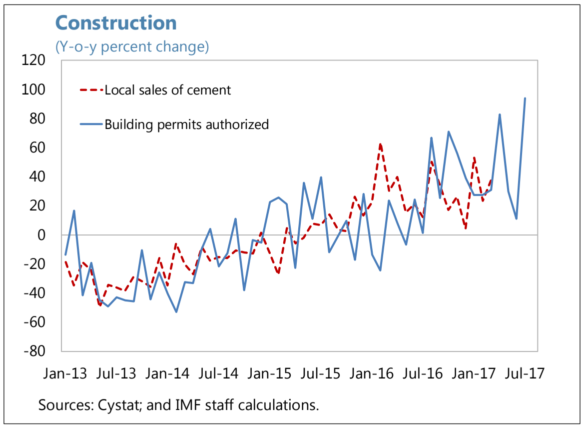
Authorities' Views

29. The authorities remain committed to fiscal prudence while continuing to support the economy by reducing the tax burden on productive sectors. A strategy of lowering tax rates and providing tax breaks has lifted GDP growth and tax revenue and, together with consolidation of government spending, enabled the swift elimination of fiscal deficits. In recent years, fiscal outturns have significantly exceeded the goal of overall fiscal balance, and the primary surplus is on track to exceed 3 percent of GDP (with an overall surplus of 1 percent of GDP) in 2017. Fiscal plans through 2020 envisage that expenditure will increase in line with medium-term GDP growth, keeping the overall surplus at around 1 percent of GDP. The collective agreement with public sector unions, and adoption of the law indefinitely freezing hiring and the law allowing extended staff mobility within the broader public sector will help to support this goal. Revenue from upside growth surprises will be saved, further accelerating the decline in gross public debt, which is expected to fall below 100 percent of GDP by end-2017, one year ahead of plan. Regarding fiscal risks, the forthcoming NHS is intended to be fiscally neutral. This assumption will be reviewed based on the external consultant's report due in early 2018. Pending legal claims for compensation for measures taken to address the financial crisis could pose additional fiscal risks.

D. Policy Priority: Ensuring Balanced and Sustainable Growth

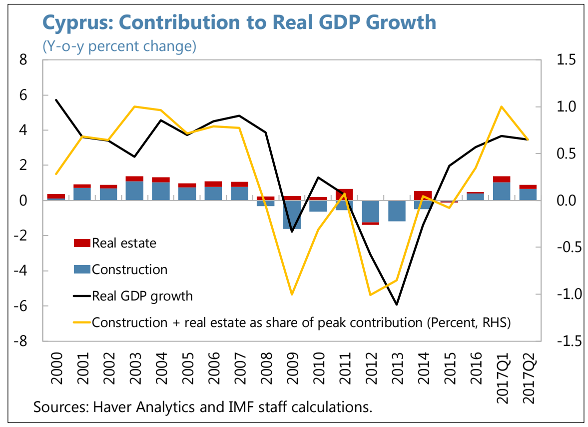
Real Estate

30. Policy adjustments are warranted to avoid a potentially unsustainable increase in construction activity. Several investment incentives, including the CbI scheme, provided welcome support to construction and the economy more broadly in the aftermath of the crisis. However, this support has now achieved its goal, and could turn procyclical. Further decoupling the scheme's eligibility requirements from real estate would help avoid excessive concentration of economic activity, and reduce the risk of over-supply of luxury properties. Full compliance with AML/CFT standards by all sectors involved in the CbI scheme and supervision of those sectors for compliance with requirements should be ensured to maintain the integrity of the CbI scheme and mitigate correspondent banking pressures. AML/CFT requirements should include checking the source of wealth and source of funds of applicants, including by the authorities as part of eligibility criteria and processes. Procedures for issuing and transferring title deeds for new properties should be streamlined, with timely transfer of titles to buyers. If signs emerge that construction in the luxury market is becoming reliant on domestic credit or that activity is spilling over to other segments, tightening bank lending standards and raising macroprudential capital requirements would be appropriate. Reinstating the recently rescinded immovable property tax (IPT) and raising the transfer duty on immovable property would provide additional countercyclical tools.



Construction
(Y-o-y percent change)

Sources: Cystat; and IMF staff calculations.



Cyprus: Contribution to Real GDP Growth
(Y-o-y percent change)

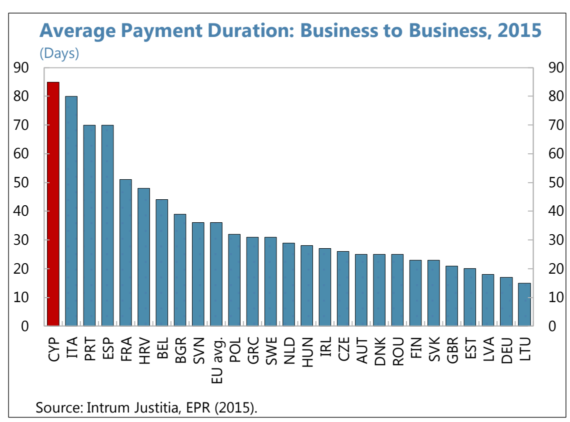
Sources: Haver Analytics and IMF staff calculations.

Authorities' Views

31. **Increased construction activity has supported the recovery, and associated risks appear manageable.** Tax and other incentives targeting the property sector helped to stabilize prices and bring jobs and economic growth. The fact that large luxury construction projects are mainly foreign financed or financed through pre-selling helps to limit financial stability risks. The CbI scheme is a general investment scheme, although real estate is the major beneficiary. Regulatory improvements to the CbI—with stricter controls on intermediaries (including real estate agents and lawyers)—are being considered, but there are no plans to amend the eligibility criteria. Some construction projects will generate future revenue streams (e.g., the casino and marinas) that will underpin their value. However, resale prices of residential units could be affected if too many are built, which could spread to prices of other properties. While developers have not relied on domestic bank financing so far, caution is needed to prevent a recurrence of such bank exposure, and tightening of lending standards is warranted for developers and in the event foreign demand spills over to the housing market for the general population. To comply with EU requirements, VAT will be imposed on transactions of buildable land, thereby partly offsetting—from a tax-incidence perspective—the previous elimination of the IPT and reduction in property transfer fees.

Enforcement of Commercial Claims

32. **Strengthening the effectiveness of commercial claims enforcement and increasing the efficiency of the courts are priorities to improve the investment climate and support NPL reduction.** Delays in court processes weaken the attractiveness of the country as a business destination and undermine effective implementation of the foreclosure and insolvency laws. To rectify these issues, the civil procedure law should be reviewed and updated; rules for appeals and interim injunctions should be modernized to limit undue delays; and consideration



Average Payment Duration: Business to Business, 2015
(Days)

Source: Intrum Justitia, EPR (2015).

should be given to introducing a streamlined procedure for enforcement of small claims. The establishment of a commercial court and introducing specialization of judges in the lower courts would allow more expeditious case handling.

Authorities' Views

33. Efficient courts and speedy administration of justice is essential for the economy and to enhance the effectiveness of NPL resolution tools. Judicial reform is high on the agenda. The authorities have commissioned a study by independent experts of the structure and operations of Cypriot courts and expect to receive recommendations by Spring 2018. The recent establishment of the Administrative Court and the anticipated commencement of a Commercial Court in 2018 would go some way toward clearing the backlog of cases. However, broader reforms to modernize and expedite the administration of justice, including civil procedure rules, are needed.

Competition and Governance

34. Improving the investment climate across a wide range of sectors requires efficiency-enhancing reforms. Attracting capital into innovative sectors would help expand investment beyond Cyprus's traditional sectors and create employment for its highly-skilled labor force. The proposal to introduce expedited procedures for investment is therefore welcome. Restarting the privatization agenda and allowing entry into protected sectors would increase competition and help raise productivity. Strengthening governance and operational efficiency in key public and private sectors, including through the adoption of pending reforms to state-owned enterprises and restarting privatization, would help modernize the economy and allow firms to better absorb the proposed 5½ percentage point increase in the payroll contribution rate that will be introduced to fund the new NHS.

Authorities' Views

35. Numerous growth-enhancing reforms have been adopted, and a pipeline of measures is awaiting implementation. Several initiatives to attract investment beyond Cyprus's traditional sectors are in progress, including simplifying licensing procedures for strategic investments and promoting the establishment of innovative start-ups and investment in the filming industry. Parliament is reviewing bills submitted by the government for reforming the local government sector and for establishing new departments headed by deputy ministers for tourism and for growth, with the aim of streamlining investment-approval procedures. The law to corporatize the Cyprus Telecom Authority (CyTA), which stipulates that the state retain majority ownership and that employees' rights are grandfathered, will be submitted to parliament for approval. Following the successful sale of the operations of the port of Limassol, assignment of the operations of the port and marina of Larnaca is expected in the coming months. Several broad-based tax reductions have been adopted, including allowing more accelerated capital depreciation and tax deductibility of equity-financing (thereby equalizing tax treatment of debt and equity), and eliminating the temporary solidarity levy on wages, which should help to partly offset the new NHS levy.

STAFF APPRAISAL

36. The Cypriot economy is continuing to bounce back from the severe disruption that followed the 2012–13 banking crisis. Prudent macroeconomic policies and progress on structural reforms since the crisis, including in the context of the IMF-ESM-supported program, together with strong foreign demand, contributed to this impressive turn around. Growth has been robust and employment has risen rapidly, helping to boost incomes and alleviate social hardship.

37. However, the legacy of excessive NPLs as well as private and public debt continue to cloud Cyprus's economic outlook. The effect of this debt overhang on GDP growth is being masked for now by accommodative global financial conditions, large foreign investment, strong tourism revenue and persistent weak payment discipline. Despite the notable improvement in domestic economic conditions, only tepid progress has been made on reducing NPLs. Thus, banks remain weak, limiting their capacity to lend, while borrowers remain heavily indebted and unable to absorb new credit. This situation poses risks to the sustainability of the current growth model.

38. Strong growth dynamics are expected to continue for the next few years, but legacy concerns and concentration of real activity could pose risks. The current robust growth momentum is likely to persist for the next several years as large foreign-financed investment projects are built while consumption will continue to be buoyed by strategic non-servicing of existing debt obligations. Thus, remaining economic slack will be exhausted, and the output gap will turn positive over the medium term even though realized growth is projected to moderate with the completion of ongoing construction projects. In the short run, growth could surprise on the upside if construction activity remains strong, but this could raise the prospect of a new boom-bust cycle. Continued slow progress on reducing NPLs would keep banking vulnerabilities elevated. Risk-off sentiment in global financial markets could weaken capital inflows. However, discovery of economically-viable offshore gas reserves could significantly increase growth prospects.

39. The current setting of strong, externally-led growth should be used to resolve legacy problems. Significantly and simultaneously reducing excessive private indebtedness and banks' NPLs in a non-disruptive manner is an urgent task. In addition, policies should be geared to ensuring economic growth becomes broader-based and avoids undue dependence on external financing. Other priorities include rebuilding fiscal buffers while avoiding procyclicality in public spending, speeding up enforcement procedures for commercial claims, and strengthening competition and governance.

40. Prompt preparation and implementation of a decisive deleveraging plan, together with improved payment discipline, is essential to normalize the economy. Banks' weak loan portfolios are the corollary of excessive private debt, and simultaneous progress on both fronts is needed to protect macro-financial stability. Hoping to passively grow out of debt is unlikely to be successful given the size of the challenge. Utilizing an array of restructuring tools, together with burden sharing, would limit the short-term dampening effect on GDP growth, especially given the cushion from strong external demand. Reducing the incidence of voluntary default requires strengthening the foreclosure framework, clarifying existing protections for primary residences, and streamlining court procedures. Raising awareness of the potentially-heavy long-term economic and social toll of weak payment discipline is also warranted.

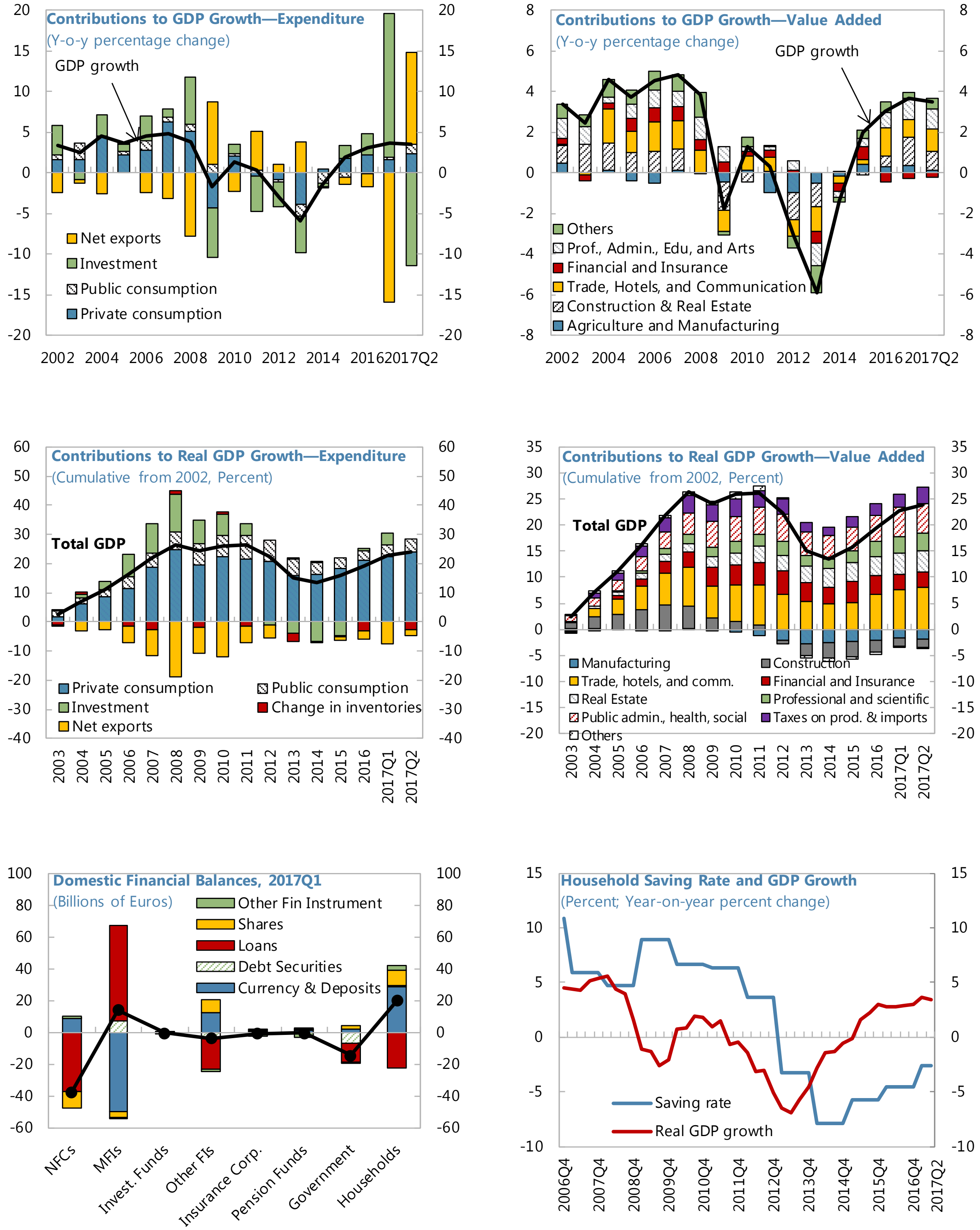
41. Banks require ambitious and credible strategies for reducing NPLs, while also complying fully with supervisory norms. New approaches are needed to tackle the large pool of smaller-value NPLs, and strategies should be consistent with long-term plans for capital and provisions that incorporate realistic assumptions on NPL recovery rates as well as the cost and availability of additional capital. Use of debt-assets swaps should be limited if banks are warehousing swapped properties on their balance sheets. Prudent standards for new lending and loan classification should be preserved.

42. Improvements in fiscal policy brought by previous expenditure reforms should be safeguarded through a ceiling on public spending. To contain spending pressures and the risk that cyclical or one-off revenue is spent, a spending cap that increases in step with medium-term GDP growth is advised. This would also secure the downward path for public debt. Adopting the draft civil service reform law that, among other things, regulates wage bill growth while closely overseeing the costs of the planned new National Health Scheme would help contain spending within the proposed cap. Pending revenue administration and public expenditure reforms should be completed to create room for growth-enhancing spending.

43. Ensuring balanced and sustainable growth calls for reinvigorating the stalled structural reform agenda. Establishing a dedicated commercial court with specialized judges would reduce delays and uncertainty in claims enforcement. Gradually rolling back incentives for construction and tightening lending standards would avoid the risk of excess supply of luxury properties, protect financial stability and ensure that economic activity does not become excessively concentrated on a relatively niche market. Restarting the privatization program and undertaking governance reform would enhance competition and increase productivity.

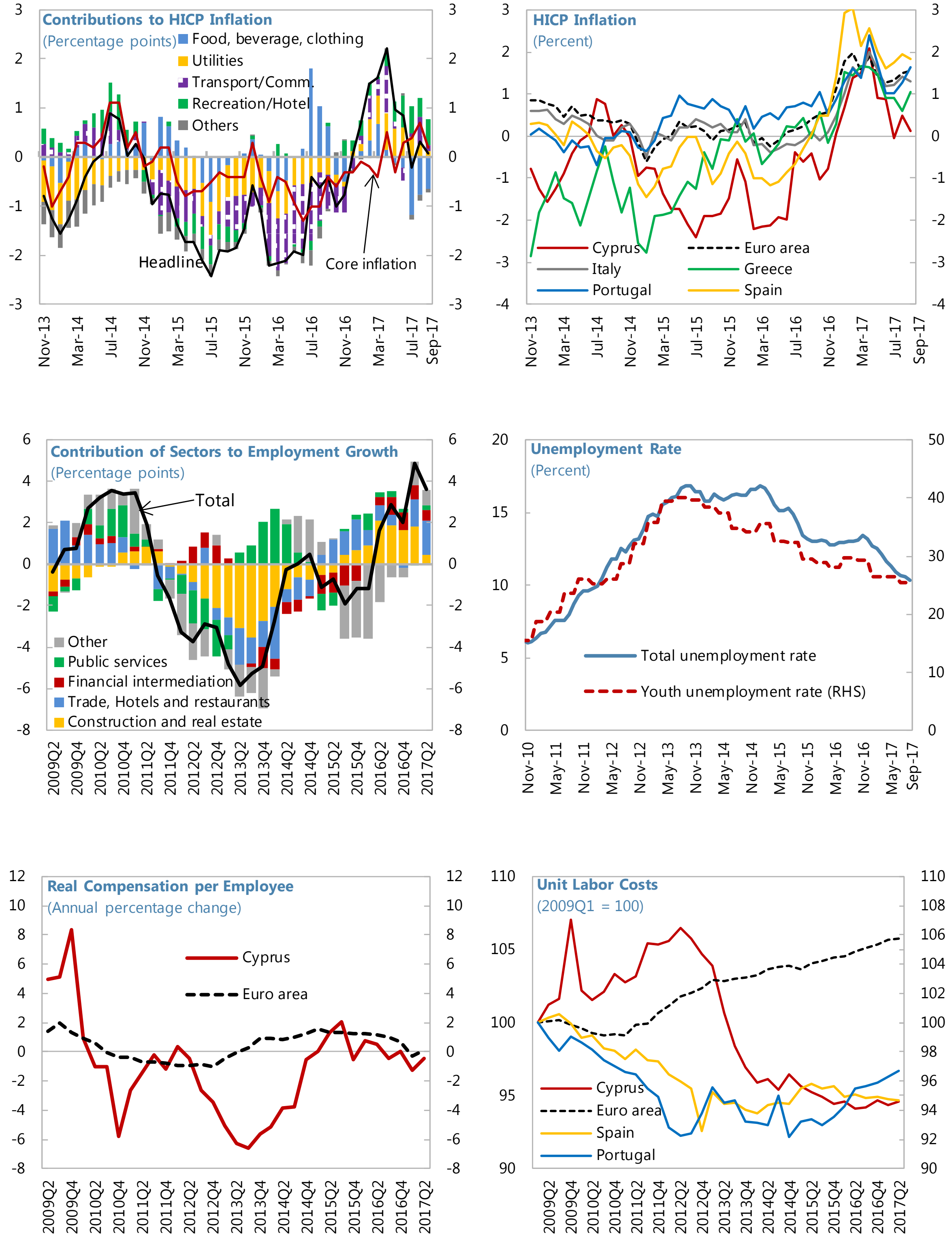
44. It is recommended that Cyprus remain on the standard 12-month Article IV consultation cycle.

Figure 1. Cyprus: Macroeconomic Performance



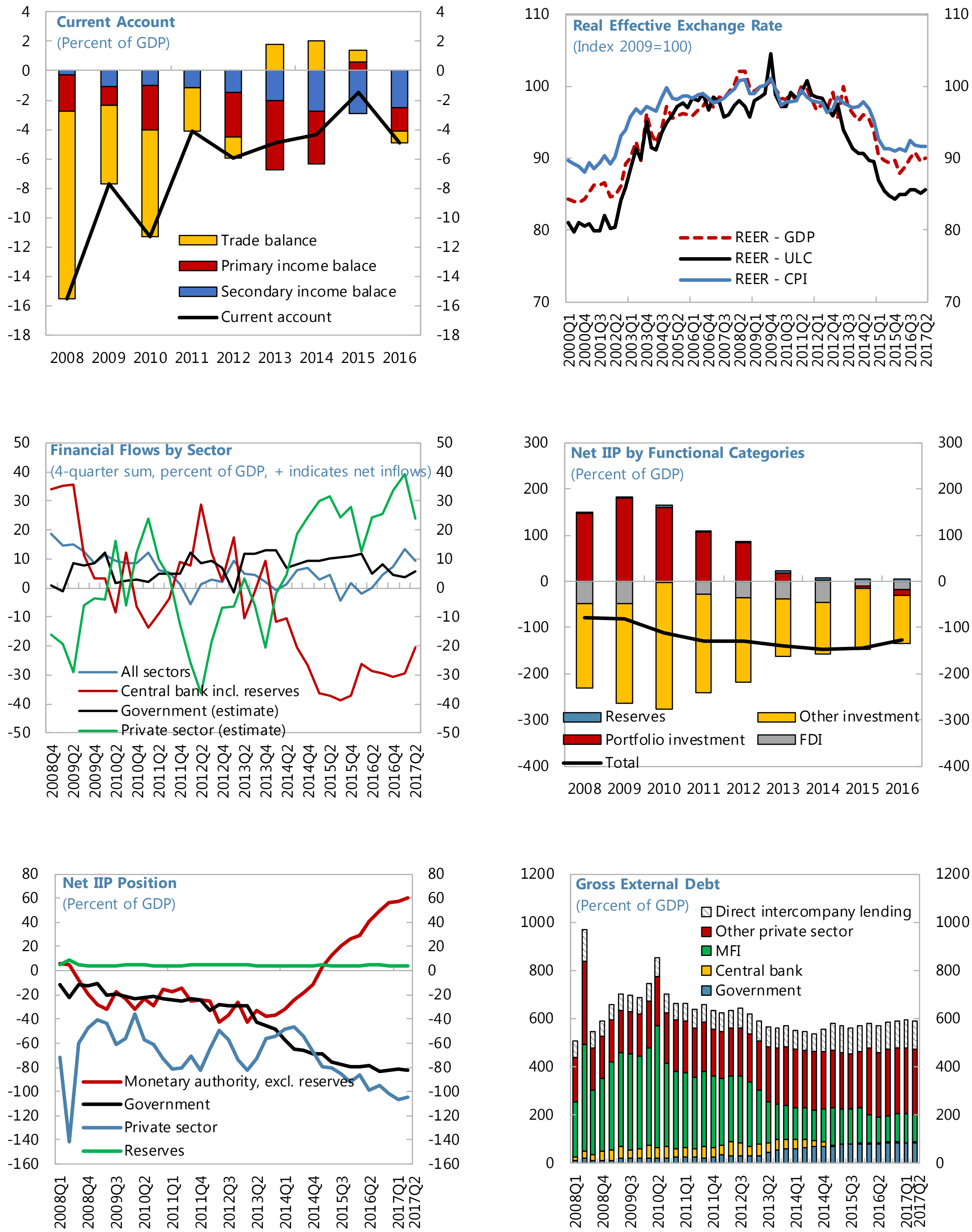
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 2. Cyprus: Inflation and Labor Market



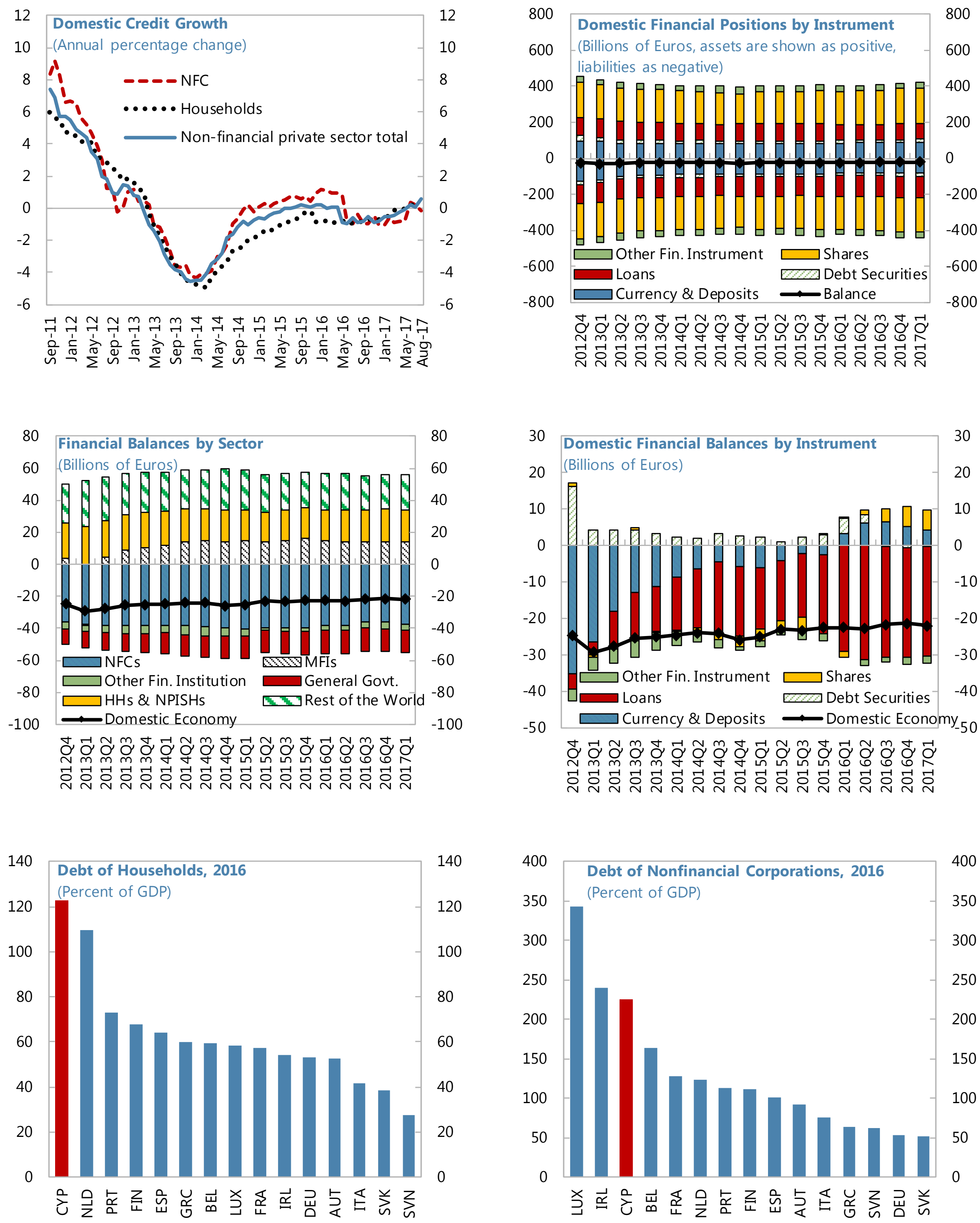
Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

Figure 3. Cyprus: External Indicators



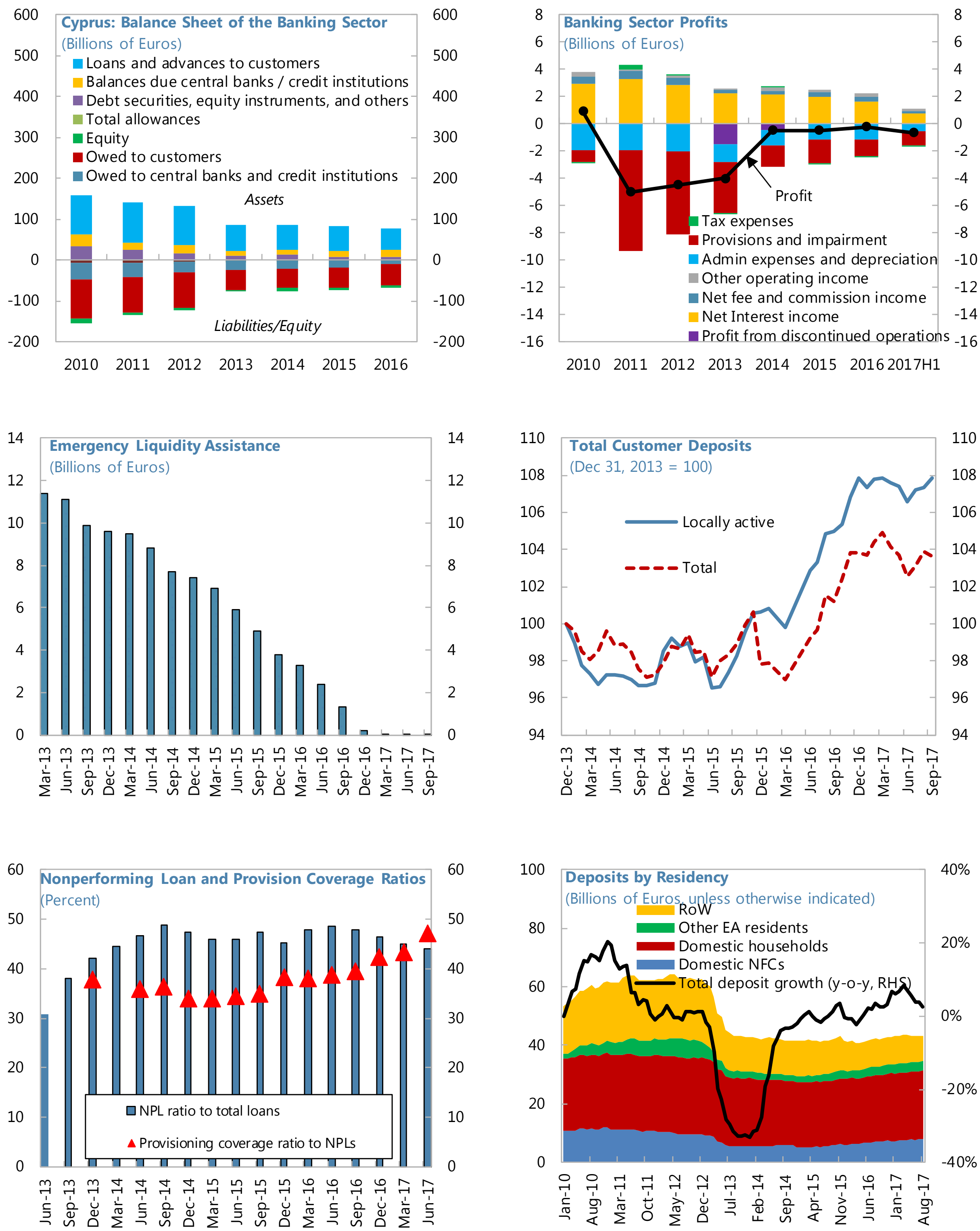
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Credit and Balance Sheets



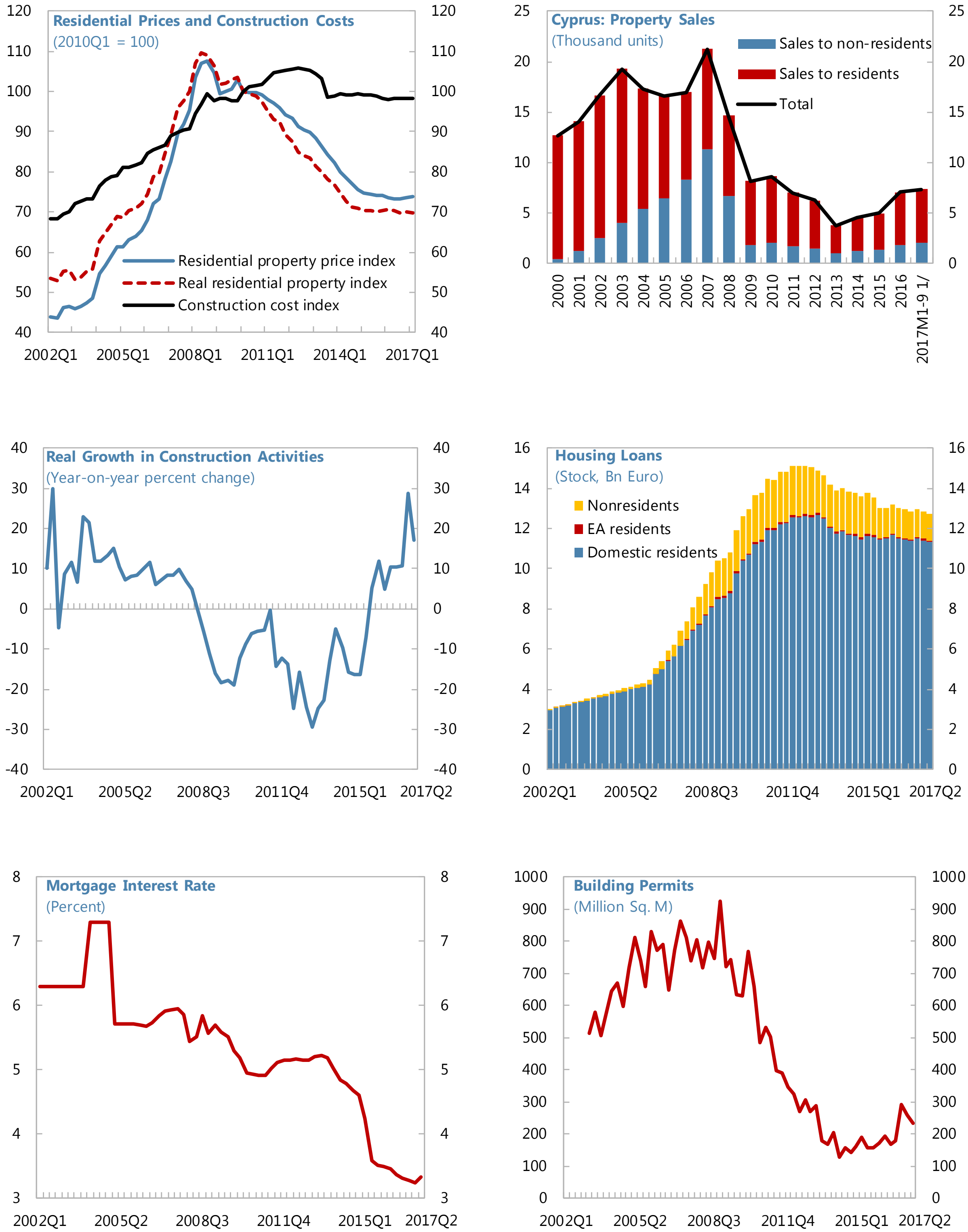
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 5. Cyprus: Banking Sector



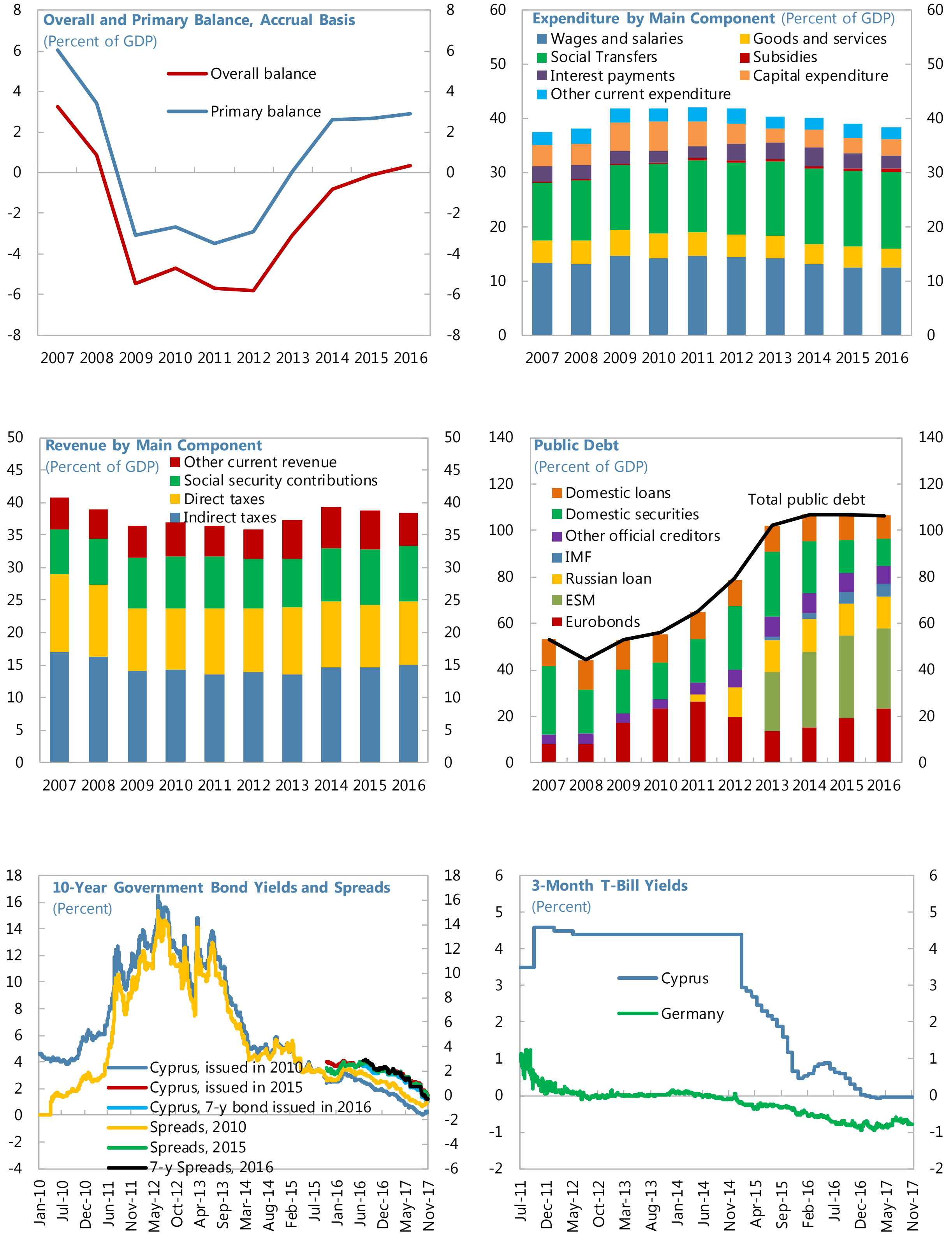
Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff estimates.
Notes: At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Housing Market



Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.
1/ Annualized.

Figure 7. Cyprus: Fiscal Developments



Sources: Bloomberg Finance LP; Ministry of Finance; and IMF staff estimates.

Table 1. Cyprus: Selected Economic Indicators, 2014–22

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections					
Real Economy			(Percent change, unless otherwise indicated)						
Real GDP	-1.4	2.0	3.0	3.8	3.6	2.9	2.6	2.5	2.5
Domestic demand	-1.5	3.3	4.8	4.4	3.6	2.9	2.7	2.5	2.5
Consumption	-1.2	1.8	2.6	3.5	2.9	2.6	2.5	2.3	2.3
Private consumption	0.7	2.6	3.3	3.4	3.2	3.0	2.8	2.6	2.6
Public consumption	-7.2	-2.8	-0.4	3.8	2.0	1.1	1.0	1.0	1.0
Gross capital formation	-3.2	12.4	17.2	8.8	6.8	4.2	3.8	3.6	3.5
Foreign balance 1/	-0.1	-0.9	-1.7	-0.5	0.0	-0.1	-0.2	-0.1	-0.1
Exports of goods and services	4.2	6.3	3.9	0.0	2.4	2.2	2.0	2.0	2.0
Imports of goods and services	4.6	8.1	6.6	0.8	2.4	2.3	2.2	2.1	2.1
Potential GDP growth	0.4	0.8	1.1	1.5	1.8	2.0	2.1	2.2	2.2
Output gap (percent of potential GDP)	-7.2	-6.0	-4.3	-2.0	-0.3	0.6	1.1	1.4	1.7
HICP (period average)	-0.3	-1.5	-1.2	0.8	0.7	1.1	1.8	1.9	2.0
HICP (end of period)	-0.9	-0.5	0.1	0.8	0.7	1.1	1.8	1.9	1.9
Unemployment rate (percent)	16.1	14.9	13.0	11.3	10.0	9.1	8.4	7.7	6.9
Employment growth (percent)	-0.6	-1.3	2.5	3.2	2.7	1.6	1.4	1.3	1.2
Labor force	-0.4	-2.6	0.3	1.2	1.2	0.6	0.6	0.5	0.3
Public Finance			(Percent of GDP, unless otherwise indicated)						
General government balance	-0.8	-0.1	0.5	1.0	1.1	1.4	1.4	1.4	1.4
Revenue	39.3	38.8	38.8	39.7	39.7	40.0	40.0	40.0	40.0
Expenditure	40.1	38.9	38.3	38.7	38.6	38.6	38.6	38.6	38.6
Primary Fiscal Balance	2.6	2.7	3.0	3.4	3.5	3.8	3.8	3.7	3.7
General government debt	107.5	107.5	107.1	99.7	95.5	90.9	85.8	81.7	75.0
Balance of Payments									
Current account balance	-4.3	-1.5	-4.9	-4.9	-4.2	-4.6	-4.8	-5.0	-5.2
Trade Balance (goods and services)	2.0	0.8	-0.8	-2.2	-1.6	-1.7	-1.8	-1.9	-1.9
Exports of goods and services	62.1	64.5	65.1	63.0	61.2	60.6	59.8	59.4	58.9
Imports of goods and services	60.0	63.7	65.8	65.2	62.7	62.3	61.6	61.2	60.8
Goods balance	-16.0	-16.7	-21.3	-21.5	-20.5	-20.7	-20.9	-21.1	-21.2
Services balance	18.0	17.5	20.6	19.2	18.9	19.0	19.2	19.2	19.3
Primary income, net	-3.6	0.6	-1.6	-0.4	-0.5	-0.8	-0.9	-1.1	-1.2
Secondary income, net	-2.7	-2.9	-2.6	-2.3	-2.2	-2.1	-2.1	-2.1	-2.1
Capital account, net	0.8	0.3	0.2	0.5	0.5	0.6	0.4	0.4	0.4
Financial account, net	-7.1	-1.6	-7.5	-4.1	-3.7	-4.0	-4.4	-4.7	-4.8
Direct investment	-7.9	47.4	-7.8	-5.1	-4.9	-4.8	-4.8	-4.8	-4.7
Portfolio investment	-17.7	-11.6	-19.1	2.1	-1.8	-1.1	0.5	-1.5	0.4
Other investment and financial derivatives	18.5	-37.4	19.5	-1.1	3.0	1.9	-0.1	1.6	-0.5
Reserves (+ accumulation)	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 2/	7.2	5.7	0.7	-1.5	0.0	0.0	-0.2	-0.8	-0.7
Errors and omissions	-3.6	-0.4	-2.8	0.3	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	7.3	11.5	12.6	12.3	13.4	13.2	13.1	13.0	13.0
Government	2.4	2.6	3.3	4.0	4.3	4.5	4.6	4.8	4.9
Non-government	4.9	8.9	9.3	8.3	9.1	8.6	8.5	8.3	8.1
Gross capital formation	11.7	13.0	17.5	17.2	17.6	17.8	17.9	18.1	18.2
Government	3.2	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.5
Private	8.4	10.2	14.6	14.2	14.4	14.6	14.6	14.7	14.7
Foreign saving	-4.3	-1.5	-4.9	-4.9	-4.2	-4.6	-4.8	-5.0	-5.2
Memorandum Item:									
Nominal GDP (billions of euros)	17.6	17.7	18.1	18.8	19.9	20.7	21.7	22.8	23.9
External debt	554.4	572.7	592.0	580.7	564.7	552.7	537.0	524.5	510.7

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.

1/ Contribution to real GDP growth.

2/ Program financing (+ purchases, - repurchases) is included under the Financial Account, with consistent sign conversion.

Table 2. Cyprus: Fiscal Developments and Projections, 2014–22 1/

(Percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections			
Revenue	39.3	38.8	38.8	39.7	39.7	40.0	40.0	40.0	40.0
Current revenue	39.3	38.7	38.5	39.5	39.5	39.8	39.8	39.8	39.8
Tax revenue	24.8	24.4	24.8	25.6	25.7	25.7	25.7	25.7	25.7
Indirect taxes	14.7	14.7	15.1	15.8	15.9	15.9	15.9	15.9	15.9
Direct taxes	10.1	9.7	9.7	9.8	9.8	9.8	9.8	9.8	9.8
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	8.2	8.4	8.5	8.8	8.7	9.0	9.0	9.0	9.0
Other current revenue	6.3	6.0	5.3	5.1	5.1	5.1	5.1	5.1	5.1
Capital revenue	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Expenditure	40.1	38.9	38.3	38.7	38.6	38.6	38.6	38.6	38.6
Current expenditure	36.9	36.2	35.5	35.7	35.4	35.4	35.3	35.2	35.1
Wages and salaries	13.1	12.5	12.4	12.5	12.3	12.3	12.3	12.3	12.3
Goods and services	3.7	3.9	3.6	3.7	3.7	3.7	3.7	3.7	3.7
Social Transfers	14.0	13.9	14.1	14.1	14.0	13.8	13.7	13.6	13.6
Subsidies	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Interest payments	3.4	2.8	2.6	2.4	2.4	2.5	2.4	2.3	2.3
Other current expenditure	2.2	2.6	2.2	2.6	2.7	2.8	2.8	2.8	2.8
Capital expenditure 2/	3.2	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.5
Overall balance 3/	-0.8	-0.1	0.5	1.0	1.1	1.4	1.4	1.4	1.4
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-0.8	-0.1	0.5	1.0	1.1	1.4	1.4	1.4	1.4
Net financial transactions	-0.8	-0.1	0.5	1.0	1.1	1.4	1.4	1.4	1.4
Net acquisition of financial assets	1.3	0.2	0.3	-2.4	2.0	0.6	0.6	1.2	-1.6
Currency and deposits 4/	1.5	0.1	0.3	-2.4	2.0	0.6	0.6	1.2	-1.6
Securities other than shares 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	2.1	0.3	-0.2	-3.3	0.9	-0.8	-0.7	-0.2	-3.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-4.6	-4.7	0.3	1.9	5.8	2.8	2.8	3.7	-1.8
Loans	6.7	5.1	-0.5	-5.2	-4.9	-3.6	-3.6	-3.9	-1.1
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Output Gap	-7.2	-6.0	-4.3	-2.0	-0.3	0.6	1.1	1.4	1.7
Primary balance (ESA2010) 3/	2.6	2.7	3.0	3.4	3.5	3.8	3.8	3.7	3.7
Cyclically adjusted primary balance 3/	5.1	5.0	4.6	4.1	3.6	3.6	3.4	3.2	3.1
Structural primary balance 3/	4.1	6.1	4.4	4.2	3.4	3.4	3.4	3.2	3.1
Structural overall balance 3/	0.9	3.3	1.8	1.8	1.1	1.0	1.0	0.9	0.8
Public debt	107.5	107.5	107.1	99.7	95.5	90.9	85.8	81.7	75.0
Public debt net of cash holding	101.7	103.7	101.7	96.1	90.2	85.4	80.0	75.0	70.1

Sources: Eurostat; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

2/ Capital expenditure in 2015 includes payments of government loan guarantees which are recorded as capital transfers under ESA.

3/ Fiscal account 2014 and 2015 excludes recapitalizations of the cooperative sector of 1.5 and 0.175 billion euros respectively.

4/ The draw down of ESM bonds and the cash drawdown used to recapitalize the cooperative sector in 2014 and 2015 respectively are excluded from these lines consistent with the exclusion of the recapitalization operations of the cooperative sector in the overall and primary balance.

Table 3. Cyprus: Balance of Payments, 2013–22 1/

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
					(Millions of Euros)					
Current Account Balance	-896	-761	-259	-889	-928	-832	-951	-1,041	-1,147	-1,238
Trade Balance (Goods and Services)	330	361	143	-142	-418	-312	-353	-384	-426	-444
Goods Balance	-2,939	-2,812	-2,970	-3,867	-4,045	-4,075	-4,292	-4,547	-4,796	-5,055
Exports	2,714	2,808	2,878	2,594	2,613	2,673	2,759	2,860	2,972	3,091
Imports	5,653	5,619	5,848	6,461	6,658	6,748	7,052	7,407	7,768	8,147
Services Balance	3,269	3,172	3,113	3,726	3,626	3,762	3,939	4,163	4,370	4,612
Exports	7,924	8,118	8,570	9,196	9,263	9,475	9,782	10,140	10,537	10,959
Imports	4,655	4,946	5,457	5,470	5,637	5,713	5,843	5,976	6,167	6,347
Primary Income	-851	-637	109	-285	-80	-91	-168	-201	-240	-285
Secondary Income	-375	-484	-511	-462	-429	-429	-429	-456	-482	-510
Capital Account	255	147	49	37	101	104	115	92	83	89
Financial Account	-343	-1,251	-283	-1,352	-768	-728	-836	-948	-1,064	-1,150
Direct Investment	-304	-1,397	8,415	-1,413	-960	-965	-1,001	-1,040	-1,085	-1,129
Portfolio Investment	-12,695	-3,111	-2,066	-3,453	390	-360	-234	113	-339	107
Financial Derivatives	-49	285	-877	345	51	51	51	51	51	51
Other Investment	12,741	2,966	-5,750	3,192	-249	546	348	-72	309	-180
Reserves (+ accumulation)	-36	6	-5	-23	0	0	0	0	0	0
Errors and Omission	298	-637	-74	-500	59	0	0	0	0	0
Memorandum items:										
Program Financing 2/	4,838	1,267	1,010	125	-282	0	0	-40	-175	-160
Private Net Capital Flows 3/	-915	-5,618	-5,940	-6,079	…	…	…	…	…	…
o/w Portfolio Investment	-13,986	-2,800	-2,275	-4,072	…	…	…	…	…	…
o/w Other Investment	13,424	-1,706	-11,203	-939	…	…	…	…	…	…
o/w MFIs	10,748	-261	-6,758	976	…	…	…	…	…	…
o/w Non-MFIs	2,676	-1,445	-4,445	-1,914	…	…	…	…	…	…
Gross External Debt	103,234	97,609	101,608	107,284	109,426	114,382	116,664	119,345	121,826	124,153
o/w Short-term Debt	43,812	36,686	34,956	36,406	37,886	41,436	43,398	45,427	47,608	49,702
					(Percent of GDP)					
Current Account Balance	-4.9	-4.3	-1.5	-4.9	-4.9	-4.2	-4.6	-4.8	-5.0	-5.2
Trade Balance (Goods and Services)	1.8	2.0	0.8	-0.8	-2.2	-1.6	-1.7	-1.8	-1.9	-1.9
Goods Balance	-16.2	-16.0	-16.7	-21.3	-21.5	-20.5	-20.7	-20.9	-21.1	-21.2
Exports	15.0	15.9	16.2	14.3	13.9	13.5	13.3	13.2	13.1	13.0
Imports	31.2	31.9	33.0	35.7	35.3	34.0	34.1	34.1	34.1	34.2
Services Balance	18.0	18.0	17.5	20.6	19.2	18.9	19.0	19.2	19.2	19.3
Exports	43.7	46.1	48.3	50.7	49.2	47.7	47.3	46.7	46.3	45.9
Imports	25.7	28.1	30.8	30.2	29.9	28.8	28.2	27.5	27.1	26.6
Primary Income	-4.7	-3.6	0.6	-1.6	-0.4	-0.5	-0.8	-0.9	-1.1	-1.2
Secondary Income	-2.1	-2.7	-2.9	-2.6	-2.3	-2.2	-2.1	-2.1	-2.1	-2.1
Capital Account	1.4	0.8	0.3	0.2	0.5	0.5	0.6	0.4	0.4	0.4
Financial Account	-1.9	-7.1	-1.6	-7.5	-4.1	-3.7	-4.0	-4.4	-4.7	-4.8
Direct Investment	-1.7	-7.9	47.4	-7.8	-5.1	-4.9	-4.8	-4.8	-4.8	-4.7
Portfolio Investment	-70.0	-17.7	-11.6	-19.1	2.1	-1.8	-1.1	0.5	-1.5	0.4
Financial Derivatives	-0.3	1.6	-4.9	1.9	0.3	0.3	0.2	0.2	0.2	0.2
Other Investment	70.2	16.8	-32.4	17.6	-1.3	2.7	1.7	-0.3	1.4	-0.8
Reserves (+ accumulation)	-0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	1.6	-3.6	-0.4	-2.8	0.3	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Program Financing 2/	26.7	7.2	5.7	0.7	-1.5	0.0	0.0	-0.2	-0.8	-0.7
Private Net Capital Flows 3/	-5.0	-31.9	-33.5	-33.5	…	…	…	…	…	…
o/w Portfolio Investment	-77.1	-15.9	-12.8	-22.5	…	…	…	…	…	…
o/w Other Investment	74.0	-9.7	-63.1	-5.2	…	…	…	…	…	…
o/w MFIs	59.2	-1.5	-38.1	5.4	…	…	…	…	…	…
o/w Non-MFIs	14.8	-8.2	-25.1	-10.6	…	…	…	…	…	…
Gross External Debt	569.1	554.4	572.7	592.0	580.7	576.0	563.7	549.4	535.5	520.5
o/w Short-term Debt	241.5	208.4	197.0	200.9	201.1	208.6	209.7	209.1	209.2	208.4

Sources: Central Bank of Cyprus; Eurostat; and IMF staff estimates.

1/ External statistics were revised in line with the BPM6 methodology.

2/ Program financing (+ purchases, - repurchases) is included under the Financial Account, with consistent sign conversion.

3/ Private net capital flows (- inflows, + outflows) are defined to exclude the public-sector flows (the central-bank flows and the general-government part of portfolio flows). It is not possible to exclude general government-related flows from "other investment" in the published data because of secondary confidentiality issues (i.e., these data are suppressed to preserve the confidentiality of data pertaining to other sectors that could otherwise be indirectly deduced).

Table 4. Cyprus: Monetary Indicators, 2010–16

(Billions of Euros, unless otherwise indicated, end of period)

	2010	2011	2012	2013	2014	2015	2016
Aggregated Balance Sheet of Monetary Financial Institutions excluding the Central Bank of Cyprus							
Assets	135.0	131.4	128.1	90.3	91.1	91.0	86.6
Claims on Central Bank of Cyprus	2.3	2.9	3.9	2.7	4.2	7.2	9.0
Claims on Cypriot resident Other MFIs	5.6	5.0	4.6	3.3	4.1	4.5	5.6
Claims on Cypriot resident non MFIs	54.0	58.2	60.6	55.0	53.5	54.1	48.1
General government	4.5	5.3	6.5	5.4	4.5	3.4	3.3
Private sector excluding SPEs 1/	46.5	48.6	49.3	46.5	45.2	44.5	41.9
Households	22.5	23.5	23.9	22.3	21.9	21.5	20.8
Non-Financial Corporations	23.3	24.1	24.4	23.4	21.8	21.9	20.0
Non-Bank Financial Intermediaries	0.7	1.0	1.0	0.8	1.6	1.1	1.2
SPEs	3.0	4.4	4.8	3.1	3.7	6.2	2.9
Claims on non-residents	69.3	61.3	55.9	25.3	25.6	21.6	19.1
Other assets	3.8	3.9	3.2	3.9	3.8	3.6	4.7
Liabilities	135.0	131.6	128.1	90.3	91.1	91.0	86.6
Liabilities to the Central Bank of Cyprus	5.5	5.5	9.8	11.2	8.5	4.7	0.9
Liabilities to Cypriot resident Other MFI	5.5	4.9	4.5	3.1	3.6	4.2	5.1
Deposits of Cypriot resident non MFIs	45.4	43.7	43.3	33.0	32.3	32.9	36.6
General government	0.5	0.5	0.5	0.4	0.5	0.5	1.0
Private sector excluding SPEs	36.8	37.4	37.5	29.9	29.3	29.9	32.4
Households	25.4	26.0	26.4	23.3	22.3	22.4	23.1
Non-Financial Corporations	6.7	6.7	5.7	3.9	3.8	4.6	5.7
Non-Bank Financial Intermediaries	4.7	4.6	5.4	2.7	3.2	2.9	3.5
SPEs	8.1	5.8	5.3	2.6	2.5	2.4	3.2
Deposits of non-residents	60.6	56.5	51.3	24.5	24.1	25.5	20.9
Debt securities	2.4	2.6	1.7	0.5	0.4	0.7	0.3
Capital and reserves	12.8	11.3	15.1	16.4	20.8	21.7	21.5
Other liabilities	2.8	7.1	2.4	1.6	1.5	1.3	1.4
Money and Credit							
Net foreign assets	4.0	-1.4	-1.0	-5.5	0.2	0.6	8.2
Monetary Financial Institutions	6.3	2.2	3.0	0.3	1.3	-4.6	-2.1
Central Bank of Cyprus	-2.3	-3.7	-4.0	-5.8	-1.1	5.2	10.2
Net domestic assets	51.7	53.9	56.4	52.0	49.6	48.2	44.8
General government sector credit, net	5.2	5.3	7.2	5.5	4.3	3.6	2.9
Private sector credit excluding SPEs	46.5	48.6	49.3	46.5	45.3	44.5	41.9
SPEs credit	3.0	4.4	4.8	3.1	3.7	6.2	2.9
Other items,net	-12.3	-11.8	-15.6	-15.1	-19.4	-19.9	-17.8
Cypriot Resident Broad money (M2)	46.6	45.0	44.6	34.5	34.1	35.0	38.1
Cypriot Resident Narrow money (M1)	10.6	11.1	11.5	10.4	11.4	12.8	15.1
			(Percent of GDP)				
General Government sector credit, net	27.1	26.6	36.8	30.5	24.4	20.7	16.2
Private sector credit excluding SPEs	241.0	246.6	253.1	256.8	257.7	252.4	234.2
SPEs credit	15.7	22.1	24.6	17.0	21.0	35.0	16.3
Cypriot Resident Broad money (M2)	241.2	228.0	229.3	190.2	194.1	198.2	212.7
Cypriot Resident Narrow money (M1)	55.2	56.4	59.0	57.4	65.1	72.8	84.3
			(Annual percentage change)				
General Government sector credit, net	-1.6	0.4	36.2	-22.9	-22.2	-15.1	-20.2
Private sector credit excluding SPEs	8.8	4.6	1.3	-5.6	-2.7	-1.7	-5.8
Gross Household and non-financial corporations credit excluding SPEs	8.5	4.2	1.2	-5.3	-4.5	-0.6	-6.0
SPEs credit	2.3	44.0	9.9	-35.6	19.9	66.8	-52.7
Cypriot Resident Broad money (M2)	10.4	-3.4	-0.8	-22.8	-1.1	2.5	9.0
Cypriot Resident Narrow money (M1)	2.3	4.4	3.2	-9.4	10.0	12.3	17.6
Memorandum items:							
Credit to deposits Ratio, Cypriot residents (in percent)	89.6	103.0	115.3	125.1	139.8	159.2	150.7
Deposits from Cypriot Private Sector excluding SPEs (y-o-y percent change)	6.5	1.7	0.3	-20.2	-2.0	2.1	8.2
SPEs Deposits (y-o-y percent change)	33.8	-28.3	-9.4	-50.3	-5.3	-1.8	31.3

Sources: European Central Bank, Central Bank of Cyprus, and Fund staff estimates.

1/ Includes public entities classified as outside the general government. The data excludes special purpose entities (SPEs).

Table 5. Cyprus: Financial Soundness Indicators, 2010–17 1/

(Percent, unless otherwise specified)

	2010	2011	2012	2013	2014	2015	2016	H1:2017
Capital Adequacy								
Regulatory capital ratio	12.3	8.6	7.3	13.5	15.3	16.6	16.8	16.4
Tier I capital ratio	10.9	7.4	6.3	12.3	14.6	16.0	16.4	15.5
Asset Quality								
Non-performing loans (NPLs) to total gross loans 2/	13.3	17.3	27.1	44.4	47.5	45.3	46.4	44.1
Non-performing loans (NPLs) to total gross loans (local operations) 3/	14.2	16.3	22.6	44.4	47.8	45.8	47.2	45.0
Provisions to NPLs	...	...	...	...	33.9	38.3	42.3	47.1
Restructured loans classified as NPLs to total NPLs	...	...	...	28.0	33.9	40.1	40.8	39.7
Earnings and Profitability								
Return on assets 4/	...	-3.7	-5.4	-14.7	-0.1	0.6	1.4	-1.8
Return on equity 4/	...	-54.5	-83.5	-100.5	-4.6	2.4	19.8	-14.3
Net interest income to gross income ratio	75.9	82.3	78.9	86.2	78.4	81.2	75.3	71.5
Net fees and commissions income to gross income ratio	13.5	13.9	16.0	13.4	11.6	13.8	14.6	15.5
Net interest margin	2.0	2.4	2.3	2.4	2.9	2.8	2.6	2.4
Liquidity								
Cash, trading and available-for-sale assets to total assets ratio	10.7	9.7	8.6	7.0	14.4	19.8	22.9	23.6
Others								
Total loans and advances to total assets ratio	71.5	76.1	82.9	83.6	73.4	73.6	69.1	68.2
Total deposits (other than from credit institutions) to total assets ratio	62.1	64.3	71.7	63.8	63.0	65.1	74.9	74.8

Sources: Central Bank of Cyprus.

1/ Unless otherwise specified, these FSIs cover consolidated accounts of domestic and foreign banks operating in Cyprus.

2/ Based on the European Banking Association's definition of NPLs. As of end-2014, banks report NPLs as per the EU's regulation on reporting NPLs and forborne exposures. The main changes with respect to the previous definition are that the minimum probation period for forborne loans remaining classified as NPLs has increased from 6 to 12 months.

3/ Local operations are confined to banks active in the local market, excluding overseas branches and subsidiaries of Cyprus-based banks.

4/ Annual return. The last observation (H1:2017) is the year-to-date return.

Annex I. Authorities' Responses to Past Policy Recommendations

Past Policy Recommendations	Policy Actions
Strengthen Financial Sector Policies	
Reduce high NPLs, including by (i) legislating and implementing insolvency and foreclosure frameworks; (ii) addressing impediments to asset sales; and (iii) ensuring ownership of titles reflects the economic ownership and accelerating the issuance of title deeds.	(i) A package of laws to reform the insolvency framework was adopted (2015) and the frameworks implemented (2015); (ii) a law to allow the sale of loans approved/implemented (2015); (iii) trapped buyer's law implemented (2015) but legal uncertainties remain and coverage limited.
Further strengthen capital buffers and continue efforts to restructure banks and the coop sector.	SSM's 2015 Capital Review Exercise identified capital and provisioning shortfalls in the CCB, which were rectified through additional budgetary support (2015). As a condition for the state aid, the CCB is undergoing an organizational restructuring and is to be privatized in stages.
Manage external payment restrictions prudently to safeguard financial stability.	All external payment restrictions have been lifted without causing detrimental effects on the financial stability (2015).
Enhance prudential supervision within the SSM framework and ensure effective AML/CFT supervision.	Cyprus signed a multilateral agreement for the automatic exchange of financial information (2014) and a peer review assessment found Cyprus was largely compliant (2017).
Put Public Debt on a Sustained Downward Path	
Implement medium-term fiscal consolidation that is carefully paced, relies on permanent measures, and is focused on unwinding the spending increases preceding the crisis.	Fiscal relaxation took place during 2015–17. Public debt has peaked and is projected to decline over the medium term, aided by revenue increases as the economic recovery continues.
Focus on implementing key reforms in public financial management (PFM) and revenue administration (RA); pass the law regulating the creation and functioning of SOEs.	PFM and RA reforms are being implemented, supported with Fund technical assistance. The law on SOEs remains to be adopted.
Implement Structural Reforms	
Implement reforms to the welfare system.	Guaranteed minimum income program has been implemented (2015).
Press ahead with a comprehensive privatization program.	Privation efforts have largely stalled.
Implement concrete actions to improve the business environment.	A comprehensive action plan has been drawn up, but implementation is slow.

Annex II. Effects of Special Purpose Entities on Cyprus's Macroeconomic Statistics

Cyprus is host to numerous special purpose entities (SPEs) with total balance sheets that are very large relative to the size of the economy. As a result, SPEs heavily influence some macroeconomic statistics, although their domestic footprint is relatively modest.

A. What is an SPE

1. **Cyprus adopts the OECD convention on classifying SPEs**.[1] An entity is considered an SPE if it generally meets the following: (i) is a company with no—or very limited—physical presence in the country in which it is registered; (ii) has few or no employees and little or no production in the economy; (iii) is controlled by a nonresident parent company; (iv) its core business is to provide group financing or holding activities; (v) most of its assets and liabilities represent investments in or from other countries; and (vi) it is subject to tax and other legal obligations of the host country.

B. Types of SPEs in Cyprus and their Business Models

2. **In Cyprus, there are three main types of SPEs:**

- *Non-financial SPEs (mainly ship-owning companies)*: these SPEs are owners of movable transport equipment, which they lease to third parties. Real assets on their balance sheets are matched by financial liabilities incurred to finance the purchase of the movable equipment.

- *Financial companies*: these SPEs belong to an international group and channel funds between related nonresident entities on behalf of their nonresident parent company. Thus, their financial assets are matched in size by their financial liabilities.

- *Factoring/invoicing companies*: these SPEs invoice the sales of the worldwide group on behalf of the parent.

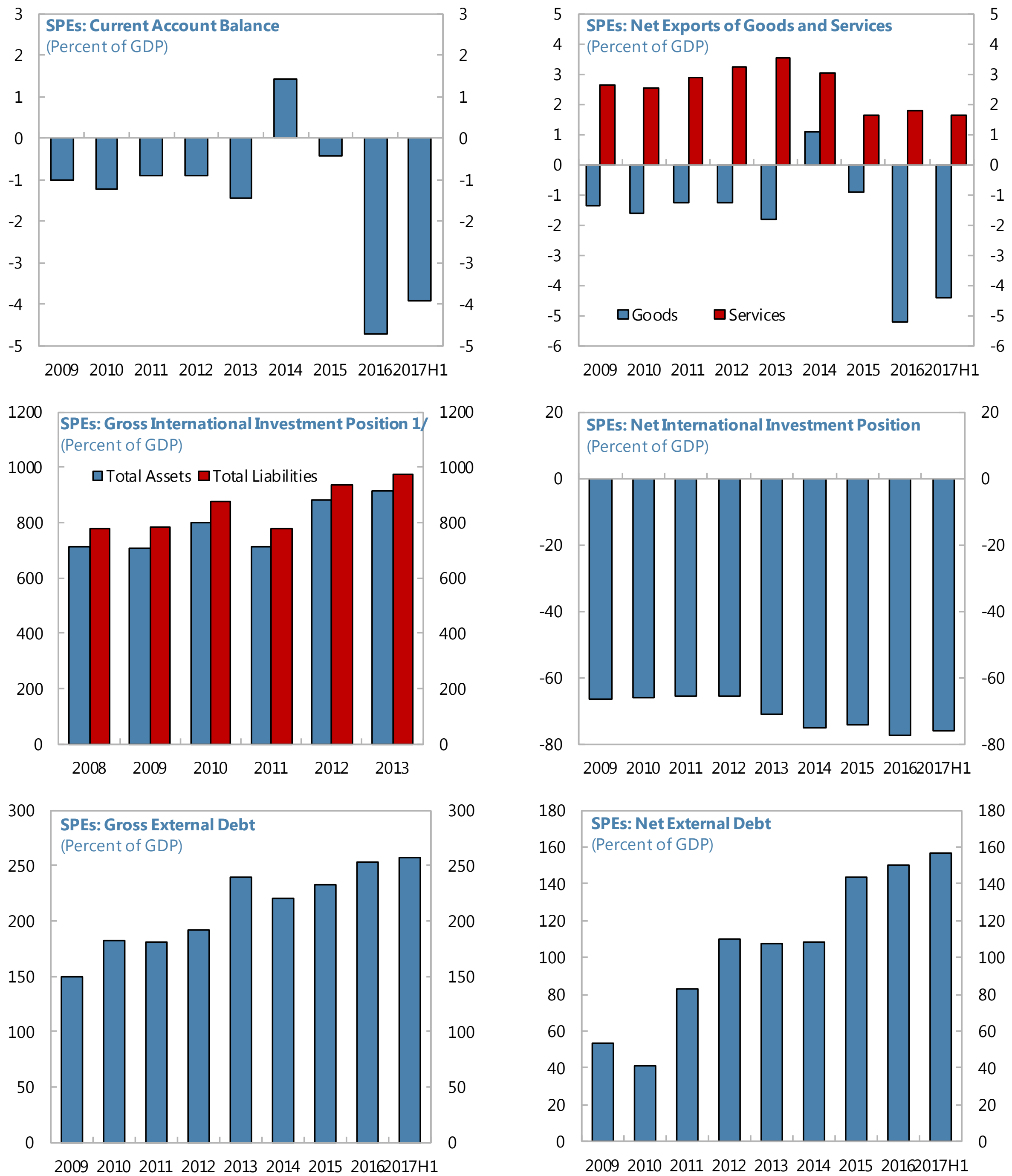
C. How SPEs affect Macroeconomic Statistics

National Accounts

3. **SPEs increase domestic value added through demand for professional (e.g., legal and accounting) and banking services.** In the case of non-financial SPEs, leasing services also contribute to domestic value added.

[1] The OECD Benchmark Definition of Foreign Direct Investment ("Final Report by the Task Force on Head Offices, Holding Companies and Special Purpose Entities") provides general guidelines on the characteristics of an SPE, but no precise definition.

Cyprus: Selected External Sector Indicators on Special Purpose Entities



Sources: Central Bank of Cyprus; Haver Analytics; WEO and IMF staff calculations.
1/ Gross international investment positions are computed as the difference between BPM5 and BPM6 compilations, during 2008-13 (the period for which statistics based on both methods overlap). SPEs are classified as nonresidents under BPM5 and residents under BPM6.

4. In the case of ship-owning SPEs, the registration and deregistration of ships—the value of which can be large relative to the size of the Cypriot economy—has no net impact on GDP due to offsetting effects on investment and external trade. Nonetheless, these transactions can give rise to significant volatility in individual GDP components and in the trade balance of the current account. Since 2015, inward transactions by ship-owning SPEs have increased, reflecting Cyprus's growing attraction as a ship-management and transport-leasing center.

External Sector Statistics

5. The magnitude of the impact of SPEs on the external sector accounts is large.

Balance of Payments

Current Account

6. Non-financial SPEs affect the current account through: (i) imports and exports of movable equipment; (ii) exports and imports of services; and (iii) repatriation of profit to parent companies and payment of interest on external debt. The first two items affect the trade balance and the third affects the income balance. Financial SPEs do not affect the net current account although they have considerable gross impact, especially on the primary income account, namely, via receipts and payments of interest, dividends and re-invested earnings.

Financial Account and Change in Reserves

7. Given their roles as conduits of international financial flows, financial SPEs have minimal net effect on financial flows. However, gross in- and out-flows related to financial SPEs are very large. These flows are mostly in the form of FDI,[2] although loans and debt liabilities are not insignificant.

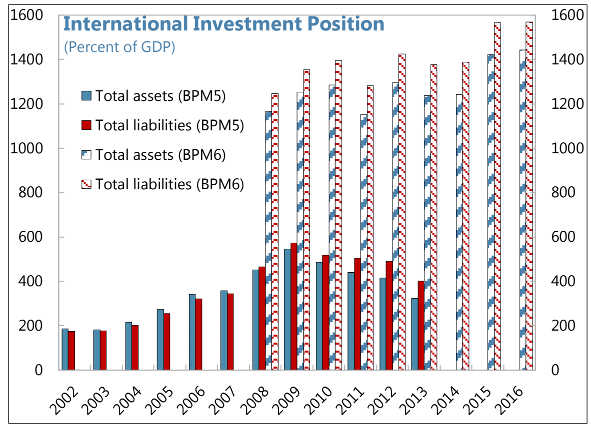
8. Non-financial SPEs affect financial flows to the extent that registration/de-registration of movable equipment is accompanied by a change in external liabilities used to fund the purchase/repay debt linked to the earlier purchase of movable equipment.

9. Owing to countervailing flows within the financial account, or between the current and financial accounts, the overall balance of payments is little affected by whether SPEs are treated as residents or nonresidents.

External Assets and Liabilities, External Debt

10. SPEs materially impact stocks of external assets and liabilities. Gross external debt of SPEs includes debt incurred by nonfinancial SPEs to finance purchases of movable equipment. SPEs also hold foreign liabilities in the form of loans and debt securities, in addition to external debt

[2] Gross FDI flows to and from Cyprus, as a ratio to GDP, are among the highest in the world, but are substantially smaller on a net basis, suggesting that it is a "pure intermediary" rather than an "ultimate investment destination."



assets. However, most foreign financial assets and liabilities of SPEs are in the form of FDI and are primarily attributable to financial SPEs. As data on gross positions of SPEs is not publicly available, an indication of the magnitude of gross external assets and liabilities can be obtained by comparing IIP data compiled under BPM5 and BPM6, where SPEs are classified as nonresidents in the former and residents in the latter. As is apparent, financial assets and liabilities are both very large, but mostly offsetting, consistent with the large presence of financial SPEs. Nonetheless, SPEs maintain a net external liability position that is large relative to Cyprus's GDP.

Domestic Banking Statistics

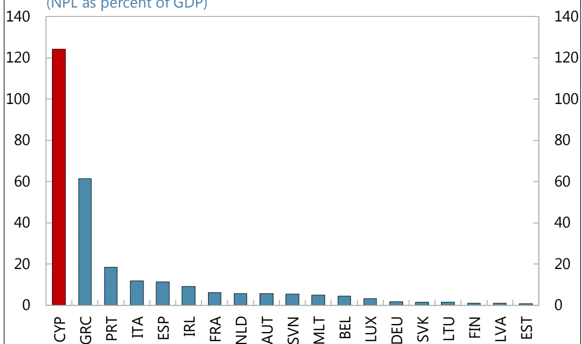
11. Non-financial SPEs are thought to have limited linkages with the domestic banking system. Domestic banks' exposure to non-financial SPEs through deposit-taking or lending is thought to be small, but this could increase in the future as banks seek out new business lines. Financial SPEs' exposure to Cypriot banks is small relative to the size of these SPEs' balance sheets. Moreover, in most cases, cross-border financial flows—while booked on the accounts of Cypriot-registered financial SPEs—are not intermediated through Cyprus.

Annex III. Evolution of Nonperforming Loans

1. Although nonperforming loans (NPLs) have declined by one fifth relative to their peak, they remain very large. NPLs stood at €22.8 billion as of June 2017, €5.9 billion below their maximum value in Q1:2015. Relative to GDP, NPLs remain the highest in the euro area at 124 percent. On a rolling-annual basis, there has been some increase in the pace of NPL reduction, but with outstanding loans also declining, the NPL ratio has declined only slowly and remains among the highest in euro area.

NPL-to-GDP Ratio in Euro Area Countries, 2017Q2

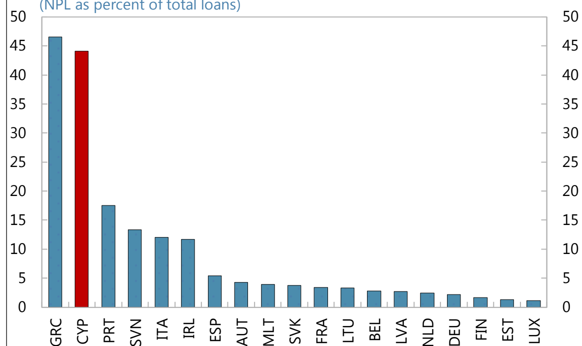
(NPL as percent of GDP)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.

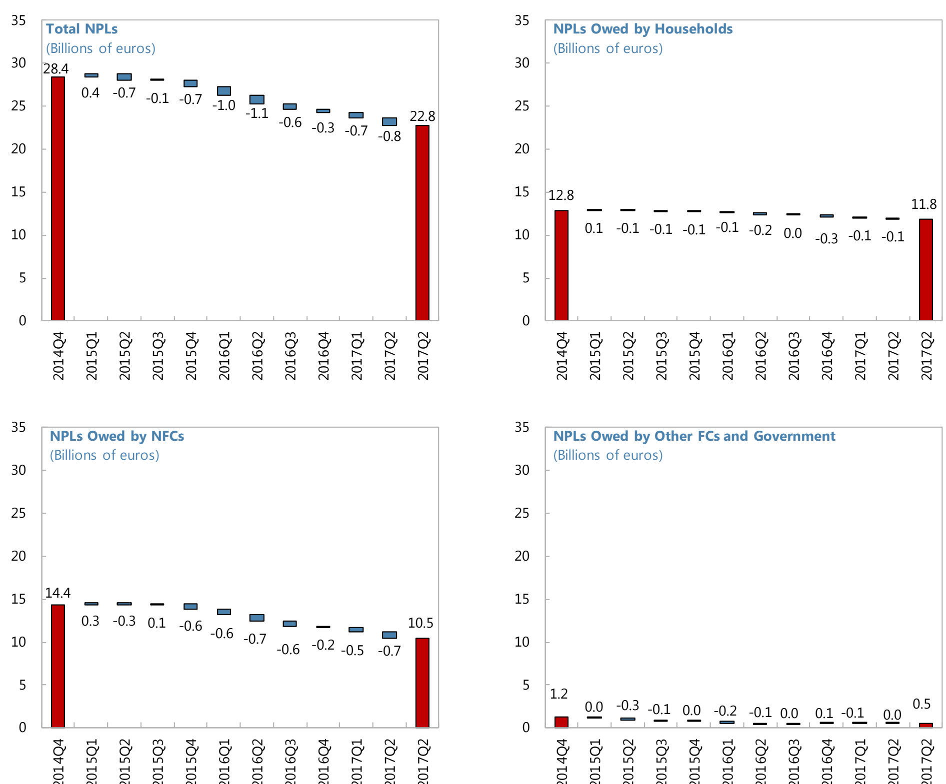
NPL Ratio in Euro Area Countries, 2017Q2

(NPL as percent of total loans)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.

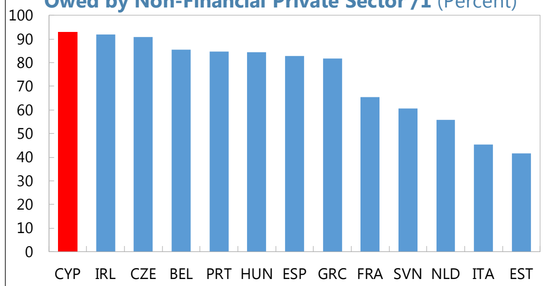
Cyprus: Evolution of NPLs by Segment



Sources: Central Bank of Cyprus; and IMF staff calculations.

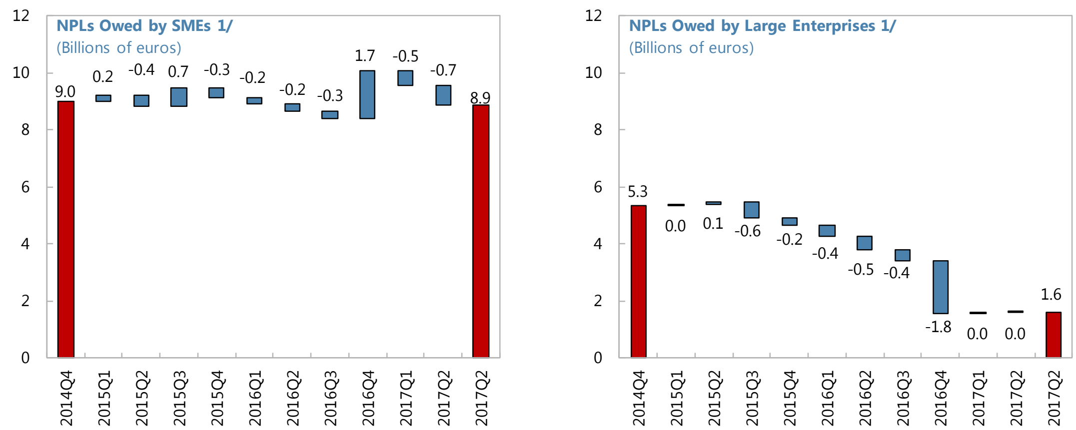
2. NPLs are primarily attributed to households and nonfinancial corporates (NFCs), which account for 56 percent and 42 percent, respectively. Reflecting their much greater presence in Cyprus, SMEs account for a larger share of NPLs than do large corporates.[1] Small borrowers (SMEs and households) account for about 90 percent of NPLs, which is among the highest in the euro area.

Share of Small Borrowers (HHs and SMEs) in NPLs Owed by Non-Financial Private Sector /1 (Percent)



Sources: CBC, ECB, EBA; and OECD.
1/ As of 2016Q2, except for CYP (2017Q1). Loans outstanding are from ECB. Breakdown of the loans owed by NFCs into SMEs and large enterprises is from OECD. NPL ratios are from EBA. CYP data are from the Central Bank of Cyprus.

Cyprus: Evolution of NPLs Owed by NFCs



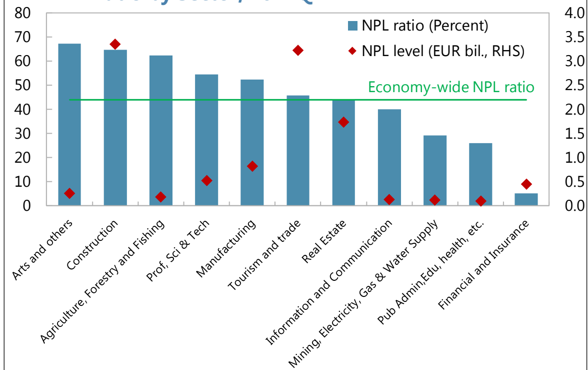
Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Definitions of SMEs and large enterprises changed in December 2016 when the CBC adopted the European Commission definitions.

3. The reduction in NPLs has been unbalanced across sectors, with NFCs accounting for most of the decline. On the other hand, and despite their larger outstanding stock, only a very limited reduction in household NPLs has occurred.

4. High NPLs do not appear to have significantly restrained growth in the affected sectors. In nominal terms, NPLs of NFCs are mostly concentrated in the construction, retail trade and tourism, and real estate sectors. These sectors also have average or above-average NPLs relative to total loans. Despite weak balance sheets, these sectors have seen brisk growth and contributed substantially to overall GDP growth in recent years, with support from liquidity provided outside of the domestic banking sector. Moreover, there is no evidence of activities having shifted toward sectors that were previously less-dependent on bank credit.

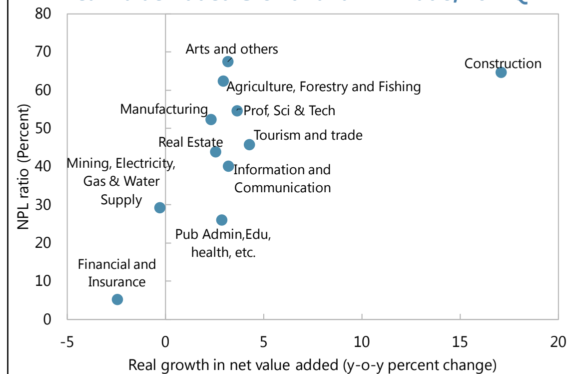
[1] A reallocation of NPLs from the "large enterprises" to "SME" categories occurred in December 2016 to align with the Eurostat classification of firms by size.

NPL Ratio by Sector, 2017Q2



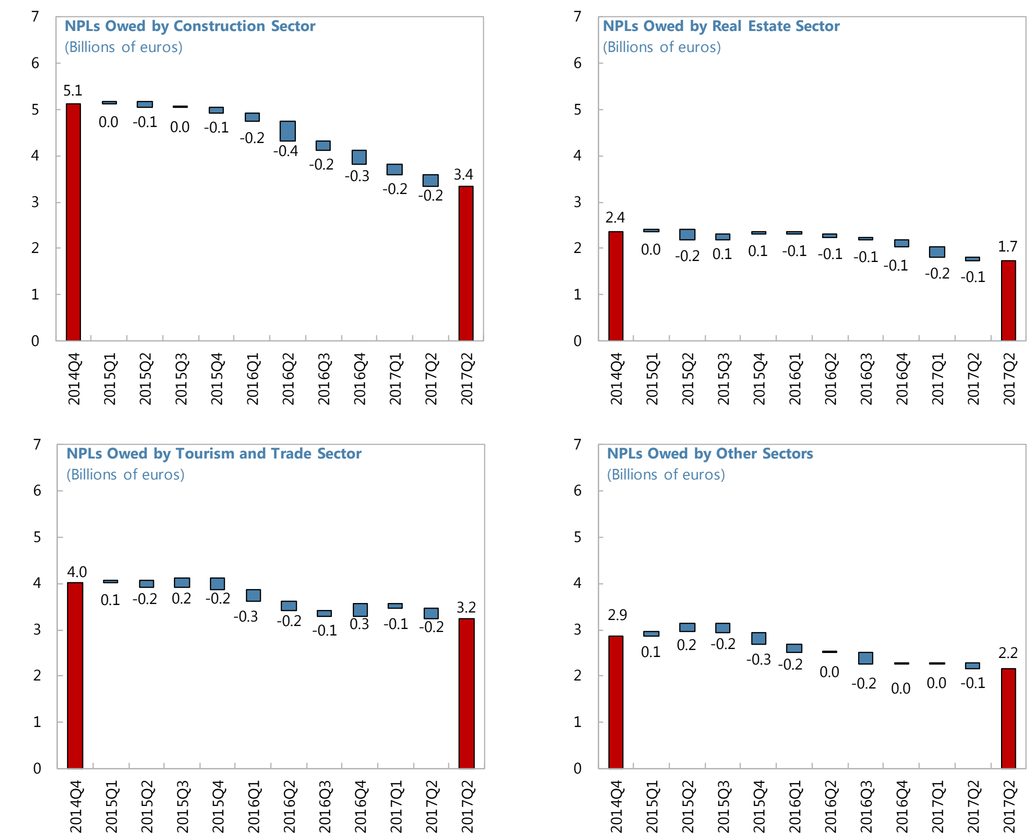
Sources: Central Bank of Cyprus; Haver Analytics and IMF staff calculations.

Real Value Added Growth and NPL Ratio, 2017Q2



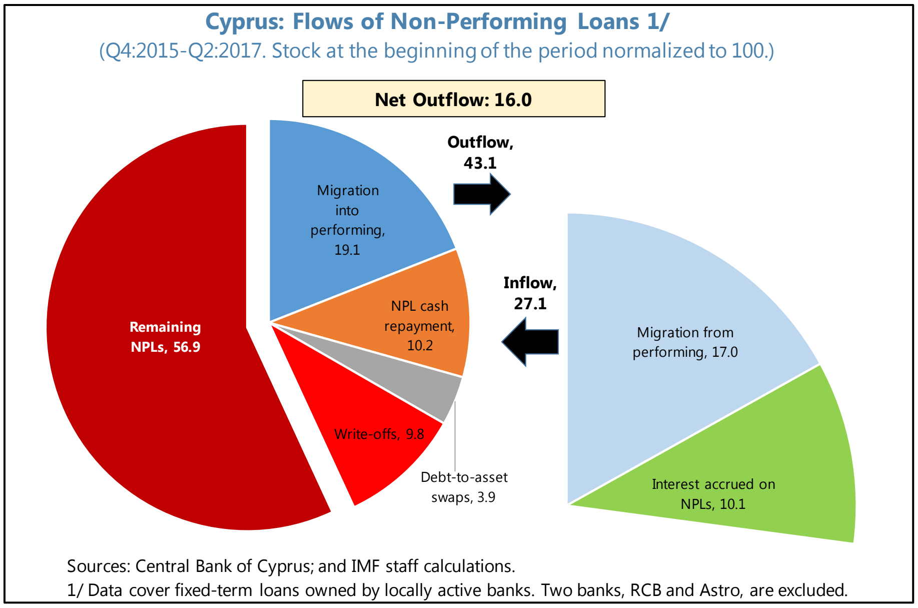
Sources: Central Bank of Cyprus, Haver Analytics and IMF staff calculations.

Cyprus: Evolution of NPLs by Sector

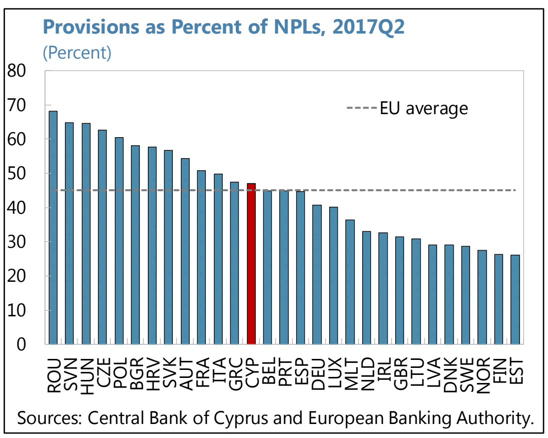


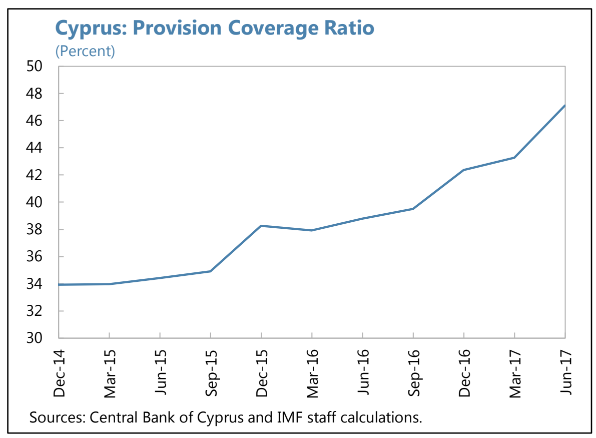
Sources: Central Bank of Cyprus; and IMF staff calculations.

5. **The evolution of the stock of NPLs reflects both outflows as well as new inflows.** Nearly a half of outflows from NPLs has been due to migration of loans to performing status, with an additional one-third reflecting loan write-offs and debt-to-asset swaps. Inflows to the nonperforming category have not eased up, and have totaled about two-thirds of gross outflows. Inflows include newly-defaulted loan, redefaults of previously-restructured loans and, consistent with international accounting standards, accrued-but-unpaid interest receipts on existing NPLs.



6. **The provisioning coverage ratio of NPLs has risen to just-above the EU-average of 45 percent.** The ratio has risen from below 35 percent during the past two years. In Q2:2017 alone, the increase was almost 4 percentage points.





Annex IV. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Expected Impact of Risk	Policy Response
Externally Sourced Risks		
High **Policy uncertainty:** Two-sided risks to U.S. growth with difficult-to-predict policies; uncertainty associated with negotiating post-Brexit arrangements; and evolving political processes, including elections in several large advanced and emerging market economies weigh on global growth.	Medium The Cypriot economy is heavily dependent on foreign demand—especially from the UK and Russia—for tourism and business services. Weaker external demand would adversely affect long-term growth.	Seek to broaden sources of foreign demand beyond a narrow set of countries. Restart structural reforms to make the economy more flexible and dynamics in response to demand shocks.
Medium **Retreat from cross-border integration:** A fraying consensus about the benefits of globalization lead to protectionism and economic isolationism, resulting in reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	Medium The Cypriot economy is heavily dependent on foreign demand for tourism and business services. Weaker external demand would adversely affect long-term growth.	Restart structural reforms to make the economy more flexible and dynamics in response to demand shocks.
High **Tighter global financial conditions:** Fed normalization and tapering by ECB increase global rates and term premia, strengthen the U.S. dollar and the euro vis-à-vis the other currencies, and correct market valuations. Adjustments could be disruptive if there are policy surprises. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	Medium Higher interest rates on Cypriot government borrowing would raise the cost of refinancing maturing official loans with market debt.	Undertake additional fiscal consolidation to reduce borrowing needs.
High **Reduced financial services by correspondent banks ("de-risking"):** Significant curtailment of cross-border financial services in emerging and developing economies.	Medium Reduced Cypriot access to foreign correspondents could weigh on the professional services sector and long-term growth.	Limit scope for reduced correspondent banking relations by ensuring full compliance with international transparency and exchange of information agreements and AML/CFT standards.
Medium **European bank distress:** Strained bank balance sheets amid a weak profitability outlook lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	High Market pressure on other euro area banks with elevated NPLs could spill over to Cypriot banks, reigniting financial sector stress, with repercussions for public debt sustainability and long-term growth.	Intensify efforts to reduce NPLs to limit potential need for additional capital and provisions. Undertake further fiscal consolidation to create precautionary headroom.
Domestically Sourced Risks		
High **Post-crisis policy slippage:** Eroding fiscal discipline and inaction on efficiency-enhancing structural reforms would slow down debt moderation.	Medium Potential growth would weaken and sovereign borrowing costs would rise, weakening public debt sustainability and long-term growth.	Resist pressure for structural fiscal easing and decisively implement structural reforms to promote efficiency and competitiveness. Save overperformance and windfall revenues and avoid expenditure slippages.
High **Slow progress on reducing NPLs:** Current resolution strategies could yield very slow NPL reduction, while weak bank profits amid low interest rates could limit capacity to boost capital and accumulate provisions.	Medium, High Scope for banks to expand lending in the longer run could be constrained by inadequate capital and provisions, retarding GDP growth (Medium). Confidence in banks could erode, creating a new bank-sovereign feedback loop, raising financing needs and borrowing costs, with repercussions for public debt and long-term growth (High).	Intensify efforts to reduce NPLs to limit potential need for additional capital and provisions. Undertake further fiscal consolidation to create precautionary headroom.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex V. External Sector Assessment and Debt Sustainability

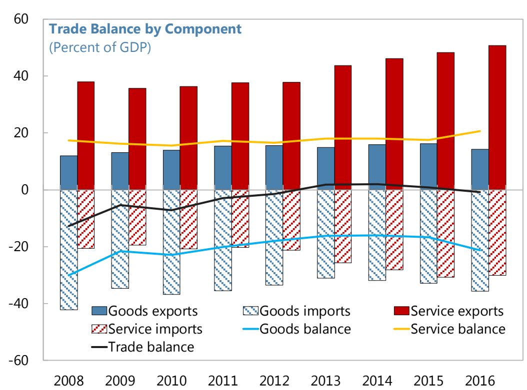
Overview of Cyprus's External Sector

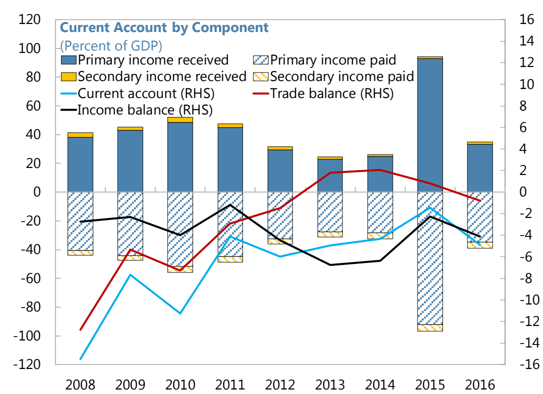
1. As a small economy with an important tourism industry and serving as a regional financial hub and business center, Cyprus consistently runs a large services-trade surplus and a goods-trade deficit. Cyprus has traditionally been a large exporter of tourism. More recently, it has expanded its exports of financial, business, ship-management and other services. Given the specialization of its economy, Cyprus sources many products from abroad, leading to a large sustained deficit in goods.

2. Cyprus maintains a deficit in the income account, reflecting its large net negative international investment position (IIP) and remittances. The net foreign liability position, including that of SPEs (Annex II), contributes to a deficit in the primary income account through net payments of dividends and interest. The deficit in secondary income reflects Cyprus's reliance on foreign workers (especially lower-skilled) from elsewhere in the EU and the rest of the world.

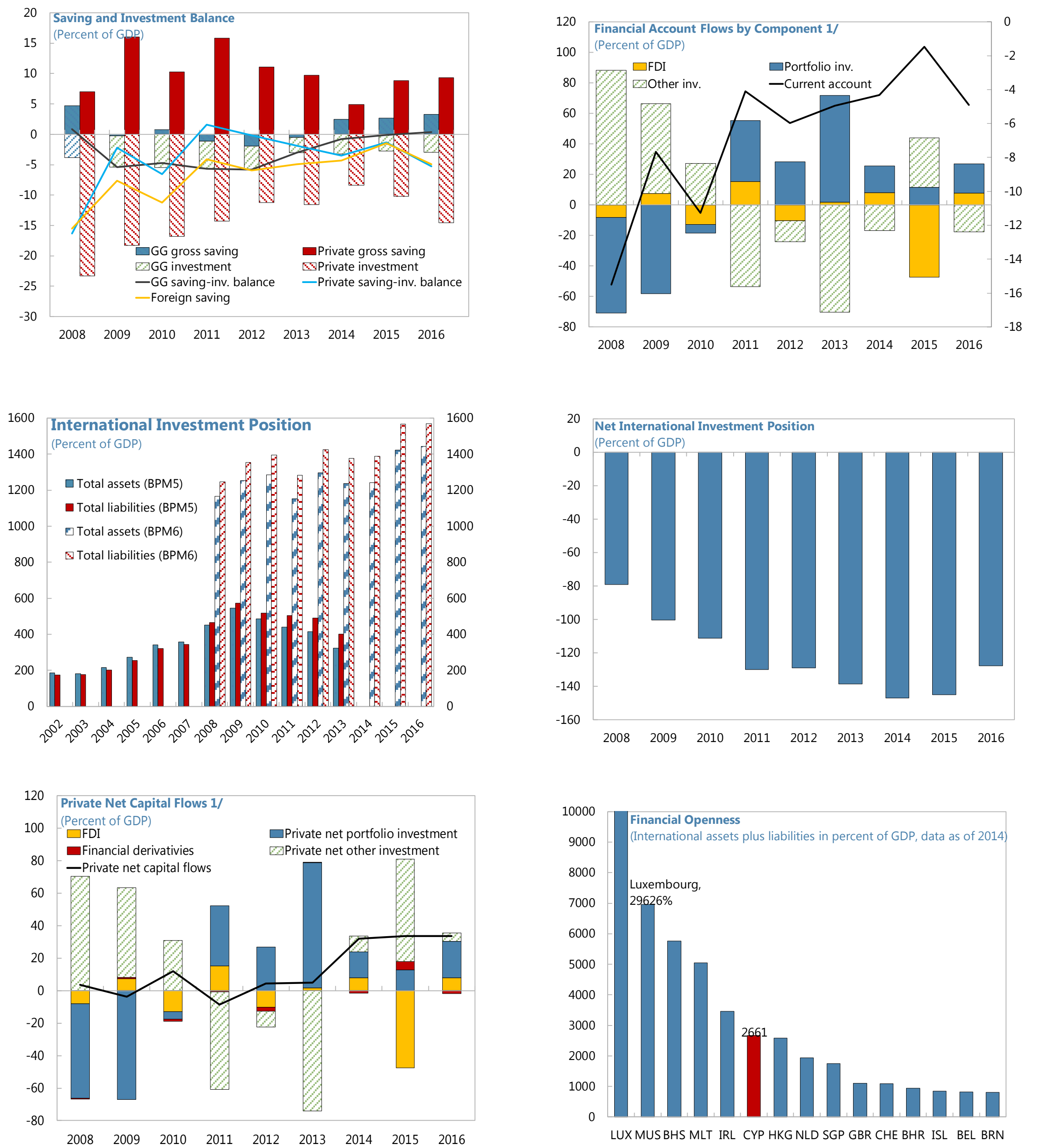
3. Cyprus tends to run current account deficits, leading to the buildup of net external liabilities. The private sector has consistently run a sizable negative saving-investment imbalance. In the past few years, the public sector has run a net surplus, offsetting part of the private imbalance. By type of instrument, financing sources have been large and volatile. In recent years, private external financing has mainly been in the form of portfolio debt and loans—both drawdown of foreign assets and increases in foreign liabilities.

Cyprus: External Indicators, 2008–16





Cyprus: External Indicators, 2008–16 (Concluded)



Sources: Central Bank of Cyprus, Haver Analytics, Lane and Milesi-Ferretti's External Wealth of Nations (EWN) dataset, MoF, WEO and IMF staff calculations.

1/ Positive value indicates inflows, negative value indicates outflows.

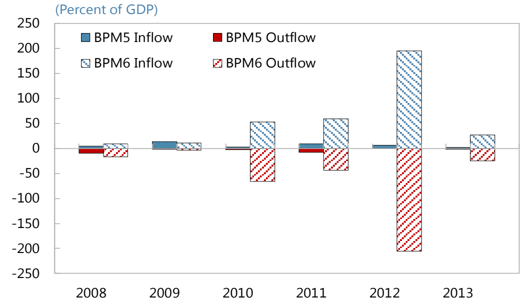
4. Gross financial flows and stocks are extremely large relative to net positions, reflecting Cyprus's status as a regional financial center.

- Annual gross in and out financial flows can be very large relative to GDP. The majority of financial flows appear to be associated with SPEs, are mainly FDI-related, and are largely offsetting.[1] Stocks of IIP assets and liabilities stood at 14 times and 16 times GDP, respectively, in 2016, and the sum of these positions relative to GDP was among the highest in the world. The importance of FDI flows is consistent with the observed global increase in FDI to and from financial centers since the Great Recession.[2] Moreover, once SPEs are removed, and FDI positions are broken down by ultimate investing economy rather than immediate counterpart economy, Cyprus—together with other small financial centers—is found to be much less important as an inward FDI destination.[3]

- Despite having contracted significantly since the financial crisis, the banking sector's other investment gross IIP assets and liabilities remain large at about one and about 1.2 times GDP, respectively, in 2016. Banks' IIP liabilities are mostly short-term deposits.

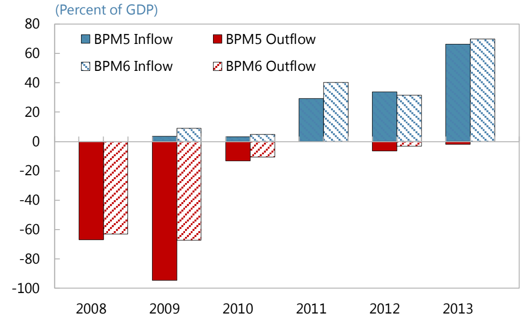
Cyprus: Financial Flows

FDI Flows 1/
(Percent of GDP)



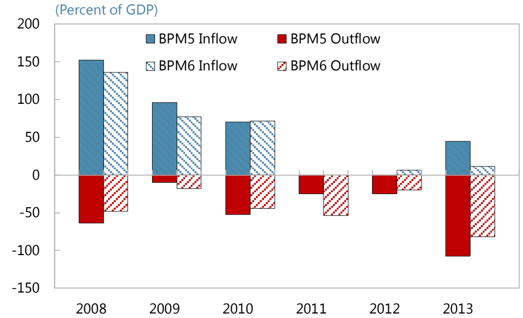
Source: Haver Analytics.
1/ Positive value indicates inflows, negative value indicates outflows.

Portfolio Investment Flows 1/
(Percent of GDP)



Source: Haver Analytics.
1/ Positive value indicates inflows, negative value indicates outflows.

Other Investment Flows 1/
(Percent of GDP)



Source: Haver Analytics.
1/ Positive value indicates inflows, negative value indicates outflows.

5. Cyprus has a large negative net IIP, equal to 128 percent of GDP at end-2016. Portfolio debt securities and loans of the general government and nonfinancial corporates (including SPEs), as well as banks' foreign deposit-taking are the largest contributors to net IIP. The net IIP excluding SPEs was a much-smaller 51 percent of GDP at end-2016.

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[1] Financial flows related to SPEs can be approximated by comparing statistics based on BPM6 and BPM5 during 2008–13, (the period for which statistics based on both methods overlap), as SPEs are classified as nonresidents in BPM5 and residents in BPM6 (Annex II).

[2] Lane, Philip R. and Gian Maria Milesi-Ferretti, 2017, "International Financial Integration in the Aftermath of the Global Financial Crisis," IMF Working Paper 17/155 (Washington: International Monetary Fund).

[3] Damgaard, Jannick and Thomas Elkjaer, 2017, "The Global FDI Network: Searching for Ultimate Investors," IMF Working Paper 17/258 (Washington: International Monetary Fund).

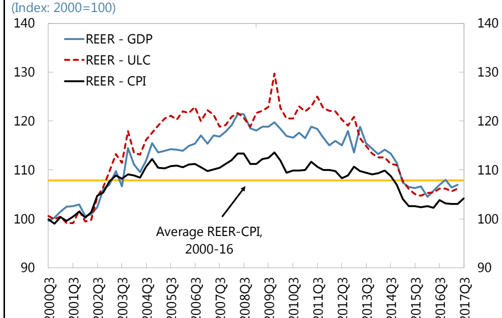
Developments During the Past Decade

6. **The current account deficit narrowed sharply during 2008–15 in response to a series of international and domestic triggers, but has recently edged wider.** With the onset of the global financial crisis, Cyprus was affected by falling tourism demand. Subsequently, Cypriot banks were adversely affected by the collapse in the credit-driven local property boom and by the haircut on Greek government bonds, in which they had heavily invested. Eventually, the banking system collapsed. As a result, demand for imports contracted sharply, reducing the current account deficit from 15 percent of GDP in 2008 to 1.5 percent of GDP in 2015. The post-2015 recovery in GDP growth has been accompanied by some rewidening of the current account deficit, although excluding lumpy transactions in transport equipment, the deficit remains low, helped in large part by sharply-lower prices of imported energy.

7. **Behind the narrowing current account deficit were sharp adjustments in sectoral saving-investment balances.** The correction was initially driven by the private sector even as the fiscal balance deteriorated owing to the emergence of a large revenue shortfall as the economy slowed. In particular, the investment-to-GDP ratio of the private sector had more than halved by 2014, even as the private saving rate moderated. In contrast, the general government initially maintained high investment levels, and its saving-investment gap narrowed only since 2013, and turned positive in 2016. Recently, the private sector gap has become more negative.

8. **Cyprus's real effective exchange rates (REERs) adjusted alongside the correction in the current account.** The credit boom that began around Cyprus's accession to the EU in 2004 was accompanied by rapid increases in unit labor cost- and CPI-based REERs, and contributed to widening the current account deficit by lowering the relative price of imports. REERs peaked in 2009 at around 15–25 percent higher than at the beginning of the decade. REERs have gradually adjusted downward since then, and are now 10–20 percent below their peak.

Cyprus: Real effective exchange rate
(Index: 2000=100)



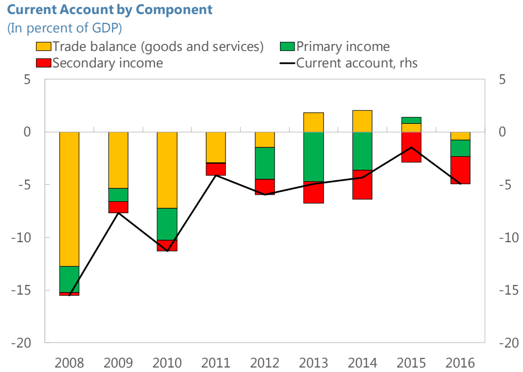
Sources: Central bank of Cyprus, ECB, and Fund staff calculations.
NBFI = non-bank financial institutions; NFC = non-financial corporations

9. **The global financial crisis and Cyprus's banking crisis led to gross and net financial outflows, which have since reversed.** Previous private sector net financial inflows changed course in 2011–13 as the Cypriot financial crisis unfolded. Nonresident deposits declined as Cyprus's banking crisis intensified following the Greek-bond PSI and bail-in of uninsured deposits. Related outflows, together with the albeit narrowing current account deficit, were covered by banks' draw-down of their holdings of foreign debt securities, central bank funding (including in 2012, emergency liquidity assistance (ELA) to a major Cypriot bank in the amount of 58 percent of GDP, causing Cyprus's Target-2 balance to shift into

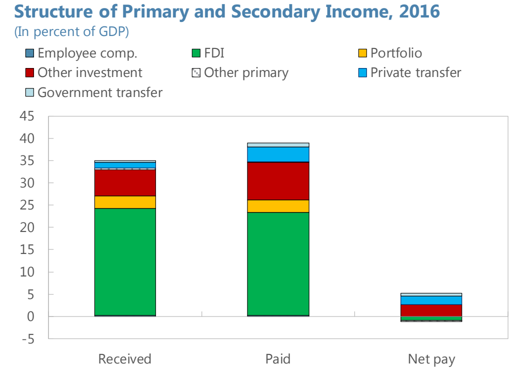
deficit),[4] and official-sector loans to the government. Net inflows to the private sector resumed strongly in 2014, reaching around 30 percent of GDP per year during 2014–16. With only a small part of these flows used to finance the current account deficit, the rest was channeled abroad through the Target-2 account, which now has amassed a surplus of more than 20 percent of GDP.

Cyprus: Recent External Balance Development

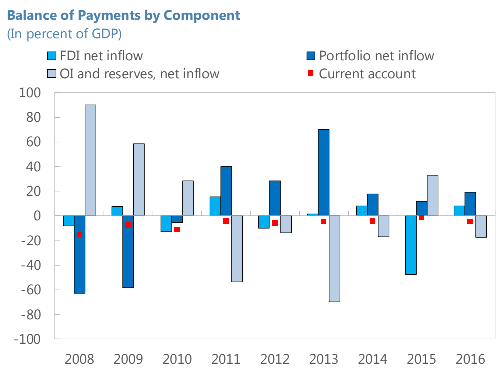
The current account has improved notably as trade balance improved,[1] but income deficit has been a drag.



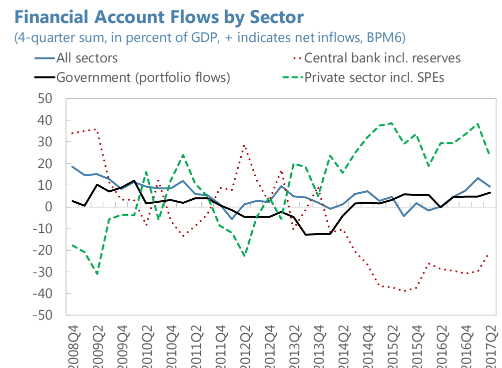
Interest payment for loans (other investment) contributes the most to the income deficit.



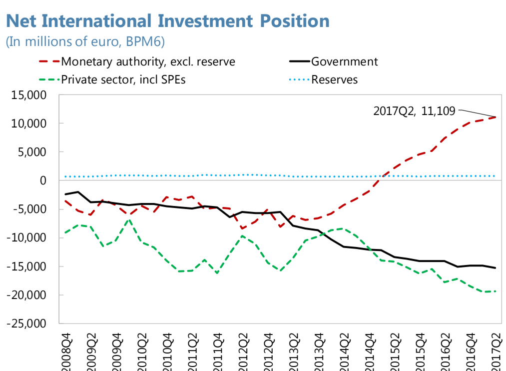
Main financing channel in the past few years has been portfolio flows reflecting bank's shedding of foreign securities.



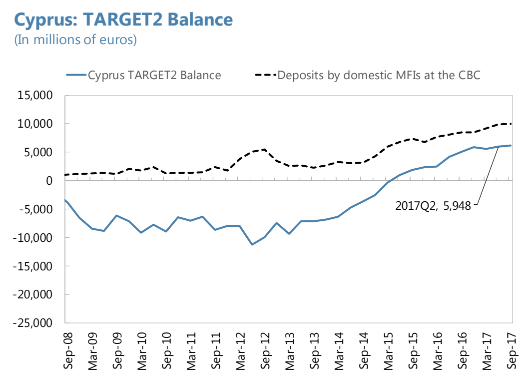
Sector-wise, the private sector received about 30 percent of GDP capital inflows in the past few years, while there are large outflows from the CBC



As a result, CBC's net international position turned to positive....



...with a half of it is sitting at the Eurosystem.



1/ The trade deficit in 2016 reflects a one-off transaction by an SPE amounting to about 3 percent of GDP.

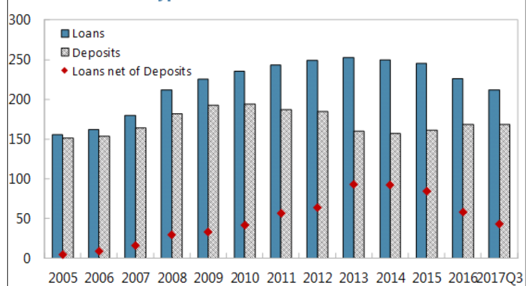
[4] A central bank's Target-2 balance shows its borrowing/lending vis-a-vis the eurosystem, with a deficit indicating the national central bank is borrowing.

External Sector Assessment

10. The three methodologies encompassed by the External Balance Assessment-Lite (EBA-Lite) yield the common result that Cyprus's external sector in 2017 is weaker than warranted by economic fundamentals and appropriate policies. This conclusion is reached, notwithstanding the sharp narrowing of the current account deficit and reduction in the REER since the global financial crisis and the Cypriot banking crisis, and after adjusting for large one-offs and effects of SPEs (Annex II).

11. An important determinant of Cyprus's external sector norms is the appropriate level of credit, and hence the credit gap. As discussed in an accompanying Selected Issues paper, bank credit to the nonfinancial private sector grew rapidly in the run-up to EU accession in 2004, and accelerated further as interest rates converged prior to euro adoption in 2008. Moreover, before EU accession, domestic credit was financed almost exclusively with domestic deposits,[5] but after accession the resident loan-to-resident deposit ratio widened sharply reflecting growing reliance on external savings intermediated through banks. Thus, after netting out high (and still-growing in nominal terms) residents' deposits, net bank credit grew even faster than gross credit through 2012, ahead of the banking and housing price collapse.[6]

Loans and Deposits of Resident Non-Financial Private Sector with Cypriot Banks (Percent of GDP)



Sources: Central Bank of Cyprus and IMF staff calculations.

12. This suggests that part of the increase in net credit was unsustainable. On the one hand, structural changes brought by EU accession and euro adoption—permanently lower policy interest rates and elimination of intra-euro area currency risk—justify some financial deepening. On the other hand, the transition itself—including the substantial loosening of monetary conditions brought by declining interest rates and phase-out of reserve requirements on euro-denominated deposits (which were formerly classified as foreign currency)—spurred an unsustainable boom in net credit. Based on the forgoing considerations, the ratio of net credit to GDP that prevailed in 2006 is seen as appropriate and sustainable. While the net credit ratio has decreased by about 50 percentage points since its peak in 2013, the remaining gap as of end-2017 is projected to be a still-large 30 percent of GDP, and will be used in the following analysis.[7, 8]

[5] At about 145 percent of GDP, credit was high even prior to EU accession, reflecting the desire for self- insurance given limited social safety nets.

[6] Residents' deposits declined sharply in nominal terms in 2013 as a result of the deposit bail in.

[7] A credit gap of 30 percent of GDP—indicating that credit is excessive—is the largest among the countries included in the Fund's EBA.

[8] While the credit gap is usually defined in terms of gross bank loans, we define it as gross loans minus deposits to capture the large amount of residents' deposits and that the build-up (and subsequent decrease) in net credit was larger than for gross credit. Also, from a macroeconomic perspective, increasing or paying-down credit financed from domestic savings would have a much more modest effect than changes in foreign-financed credit on activity and the current account—which is the focus of the external balance assessment.

13. The residency classification of SPEs may also materially affect the external sector assessment. As discussed in Annex II, SPEs have large gross external financial assets and liabilities, a net liability position, and also affect the current account through various channels. While these entities are registered in Cyprus, their economic footprint is—by definition—limited. Treating SPEs as nonresidents is therefore appropriate for the purpose of evaluating the external sector. The NIIP excluding SPEs was minus 51 percent of GDP at end-2016 (compared with -128 percent of GDP for all residents).

Current Account Approach

14. The EBA-lite CA results indicate the external sector, assessed as of 2017, is weaker than implied by fundamentals and desirable policy settings:

- The assessment is based on the underlying CA, which excludes the contribution of SPEs and one-off imports of aircrafts due to the commencement of a new airline. The underlying CA for 2017 is projected to be a deficit of 2.3 percent of GDP, compared with a headline CA deficit of 4.9 percent of GDP.

- The estimated CA balance for Cyprus, based on fundamentals and current policy settings in Cyprus and the rest of the world (ROW), results in a fitted value of +0.1 percent of GDP. Fiscal policy and private credit push up the fitted value reflecting the tighter fiscal stance in Cyprus than in the ROW and that private-sector credit in Cyprus has declined faster than in the ROW in recent years. These effects are largely offset by the negative intercept term of the regression. The estimated residual between the underlying CA and the fitted value is -2.4 percent of GDP for 2017, while the residuals are very small in 2015 and 2016.

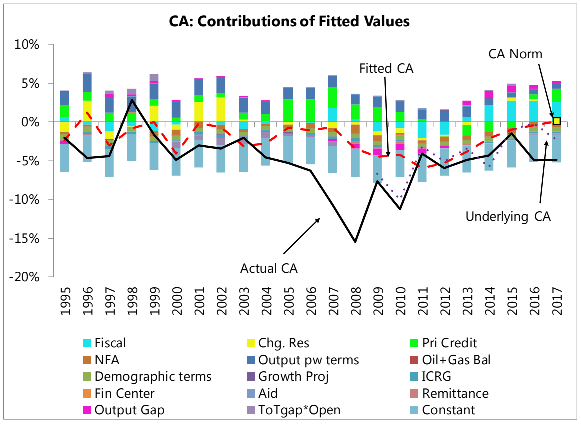
- Policy gaps, reflecting deviations of current policy settings in Cyprus and the ROW from their desired settings, contribute -0.1 percentage points. This net effect can be decomposed into the contribution from (i) the private credit gap (-1.3 percentage points) reflecting that Cyprus's remaining credit gap is still large relative to the ROW's, and (ii) fiscal policy (1.1 percentage points) that is entirely due to the ROW as Cyprus's cyclically-adjusted fiscal balance is considered appropriate.[9]

- The CA norm (sum of the fitted CA and contribution of policy gaps) is about 0.1 percent of GDP. As a result, the CA gap (sum of the estimated residual and policy gaps) is -2.4 percent of GDP, indicating that the current account balance is too low. The gap could be reduced by narrowing the private credit gap through lower consumption and investment.

[9] Regarding other policy gap assumptions: (i) there is no policy gap for international reserves (which are determined at the euro-area level); and (ii) the capital control index, which reflects the restrictions on outflows imposed during the crisis, will revert to fully open only with a lag. All elasticities are set to default levels.

Cyprus: EBA-Lite CA Approach

(Percent of GDP)



	CA actual	-4.9%
	One-off factors	-2.6%
(1)	**Underlying CA**	-2.3%
	CA norm	0.1%
(2)	CA fitted	0.1%
(3)	Policy gap	-0.1%
(4) = (1) - (2)	Estimated residual	-2.4%
(4) + (3)	**CA gap**	-2.4%
	Implied REER gap (elasticity: -0.47)	5.2%

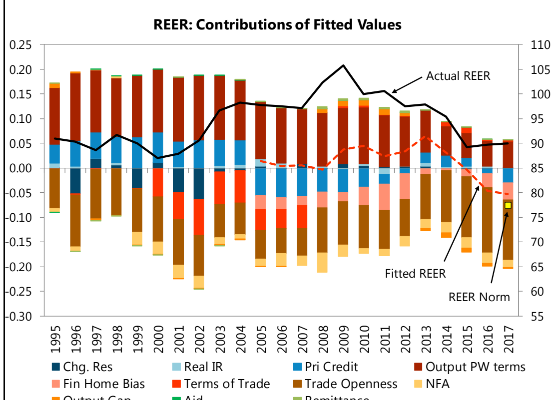
Sources: Central Bank of Cyprus, and IMF staff estimates.
Note: Private credit is loans net of deposits. NFA excludes SPEs.

REER Approach

The EBA-lite REER model indicates that the external sector is weaker than warranted by fundamentals and desirable policies (Annex Figure 6):

- The fitted REER, reflecting fundamentals and current policy settings, is estimated to be 12 percent lower than the actual REER.
- In addition, policy gaps augment the estimated residual by about 3 percentage points, mostly due to the private sector credit gap (2.8 percentage points).
- As a result, the total REER gap in 2017 is estimated at 15 percent, despite the sizable depreciation that occurred since the Cypriot crisis.

Cyprus EBA-Lite REER Approa ch



REER - Actual: (1)	90.0
REER - Fitted: (2)	79.8
REER - Norm: (3) = (2)*(1 - (6))	77.4
REER gap: (4) = (5) + (6) or ln((1) / (3))	15.0%
o/w Residual: (5) = ln((1) / (2))	12.0%
o/w Policy gap: (6)	3.0%

Sources: Central Bank of Cyprus, and IMF staff estimates.
Note: Private credit is loans net of deposits. NFA excludes SPEs.

External Sustainability Approach

15. The external sustainability (ES) approach indicates that a CA of just below zero is needed to reach a sustainable net foreign liability position over the medium term. This suggests that the external sector is weaker than warranted by fundamentals and desirable policies.

- A net foreign liability position for 2016 of -51 percent of GDP is used, instead of the economy-wide position of -128 percent of GDP, to remove the contribution of SPEs' foreign financial positions.
- Stabilizing the net IIP at the current high negative level would only require the CA deficit to be at 3.1 percent of GDP, which is some 0.8 percentage points higher than the estimate for the underlying CA in 2017.
- Reaching a net IIP of -35 percent of GDP—the level indicated by the European Commission as a threshold for their assessment of macroeconomic imbalances—by 2022 (i.e., over six years) requires sustaining a current account of close to balance, implying a needed reduction in the deficit by just above 2.0 percent of GDP.

External Sustainability Approach

			CA norm (% of GDP)	Underlying CA (% of GDP)	CA gap	REER gap
Scenario 1: Stabilizing net IIP at	-50.6 % of GDP		-3.1	-2.3	0.8	-1.7
Scenario 2: Reaching net IIP at	-35.6 % of GDP in	2022	-0.3	-2.3	-2.0	4.2

Sources: Central Bank of Cyprus and IMF staff estimates.

Conclusion

16. Despite the sizable reduction in the CA deficit and REER in recent years, all three EBA-lite approaches point to the external sector being weaker than warranted by fundamentals and desirable policy settings. Albeit with high estimation uncertainty, the CA gap is estimated to be within the range of negative 2 to negative 2½ percentage points of GDP, with an associated REER gap within the range of 4 to 15 percent.[10] To a large extent, these results are contingent on the assumption of a private credit gap of 30 percent of GDP. Unwinding the credit gap would be associated with a stronger external balance and higher saving relative to investment that would gradually reduce (or slow the build-up of) net external liabilities.

[10] In addition to estimation errors, the assessment is subject to methodological caveats and data issues. Specifically, the coefficient on the credit gap in EBA-Lite is considerably larger than in the EBA model.

External Debt Sustainability Analysis

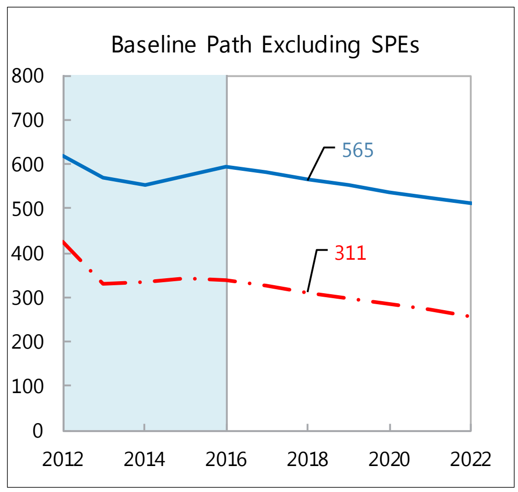
Background

17. Given its role as a financial center, Cyprus's external debt is large, at nearly six times GDP, but net debt is considerably smaller at 1.6 times GDP. Excluding SPEs reduces gross external debt to 3.4 times GDP. Large gross debt assets—which include the CBC's TARGET-2 balance and assets held through its participation in the ECB's asset purchase program, and total 59 percent of GDP—reduce net external debt excluding SPEs to only 1½ percent of GDP.

18. Nondebt-creating flows have played a major role in funding Cyprus's external financing needs. This includes portfolio equity investment and repatriation of foreign assets, while net FDI inflows have been relatively modest and volatile. Past debt dynamics have also been significantly affected by valuation changes in tradable debt securities. Large mark-to-market price declines were recorded in 2012–13, while large gains were registered in 2014–15.

Baseline Projection

19. Under the baseline scenario, external debt is forecast to decline modestly over the medium term. Gross external debt is projected to decline from about 600 percent of GDP (€107 billion) in 2017 to a still-very-large 511 percent of GDP (€122 billion) by 2022 (Annex Table 2).[11] Government external debt declines over the medium term on the assumption of continued fiscal prudence. Banks are forecast to maintain their current level of external debt (mainly nonresident deposits). External debt of private nonbank sectors is forecast to increase in the near term and then stabilize, as projected current account deficits are assumed to be mostly financed by net FDI inflows.[12] Even excluding external debt of SPEs, gross debt is forecast to remain above 2.5 times GDP in 2022, although the associated net position (excluding SPEs) would become positive.



[11] Cyprus is a regional financial center and its external assets and liabilities are very large. The external DSA focuses on gross external debt and associated gross interest payments. However, changes in gross external debt may be accompanied by changes in gross external assets, which—in a financial center—could be large and volatile if SPEs engage in operations to expand or shrink their balance sheets, even though net positions may be unchanged. Large historical residuals in the external DSA suggest that indeed past increases in external debt were accompanied by increases in external assets. This notwithstanding, the DSA provides a tool for assessing risks emanating from macro-financial shocks in the presence of large gross external debt.

[12] While staff assumes that the expansion in gross external debt due to SPEs slows over the medium term under the baseline, there is substantial uncertainty regarding the course of this sector given limited information on its activities and its dependence on developments in the home countries of beneficial owners.

20. The decline in the gross external debt ratio over the medium term is mostly driven by nominal GDP growth. In the projection period, nominal GDP is forecast to grow by 4.7 percent on average, which by itself would account for an annual external debt reduction of 25 percentage points of GDP. Such a large denominator effect is due to the high level of external debt. Debt-creating flows, including the trade deficit (2 percent of GDP annually) and net interest payments (6 percent of GDP annually), are forecast to partially offset this denominator effect, leading to an annual decline in external debt by 14 percentage points of GDP on average.

Risks to External Debt Sustainability

Standard bounds tests indicate that the baseline scenario is vulnerable to macroeconomic shocks. Standardized shocks to interest rates and economic growth would halt debt reduction, as the large size of external debt would markedly increase debt service costs in case of higher interest rates and reduce the denominator effect on the debt-to-GDP ratio. On the other hand, standardized current account deficit shocks are small in size and would have a limited impact on the debt ratio.

- **Interest rates.** A 2 percentage points increase in average interest rates on external debt throughout the projection period would increase the debt ratio by about 65 percentage points by 2022, compared to the baseline.

- **Growth.** A one-half standard deviation decrease in projected real GDP growth throughout the projection period could increase the debt-to-GDP ratio by 64 percentage points by 2022 compared to the baseline.

- **Current account deterioration.** The impact of a one-half standard deviation shock to the current account balance is limited.

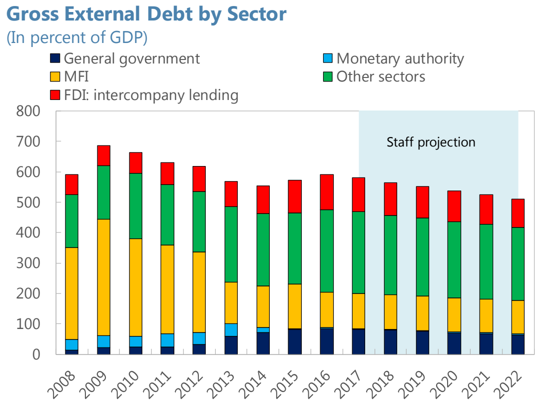
- **Combination of shocks.** A combination of one-quarter standard deviation shocks to the nominal interest rate, growth, and current account would raise the debt ratio by 60 percentage points by 2022 relative to the baseline.

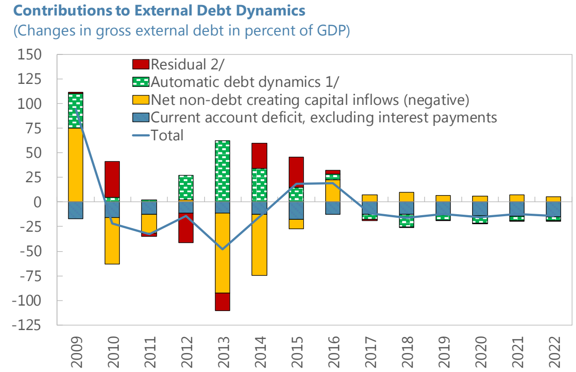
- **Historical scenario.** Reversion of the growth rate, interest rate, inflation, and the current account balance to their average levels during the previous five years would boost the debt ratio by more than 200 percent of GDP by 2022. Most of this increase would be due to the low growth rate (-1.1 percent), and to a lesser extent, deflation. However, the period includes the Cypriot banking crisis episode, so this could be considered an extreme scenario.

Cyprus: External Debt Development and Forecast, Including SPEs

External debt declines over the medium-term, led by the government and the non-bank private sectors…

…and supported by robust economic growth.





1/ Including the effects from interest rate, GDP growth, and price and exchange rate effects.
2/ Including valuation effects.

Sources: Central Bank of Cyprus, and IMF staff projections.

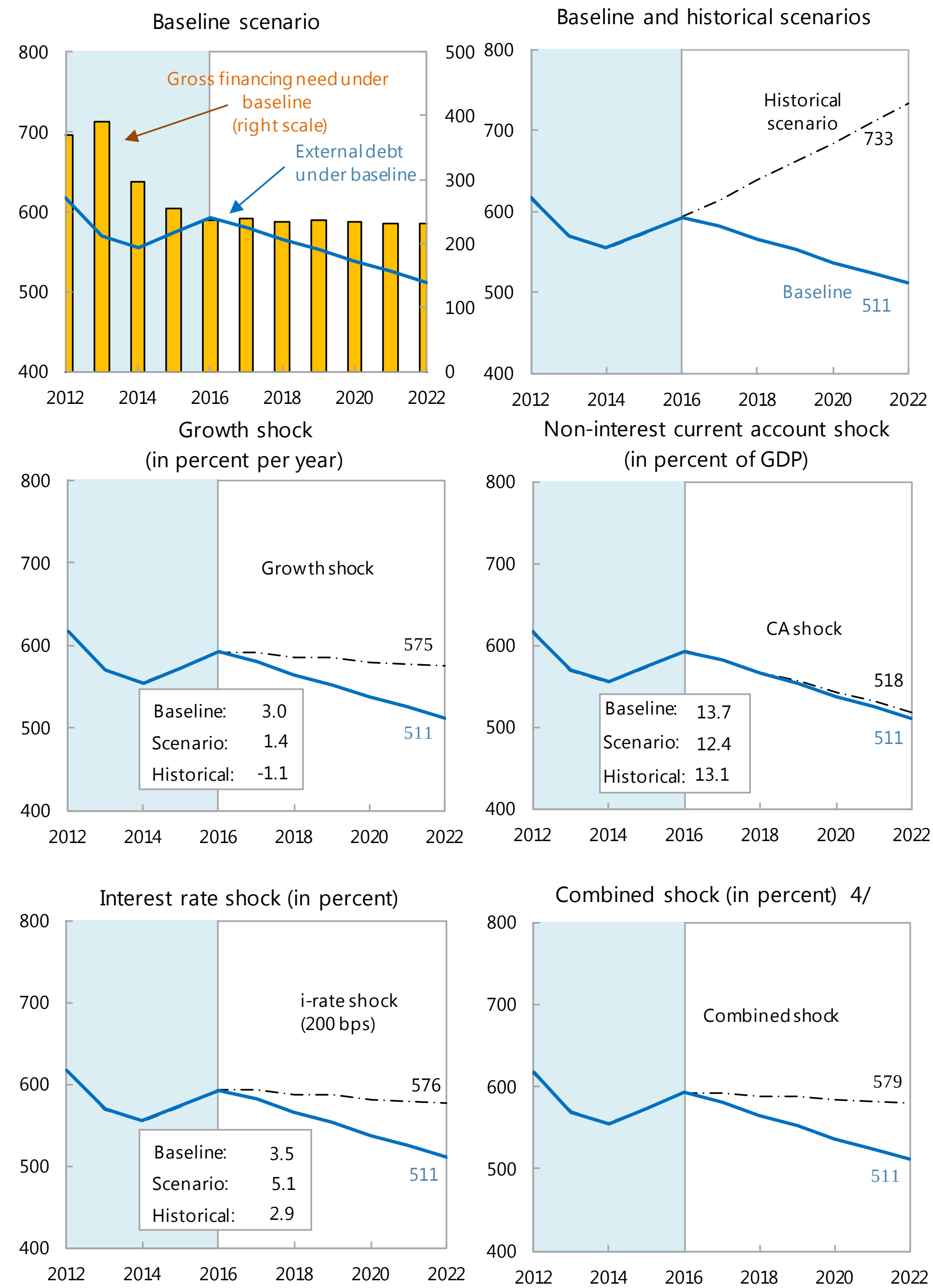
Gross Financing Needs

21. **Gross external financing needs are projected to remain very high (about 2.5 times GDP) over the projection period.** This reflects the projected large stock of short-term debt. About 85 percent and 40 percent of external debt owed by banks and other private sector borrowers, respectively, is short-term. This raises the potential for rollover risk if borrowers do not have sufficient liquid assets or if market funding become unavailable at reasonable costs.

Conclusion

22. **While the preceding analysis indicates that external debt is sustainable in the baseline, its high level poses risks under various scenarios.** The continued macroeconomic recovery from the Cypriot crisis and downsizing of the banking sector, and medium-term fiscal consolidation notably reduce the external debt ratio. Nonetheless, gross external debt is expected to remain very large relative to GDP, reflecting Cyprus's status as a regional financial center. The possibility of continued expansion of SPEs' external liabilities could increase the debt ratio appreciably. Very large gross external financing needs—especially in the absence of an investment grade credit rating—could expose the economy to liquidity and other risks that may be difficult for the private and public sectors to absorb, especially given still very large nonperforming loans, high debt overhang in the household and nonfinancial corporate sectors, and elevated public debt. Closely aligning the maturity and currency of external assets and liabilities is therefore important, together with maintaining fiscal prudence and sound financial sector policies.

Cyprus: External Debt Sustainability—Bound Tests 1/ 2/ 3/
(In percent of GDP)



Sources: Ministry of Finance; Central Bank of Cyprus; and IMF staff estimates.

1/ External statistics were revised in line with the BPM6 methodology.

2/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.

3/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead. Unlike the default settings, the path of non-debt creating flow is set to be the same as the baseline, because its historical average is influenced by exceptional flows during the crisis period and seems too optimistic.

4/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Cyprus: External Debt Sustainability Framework, 2012–22

(Percent of GDP, unless otherwise indicated)

	Actual							Projection						Debt-stabilizing non-interest current account 5/
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	
Baseline: External debt	617	569	554	573	592			**581**	**565**	**553**	**537**	**525**	**511**	**1.9**
Change in external debt	-14.5	-48.1	-14.7	18.3	19.3			-11.3	-16.0	-12.0	-15.7	-12.5	-13.8	
Identified external debt-creating flows (4+9+14)	16.1	-30.6	-40.3	-12.8	15.3			-10.3	-15.5	-11.4	-15.2	-12.1	-13.5	
Current account deficit, excluding interest payments	-11.1	-11.4	-12.7	-17.5	-12.8			-12.3	-12.8	-13.2	-13.8	-14.6	-15.4	
Deficit in balance of goods and services	1.5	-1.8	-2.0	-0.8	0.8			2.2	1.6	1.7	1.8	1.9	1.9	
Exports	53.4	58.6	62.1	64.5	65.1			63.0	61.2	60.6	59.8	59.4	58.9	
Imports	54.9	56.8	60.0	63.7	65.8			65.2	62.7	62.3	61.6	61.2	60.8	
Interest receipts (negative)	-15.9	-12.7	-10.9	-12.3	-11.1			-10.9	-11.0	-11.8	-12.6	-13.6	-14.6	
Net non-debt creating capital inflows (negative)	2.3	-81.4	-61.9	-10.0	22.4			7.4	10.0	6.8	6.1	7.1	5.6	
Net foreign direct investment, equity	16.7	-4.1	-15.1	38.5	3.4			-4.1	-3.9	-3.8	-3.8	-3.8	-3.8	
Net portfolio investment, equity	-36.7	-65.6	-14.9	-9.5	4.4			4.5	3.3	2.6	3.0	2.9	0.5	
Net sales of assets under other investment	19.9	-11.5	-33.5	-34.0	12.7			6.7	10.3	7.8	6.7	7.8	8.6	
Financial derivatives, net	2.4	-0.3	1.6	-4.9	1.9			0.3	0.3	0.2	0.2	0.2	0.2	
Automatic debt dynamics 1/	24.8	62.2	34.3	14.7	5.7			-5.4	-12.7	-5.0	-7.6	-4.7	-3.7	
Contribution from nominal interest rate	17.0	16.3	17.0	19.0	17.7			17.2	17.0	17.8	18.6	19.6	20.6	
Contribution from real GDP growth	19.6	39.3	8.2	-10.9	-17.0			-21.9	-19.9	-15.5	-13.6	-12.8	-12.4	
Contribution from price and exchange rate changes 2/	-11.7	6.6	9.0	6.6	5.0			-0.8	-9.8	-7.3	-12.5	-11.5	-11.9	
Residual (2-3 or 19+20+21+22)	-30.6	-17.5	25.7	31.1	4.0			-0.9	-0.5	-0.6	-0.4	-0.4	-0.4	
Net accumulation of official reserve assets	-0.2	-0.2	0.0	0.0	-0.1			0.0	0.0	0.0	0.0	0.0	0.0	
Captial account flows, net (negative)	-0.2	-1.4	-0.8	-0.3	-0.2			-0.5	-0.5	-0.6	-0.4	-0.4	-0.4	
Errors and omissions, net (negative)	-3.6	-1.6	3.6	0.4	2.8			-0.3	0.0	0.0	0.0	0.0	0.0	
Changes in debt stock without flow transactions, incl. valuation changes, write-offs, and reclassifications	-26.5	-14.2	22.8	31.0	1.6			-0.1	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	1155	970	893	888	910			921	923	912	897	883	867	
Gross external financing need (in billions of euros) 3/	72	71	52	45	43			45	47	49	51	53	55	
in percent of GDP	369	391	296	254	237			240	234	236	234	232	232	
Scenario with key variables at their historical averages 4/						5-Year Historical Average	5-Year Standard Deviation	**613**	**637**	**660**	**683**	**708**	**733**	Projected Average
Key Macroeconomic Assumptions Underlying Baseline														
Nominal GDP (in billions of euros)	19.5	18.1	17.6	17.7	18.1			18.8	19.9	20.7	21.7	22.8	23.9	
Real GDP growth (in percent)	-3.1	-5.9	-1.4	2.0	3.0	-1.1	3.7	3.8	3.6	2.9	2.6	2.5	2.5	3.0
GDP deflator in euros (change in percent)	1.9	-1.1	-1.6	-1.2	-0.9	-0.6	1.4	0.1	1.7	1.3	2.3	2.2	2.3	1.7
Nominal external interest rate (in percent)	2.7	2.5	2.9	3.5	3.2	2.9	0.4	3.0	3.1	3.3	3.5	3.8	4.1	3.5
Growth of exports (euro terms, in percent)	-0.3	2.1	2.7	4.8	3.0	2.5	1.8	0.7	2.3	3.2	3.7	3.9	4.0	3.0
Growth of imports (euro terms, in percent)	-2.9	-3.7	2.5	7.0	5.5	1.7	4.8	3.0	1.4	3.5	3.8	4.1	4.0	3.3
Current account balance, excluding interest payments	11.1	11.4	12.7	17.5	12.8	13.1	2.6	12.3	12.8	13.2	13.8	14.6	15.4	13.7
Net non-debt creating capital inflows	-2.3	81.4	61.9	10.0	-22.4	25.7	44.1	-7.4	-10.0	-6.8	-6.1	-7.1	-5.6	-7.2

Source: IMF staff estimates.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and non-interest current account in percent of GDP.

5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex VI. Public Sector Debt Sustainability Analysis

The Public DSA framework for Market-Access Countries indicates that in the baseline, public debt is on a rapid downward path and gross financing needs are manageable. However, risks to debt sustainability remain high and debt reduction could be temporarily halted by an adverse short-term growth shock and significantly delayed by a combination of sustained stagnation, a modest primary deficit and persistent deflation. If a large contingent liability were to materialize, public debt would rise to and remain at a very high level.

Baseline Scenario

1. Cyprus's public debt has peaked and is on a rapid downward path. Public debt, at 107.1 percent of GDP at end-2016, remained broadly unchanged at the 2015 level. After declining to just below 100 percent of GDP in 2017, public debt is projected to decline steadily to 75 percent of GDP by 2022, underpinned by a further widening of the primary surplus to 3.8 percent of GDP by 2019 (from 3.0 percent of GDP in 2016) and stabilizing at that level. Under the baseline, the public debt ratio would fall below the benchmark for advanced economies (85 percent of GDP) by 2020.

2. Public debt is projected to decrease more rapidly than previously envisaged. Public debt in 2016 was higher than forecast in the 9th EFF review (99.8 percent of GDP), in part reflecting more limited progress on privatization. However, rapidly-rising cash balances arising from the increasing primary surplus has enabled the government to make early repurchase to the Fund in July 2017 and repay part of the debt owed to the CBC in November 2017, which will likely push down the public debt to just below 100 percent of GDP by end-2017. Looking ahead, the public debt ratio is projected to decline close to the goal of just over 70 percent by 2022 that was envisaged in the 9th EFF review under the baseline, even without any significant asset transactions Net debt is forecast to reach 70 percent of GDP by 2022.

3. Gross public financing needs (GPFN) are expected to be manageable. GPFN will remain less than half the benchmark for advanced economies (20 percent of GDP) over the projection horizon. Moreover, taking advantage of strong market access, the authorities undertook transactions to eliminate a prior repayment hump in 2019–20. Specifically, in June 2017, the authorities issued €850mn in Eurobonds and bought-back bonds scheduled to mature in 2019. They also made early repurchase to the Fund in July. Looking forward, the authorities plan to issue medium or long-term Eurobonds each year to maintain a cash buffer sufficient to cover gross financing needs on a forward rolling 12-month basis.

Risk Assessment

4. Cyprus's current high level of public debt leaves it more vulnerable to macro-fiscal shocks. Under the baseline, Cyprus's public debt ratio is projected to remain above the benchmark for advanced economies (85 percent of GDP) until 2020. Assuming that adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 100 percent by 2022 with a probability of more than 15 percent (fan chart in Annex Figure 1).[1]

5. GPFN will remain contained even in the presence of sizable shocks. In the event of short-duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would peak at around 12 percent of GDP, still comfortably below the 20 percent benchmark.

6. The profile of Cyprus's public debt points to vulnerabilities as well as mitigating factors:

- Reflecting Cyprus's role as a financial center and business hub, private sector short-term foreign liabilities are very large, reflecting mainly nonresident deposits in Cypriot banks and foreign debts of nonfinancial corporates. These private sector GFN may create pressures if liabilities are not rolled over or flows reverse, although to a large extent, gross liabilities are matched by gross assets of a similar duration.

- About 80 percent of public debt is owed to non-residents. However, about three-quarters reflects official financing from the ESM and IMF, a bilateral loan from Russia, and loans from the European Investment Bank and Council of Europe Development Bank. The relatively low and/or fixed interest rate on official liabilities, combined with long maturities and back-loaded repayment schedule on a significant share mitigates interest rate and financing risks.[2]

- The sovereign spread relative to German bunds—an indicator of market perception of sovereign risk—is around 125 basis points, below the lower risk-assessment benchmark. However, Cyprus's bonds remain at least one notch below investment grade even after a series of upgrades by major rating agencies during 2015–17.

- Reliance on short-term debt is limited and considered low risk.

Realism of Baseline Assumptions

7. GDP growth and fiscal outturns have surpassed staff's forecasts in recent years, in contrast to previous excessive optimism. Recent GDP growth and the fiscal balance have been stronger than expected, due in part to robust external demand and private financial inflows that have substituted for new bank lending. This over-performance occurred despite the sizable structural fiscal consolidation during the program. In contrast, projection errors during 2012–13 indicate excessive optimism although these errors reflect difficult-to-foresee events (damage to the sole power plant in 2011 and the write-down of banks' holdings of Greek public debt in 2012).

[1] In the asymmetric distribution, upside shocks to growth and the primary surplus are limited to 1 percentage point and 2 percentage points, respectively.

[2] Weighted average maturity of total debt is 7.6 years while that of marketable debt is 4.8 years as of end-June 2017. The shares of debt that falls due within 1 year and 5 years are 2.9 percent and 35.1 percent, respectively.

Stress Tests

8. Although various macro-fiscal and contingent liability shocks would postpone debt reduction, the debt path would nonetheless remain bounded:

- **Growth shock.** A one standard deviation (3.4 percentage points) decrease in growth during 2018–19, accompanied by (i) a 25 bp rise in interest rates, and (ii) a decrease in inflation by 0.25 percentage points per percentage point reduction in GDP growth, would raise public debt by 13 percentage points to 104 percent of GDP by 2019, before declining to 88 percent of GDP by 2022.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.7 percent of GDP during 2018–19, or an increase in the real interest rate by 411 bp during 2018–22 would raise public debt marginally to around 78 percent of GDP and 77 percent of GDP, respectively, by 2022.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 107 percent of GDP in 2019 before declining to 94 percent of GDP by 2022. Gross financing needs would peak at 13.3 percent of GDP in 2019—still below the 20 percent benchmark—before falling back.

- **Contingent liability shock.** A one-off 40 percent of GDP increase fiscal spending (corresponding to about 10 percent of banking sector assets), accompanied by weaker nominal GDP growth, higher interest rates and lower inflation, would push up public debt to about 148 percent of GDP, 73 percentage points of GDP higher than the baseline by 2022.[3] The attendant high level of GPFN and sharp increase in borrowing costs may preclude market access.

[3] Accompanying macroeconomic assumptions are: (i) a 1 standard deviation real GDP growth shock; (ii) a 0.25 percentage point decline in inflation for every 1 percentage point decline in growth; and (iii) an increase in interest rates by 25 bp for every 1 percent of GDP deterioration in primary balance.

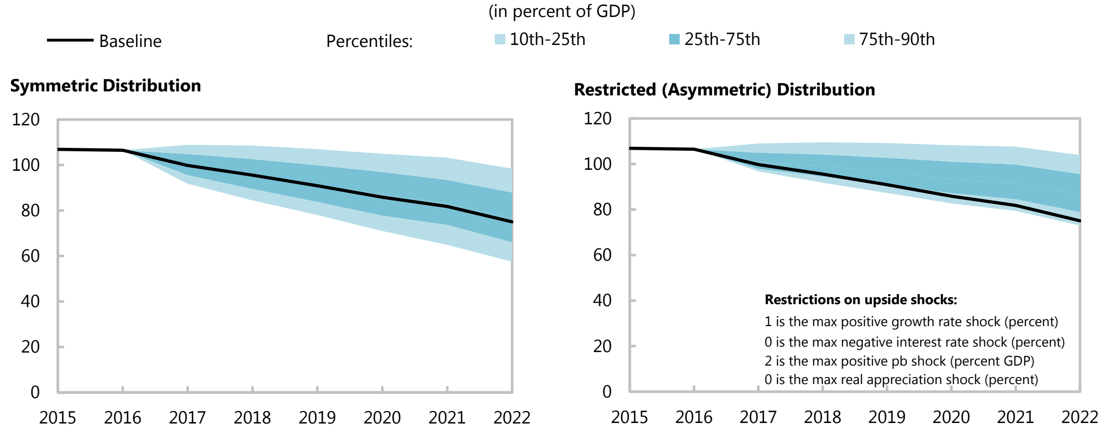
Cyprus: Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

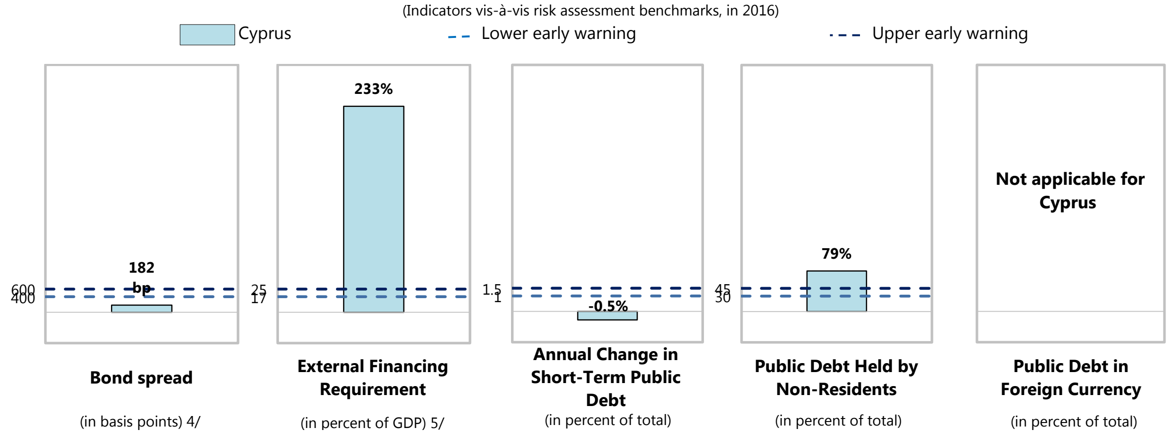
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

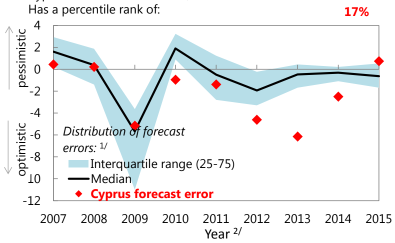
4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Aug-17 through 31-Oct-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

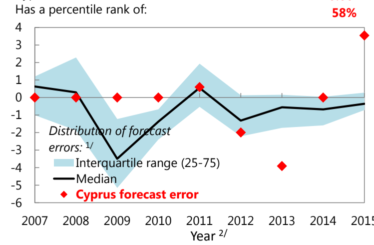
Cyprus: Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus program countries

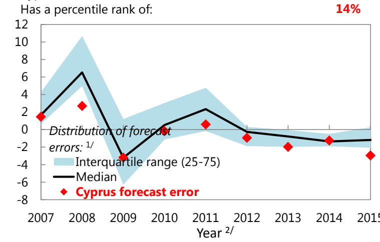
Real GDP Growth
(in percent, actual-projection)
Cyprus median forecast error, 2007-2015: -1.39
Has a percentile rank of: 17%



Primary Balance
(in percent of GDP, actual-projection)
Cyprus median forecast error, 2007-2015: 0.00
Has a percentile rank of: 58%

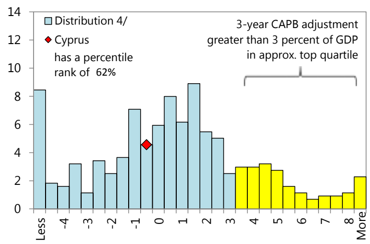


Inflation (Deflator)
(in percent, actual-projection)
Cyprus median forecast error, 2007-2015: -0.94
Has a percentile rank of: 14%

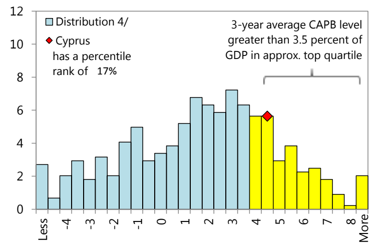


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

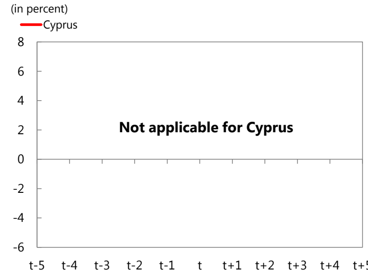


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Cyprus, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Cyprus: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

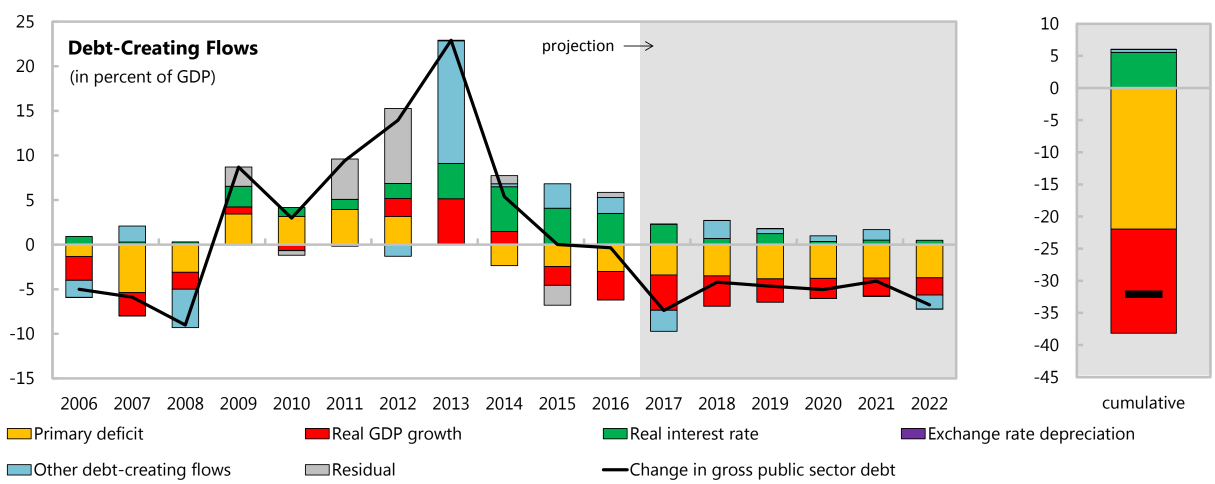
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	68.8	107.5	107.1	99.8	95.5	90.9	85.8	81.8	75.0
Public gross financing needs	12.7	18.1	8.9	11.1	6.3	6.7	6.3	5.4	7.8
Real GDP growth (in percent)	0.3	2.0	3.0	3.8	3.6	2.9	2.6	2.5	2.5
Inflation (GDP deflator, in percent)	1.7	-1.2	-0.9	0.1	1.7	1.3	2.3	2.2	2.3
Nominal GDP growth (in percent)	2.1	0.8	2.1	4.0	5.4	4.2	5.0	4.7	4.8
Effective interest rate (in percent) [4/]	4.4	2.6	2.4	2.4	2.5	2.7	2.8	2.9	3.0

As of October 31, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		124
5Y CDS (bp)		207
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB+	BB+
Fitch	BB	BB

Contribution to Changes in Public Debt

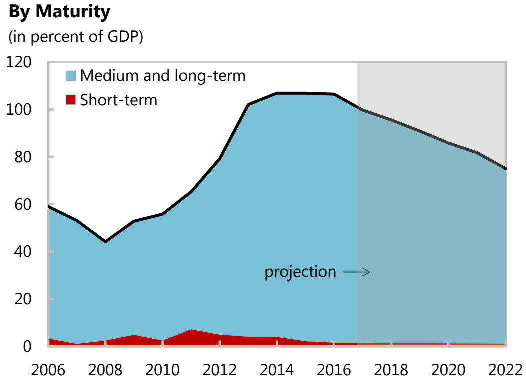
	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.8	0.0	-0.4	-7.4	-4.2	-4.7	-5.0	-4.1	-6.7	-32.1	
Identified debt-creating flows	3.1	2.3	-0.9	-7.4	-4.2	-4.7	-5.0	-4.1	-6.7	-32.2	
Primary deficit	0.2	-2.5	-3.0	-3.4	-3.5	-3.8	-3.8	-3.7	-3.7	-22.0	-3.0
Primary (noninterest) revenue and grants	37.5	38.6	38.8	39.7	39.7	40.0	40.0	40.0	40.0	239.4	
Primary (noninterest) expenditure	37.6	36.1	35.8	36.3	36.2	36.2	36.2	36.3	36.3	217.4	
Automatic debt dynamics [5/]	2.0	2.0	0.3	-1.7	-2.7	-1.4	-1.9	-1.5	-1.4	-10.7	
Interest rate/growth differential [6/]	2.0	2.0	0.3	-1.7	-2.7	-1.4	-1.9	-1.5	-1.4	-10.7	
Of which: real interest rate	1.8	4.1	3.5	2.3	0.7	1.2	0.3	0.5	0.5	5.5	
Of which: real GDP growth	0.1	-2.1	-3.2	-4.0	-3.4	-2.6	-2.2	-2.0	-1.9	-16.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.9	2.7	1.8	-2.4	2.0	0.6	0.6	1.2	-1.6	0.5	
Privatization/Drawdown of Deposits (+ r	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	0.9	2.7	1.8	-2.4	2.0	0.6	0.6	1.2	-1.6	0.5	
Residual, including asset changes [8/]	1.7	-2.2	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

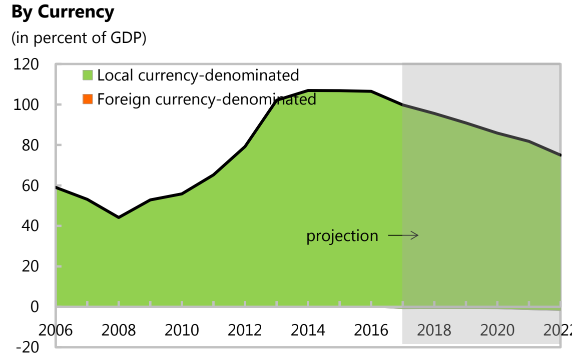


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

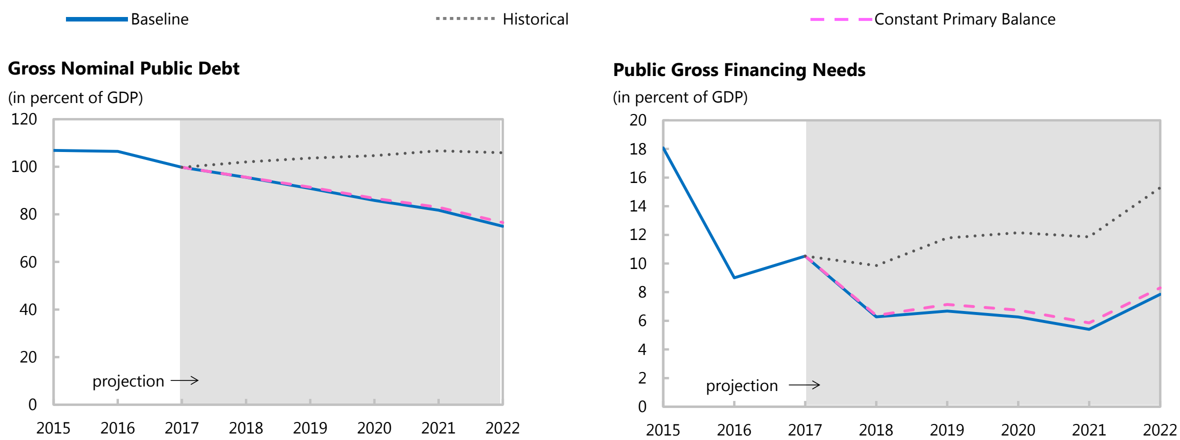
Cyprus: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt





Alternative Scenarios



Underlying Assumptions
(in percent)

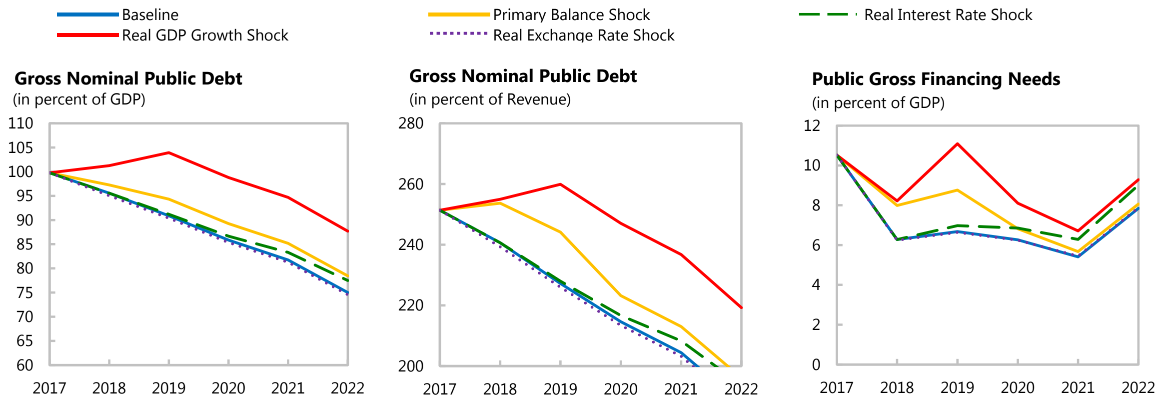
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.8	3.6	2.9	2.6	2.5	2.5
Inflation	0.1	1.7	1.3	2.3	2.2	2.3
Primary Balance	3.4	3.5	3.8	3.8	3.7	3.7
Effective interest rate	2.4	2.5	2.7	2.8	2.9	3.0
Constant Primary Balance Scenario						
Real GDP growth	3.8	3.6	2.9	2.6	2.5	2.5
Inflation	0.1	1.7	1.3	2.3	2.2	2.3
Primary Balance	3.4	3.4	3.4	3.4	3.4	3.4
Effective interest rate	2.4	2.5	2.7	2.8	2.9	3.0

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.8	0.3	0.3	0.3	0.3	0.3
Inflation	0.1	1.7	1.3	2.3	2.2	2.3
Primary Balance	3.4	0.2	0.2	0.2	0.2	0.2
Effective interest rate	2.4	2.5	2.9	3.2	3.5	3.8

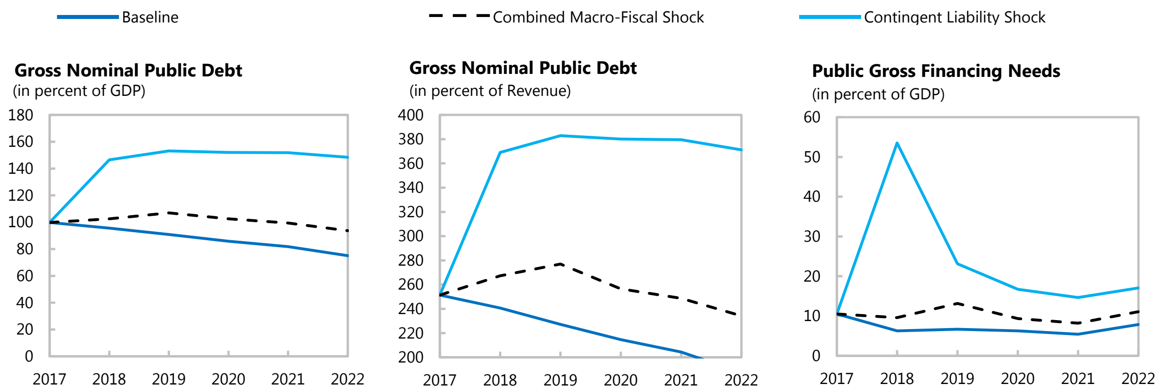
Source: IMF staff.

Cyprus: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

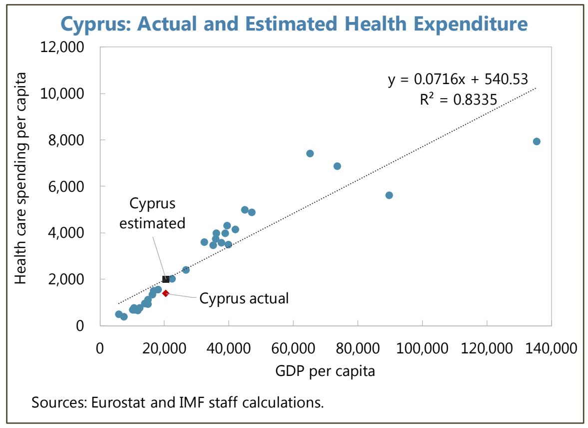
(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.8	3.6	2.9	2.6	2.5	2.5
Inflation	0.1	1.7	1.3	2.3	2.2	2.3
Primary balance	3.4	1.8	2.1	3.8	3.7	3.7
Effective interest rate	2.4	2.5	2.7	2.9	2.9	3.1
Real Interest Rate Shock						
Real GDP growth	3.8	3.6	2.9	2.6	2.5	2.5
Inflation	0.1	1.7	1.3	2.3	2.2	2.3
Primary balance	3.4	3.5	3.8	3.8	3.7	3.7
Effective interest rate	2.4	2.5	3.0	3.4	3.8	4.2
Combined Shock						
Real GDP growth	3.8	0.2	-0.5	2.6	2.5	2.5
Inflation	0.1	0.9	0.5	2.3	2.2	2.3
Primary balance	3.4	0.6	-0.7	3.8	3.7	3.7
Effective interest rate	2.4	2.5	3.1	3.6	4.1	4.5

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.8	0.2	-0.5	2.6	2.5	2.5
Inflation	0.1	0.9	0.5	2.3	2.2	2.3
Primary balance	3.4	2.0	0.7	3.8	3.7	3.7
Effective interest rate	2.4	2.5	2.7	2.9	3.0	3.1
Real Exchange Rate Shock						
Real GDP growth	3.8	3.6	2.9	2.6	2.5	2.5
Inflation	0.1	2.1	1.3	2.3	2.2	2.3
Primary balance	3.4	3.5	3.8	3.8	3.7	3.7
Effective interest rate	2.4	2.5	2.7	2.8	2.9	3.0
Contingent Liability Shock						
Real GDP growth	3.8	0.2	-0.5	2.6	2.5	2.5
Inflation	0.1	0.9	0.5	2.3	2.2	2.3
Primary balance	3.4	-43.2	3.8	3.8	3.7	3.7
Effective interest rate	2.4	2.6	6.7	6.3	6.3	6.3

Source: IMF staff.

Annex VII. The Proposed National Health Service



1. Long life expectancy suggests that the current healthcare system in Cyprus provides generally good quality care, and does so at a low total and public-sector cost. Life expectancy at birth has risen by four years since 2000, reaching 81.8 years in 2015, above the EU-average of 80.6 years. The population has access to healthcare through public hospitals and health-care centers as well as through private health facilities. Total health expenditure in Cyprus was 6.8 percent of GDP in 2015, well below the EU-average of 9.8 percent. At 42.6 percent, the government's share of health spending was the lowest in the EU, and less of total government spending is allocated to health (7.1 percent) than in other EU members. Indeed, a cross-country comparison suggests that health expenditure in Cyprus is well below the expected level consistent with its per-capita income.

2. However, the current health system has several important deficiencies. There is excess demand for public health care owing to almost-free access for about 80 percent of the population,[1] resulting in significant rationing of service within the public health sector. Given the generally better-quality of care in the private health sector and rationing in the public sector, many of those entitled to free public health care are forced to resort to private providers. This raises out-of-pocket spending, including by lower-income households. Compared with the EU-average of 15 percent, 44 percent of total health spending in Cyprus is financed out-of-pocket. Moreover, too-little capacity in the public system co-exists with overcapacity in the private system. There is also little pooling of financial risk—either through the publicly-funded system given rationing of access, or through private voluntary health insurance, which is mostly not available because of very high administrative costs associated with the small population.

3. In June 2017, Parliament adopted two key health bills—making public hospitals and health centers autonomous and introducing a National Health System (NHS)—thus enacting a health sector reform conceived in the early 2000s. The two laws require:

- granting managerial and financial autonomy to hospitals so as to encourage competition between public and private health service providers. Currently, the state budget covers the costs of public hospitals and health centers, and employees of state hospitals, including health professionals, are government employees.

- establishing a NHS aiming to provide free universal access to basic healthcare services. Notable aspects of the NHS include:

[1] Small co-payments apply for households with incomes above €15,400 without dependents. For families with incomes below €30,750, this income threshold for co-payments is increased by €4,700 for each dependent child.

- the NHS will become operational in two stages: June, 2019 for general practitioner and outpatient services, pharmaceuticals and laboratory tests, and June, 2020 for in-patient services.

- the NHS will include public health service providers, and those private providers who elect to participate. All-but-elective services will be covered, with modest copayments charged for specialist and in-patient treatment.

- Funding will rely on a combination of employee, employer and government contributions, calculated as fixed payroll percentages (up to a maximum income level), and contributions on non-earned income (including interest earnings and pensions). Contribution rates have been calibrated to generate an amount equal to the current country-wide health spending. The NHS will operate under a global budget, reimbursing service-providers with fee-for-service payments.

- Part of existing government spending on state hospitals and health centers will be allocated to the NHS. The government will cover any residual costs associated with state hospitals and health centers.

Cyprus: NHS Contribution Rates
(percent)

	From March 1, 2019	**From March 1, 2020**
Employees/government officials	1.7 percent of payroll	2.65 percent of payroll
Employers	1.85 percent of payroll	2.9 percent of payroll
State contribution	1.65 percent of economy-wide payroll	4.7 percent of economy-wide payroll
Self-employed	2.55 percent of income	4.0 percent of income
Pensioners/those living on other income	1.7 percent of income	2.65 percent of income

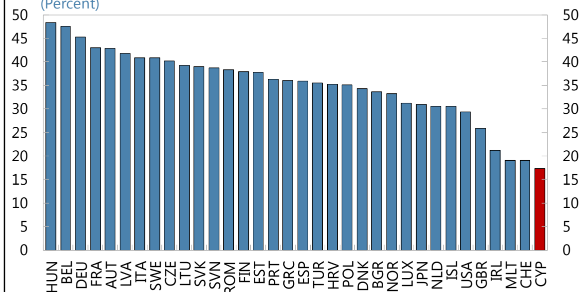
4. **The planned health sector reform is intended to address several deficiencies present in the current system.** The NHS aims to provide universal coverage under a single-payer system, financed by contributions from employers and employees, the government budget, and patients' own co-payments. Patients will have access to health providers of their choice—both private and public—at a nominal cost and will be insured against a significant part of health costs. As a result, households should be better able to smooth consumption and have less need to accumulate large precautionary savings. Moreover, it is anticipated that patient choice of providers, together with reforming public health facilities, will foster competition, reduce costs, reallocate demand (capacity) away from (to) public facilities, and improve quality of care.

5. **However, public spending on healthcare could increase substantially under the NHS.** International evidence suggests that without sizable user fees, broad health coverage can increase demand and overall spending. In Cyprus, the introduction of the NHS comes against the backdrop of low total and public health spending relative to the country's income level—partly due to rationing of care at public health facilities. Rapid population ageing will also add to future health care needs. Nonetheless, as currently budgeted, the introduction of the NHS will be largely fiscally

neutral. However, the government will be obligated to cover any funding shortfalls at the public health providers, or else those facilities may be forced to run arrears or (once again) ration service.

6. The NHS could also have implications for the competitiveness of the Cypriot economy. Much of the funding for the NHS is to come from a new 6 percentage point levy on employment, which could adversely affect demand for labor. This could be the case especially among low-wage workers, whose employment tax wedge currently fares well compared to similar workers in other advanced economies. This new levy could also push low-wage employment into the shadow economy. There is also a clear risk that tax wedge may need to increase in the future if contributions are insufficient to cover NHS costs.[2] On the other hand, it is also possible that a larger-than-currently-expected share of users opt to forgo facilities participating the NHS, and pay out-of-pocket for private providers outside the scheme, even though such users have already "paid" for NHS services through their contributions. In that case, there would be less pressure on contribution rates.

Tax Wedge on Labor Costs, 2016 1/2/
(Percent)



Source: Eurostat.
1/ Defined as income tax on gross wage earnings plus the employee's and the employer's social security contributions, expressed as a percentage of the total labour costs of the earner.
2/ 2015 for LTU, ROM, HRV, BGR and MLT. Staff calculation for CYP, excluding the temporary solidarily levy on wages.

[2] The NHS law stipulates five-yearly functional reviews by Parliament, including the option to amend contribution rates.

INTERNATIONAL MONETARY FUND

CYPRUS

November 28, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By
European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of October 31, 2017)

Membership Status: Joined December 21, 1961; Article VIII

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	303.80	100.00
Fund holdings of currency	788.38	259.51
Reserve position in Fund	85.06	28.00

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	132.80	100.00
Holdings	49.26	37.09

Outstanding Purchases and Loans:	**SDR Million**	**Percent of Quota**
Extended Arrangement	569.63	187.50

Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
EFF	May 15, 2013	Mar 6, 2016	891.0	792.00

Actual and Projected Payments to the Fund (SDR millions; Projected from 2017)

	Principal	**Charges/Interest**	**Total**
2015	0.00	7.52	7.52
2016	0.00	13.12	13.12
2017	222.38	13.78	236.16
2018	0.00	9.82	9.82
2019	0.00	9.82	9.82
2020	31.31	9.82	41.13
2021	138.19	8.68	146.87
2022	125.81	6.53	132.34

Exchange Rate Arrangement and Exchange Restrictions:

Cyprus is a member of the euro area, and its currency—the euro—floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4. External payment restrictions introduced in 2013 in the wake of the banking crisis were fully eliminated, effective April 6, 2015. Cyprus maintains a system free of restrictions on the making of payments and transfers for current international transactions except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

Last Article IV consultation, Post-Program Monitoring discussions, and program relations:

Article IV. Cyprus is currently on a standard 12-month consultation cycle. The last Article IV consultation was concluded on July 30, 2014 (IMF Country Report No. 14/313), when Cyprus was on a 24-month cycle while under an Extended Arrangement.

EFF. Cyprus's three-year, SDR 891 million (293 percent of current quota) Extended Arrangement under the Extended Fund Facility (EFF) was approved by the IMF Executive Board on May 15, 2013. The total amount drawn was SDR 792 million (260.7 percent of quota). The EFF arrangement was coordinated with the European Stability Mechanism (ESM), which disbursed €6.3 billion. The ninth (and penultimate planned) review was completed on January 23, 2016 (IMF Country Report No. 16/26). The EFF arrangement was cancelled by the authorities on March 7, 2016, about two months before it was scheduled to expire. The cancellation coincided with the expiration of the three-year ESM program.

PPM and repurchases. The Fund initiated PPM on March 18, 2016. Board consideration of the First Post-Program Monitoring (PPM) discussions was held on June 7, 2017 (IMF Country Report No. 17/148). An early repurchase on July 11, 2017 reduced outstanding Fund credit to Cyprus to SDR 570 million (187.5 percent of quota), which is below standard PPM-eligibility thresholds. The Board approved a one-year PPM extension on August 2, 2017.

Technical Assistance:

Department	**Purpose**	**Date**
FAD	Revenue administration	October–November 2014
FAD	Revenue administration	January–February 2015
FAD	Functional review of Ministry of Finance	February 2015
FAD	Government guarantees	February 2015
MCM	Cooperative credit sector restructuring	February–March 2015
FAD	Public financial management	March 2015
STA	Balance of payments	March–April 2015
FAD	Public financial management	August 2015
MCM	NPL management	August-September 2015
MCM	Macro-financial modeling	September 2015
MCM	NPL management	September 2015
FAD	Public financial management	September-October 2015
MCM	Financial aspects of reunification	November 2015
FAD	Revenue administration	November-December 2015
MCM	Central bank governance	December 2015

STA	Statistical aspects of reunification	December 2015
FAD	Fiscal aspects of reunification	December 2015
MCM	Financial aspects of reunification	December 2015
MCM	Financial aspects of reunification	January 2016
MCM	Financial aspects of reunification	February 2016
STA	Statistical aspects of reunification	February 2016
FAD	Fiscal federalism workshop	February 2016
FAD	Fiscal aspects of reunification	February-March 2016
MCM	Debt management	March 2016
FAD	Public financial management	March-April 2016
MCM	Financial aspects of reunification	April 2016
FAD	Revenue administration	April-May 2016
STA	Statistical aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	May 2016
MCM	Financial aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	June–July 2016
MCM	Financial aspects of reunification	June–July 2016
FAD	Revenue administration	October 2016
FAD	Spending review	October 2016
FAD	Fiscal aspects of reunification	November 2016
STA	Central bank financial statistics	January 2017
FAD	Revenue administration	March 2017
FAD	Spending review	April-May 2017
MCM	Financial stability	July 2017
MCM	NPL management	July 2017
MCM	Macro-prudential policy	September 2017
LEG	Insolvency legal framework workshop	September 2017
FAD	Spending review	September–October 2017
FAD	Revenue administration	October 2017
MCM	NPL management	November 2017

Two FAD long-term resident advisors provided technical assistance on public financial management (from February, 2014 to October, 2016) and on revenue administration (from July, 2015 to December, 2016).

Resident Representative:

Mr. Vincenzo Guzzo assumed his position in September, 2013.

STATISTICAL ISSUES

(As of November 24, 2017)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is adequate for surveillance purposes.
National accounts and real sector data: Since September 2014, the Statistical Service of Cyprus (CYSTAT) publishes a full set of national accounts based on the European System of National and Regional Accounts (ESA 2010) methodology, including quarterly GDP estimates. The data are available from the first quarter of 1995; the quarterly and annual data are consistent, although the timing of revisions to annual and quarterly statistics may not coincide. CYSTAT publishes the Consumer Price Index, and the Harmonized Index of Consumer Prices (HICP) according to the methodology of EU member states. Control and quality assessment are ensured through the supervision of Eurostat.
Fiscal sector data: Ministry of Finance publishes monthly cash budget data based on ESA 2010 for the general government and its breakdown into central government, local government and social security fund.
External sector data: The Central Bank of Cyprus (CBC) compiles and disseminates online the statistics of the balance of payments and the international investment positon on a quarterly and annual basis, according to the IMF's sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6). The data are released with a one-quarter lag (e.g., 2017:Q2 data were released in October 2017). The data have included special purpose entities (SPEs) as residents since July 2014, when the BPM6 methodology was adopted, while SPEs had been treated as non-residents before that. Historical data up to 2008 were also revised in October 2015 with the same definition. The treatment of SPEs is fully in line with the international standards including the BPM6. The data coverage of SPEs is currently estimated at about 80 percent of the total, mainly due to the difficulty of collecting data on SPEs. Some historical statistics on SPEs (including current account balance, net international investment position, and gross and net external debt) were published in November 2017.
Monetary and financial sector data: Data on central bank balance sheet, key aggregate financial indicators for other monetary financial institutions, and financial positions of domestic institutional sectors are available from the CBC website and comply with European standards. The CBC also provides monthly monetary statistics to the IMF through the ECB. A structutural break exists for some financial sector data due to the migration to Basel III (in 2014:Q1) and adoption of the European Banking Authorities definition of non-performing loans (in 2014:Q4).
Financial sector surveillance: Cyprus participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS). Cyprus reported all twelve core financial soundness indicators (FSIs) and all thirteen encouraged FSIs for the deposit takers on quarterly basis up to Q1:2016. However, some FSIs have been missing or only partly reported since then. In addition, encouraged FSIs for the other sectors are not available.

II. Data Standards and Quality
Cyprus subscribes to the Fund's Special Data Dissemination Standard (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Boards. Cyprus's economic database is comprehensive and of generally good quality. Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a wide range of economic and financial data, as well as a calendar of dates for the main statistical releases. Cyprus is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted ESA 2010. No data ROSC is available.

Cyprus: Table of Common Indicators Required for Surveillance
(As of October 31, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2017	Oct. 2017	M	M	M
Reserve/Base Money	Sep. 2017	Oct. 2017	M	M	M
Broad Money	Sep. 2017	Oct. 2017	M	M	M
Central Bank Balance Sheet	Sep. 2017	Oct. 2017	M	M	M
Consolidated Balance Sheet of the Banking System	Sep. 2017	Oct. 2017	M	M	M
Interest Rates[2]	Current	Current	D	D	D
Consumer Price Index	Sep. 2017	Oct. 2017	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep. 2017	Oct. 2017	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Sep. 2017	Oct. 2017	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sep. 2017	Oct. 2017	M	M	M
External Current Account Balance	2017:Q2	Oct. 2017	Q	Q	Q
Exports and Imports of Goods and Services	2017:Q2	Oct. 2017	Q	Q	Q
GDP/GNP	2017:Q2[7]	Sep. 2017	Q	Q	Q
Gross External Debt	2017:Q2	Oct. 2017	Q	Q	Q
International investment position[6]	2017:Q2	Oct. 2017	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government, social security funds and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] National accounts are available up to 2017:Q2, but do not reflect the recent revisions to annual data. Revised quarterly national accounts accounts are scheduled to be released in December.

[8] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

Statement by Mr. Richard Doornbosch, Alternate Executive Director for Cyprus, and Ms. Jeske De Lint, Advisor to the Executive Director
December 13, 2017

The authorities highly appreciated the discussions with staff during the 2017 Article IV consultation. Although engagement with the Fund has been intense over the last couple of years in the context of the Extended Arrangement under the Extended Fund Facility (EFF) and after that the first post-program monitoring (PPM), it has been three years since the last Article IV consultation took place. The authorities value the comprehensive assessment of Cyprus' economy and policy discussions, which are of a different nature than in the context of a program.

As staff rightly points out, Cyprus has achieved an impressive turnaround since its banking crisis. 2014 and 2015 were pivotal years. In 2014, Cyprus made a swift debt market comeback when the authorities were able to tap into the international bond markets, selling a five-year debt instrument. In 2015, less than three years after the start of the crisis, Cyprus was already able to issue a 10-year maturity sovereign bond. That same year Cyprus returned to positive economic growth and in April of that year all capital controls, imposed as a result of the crisis, were abolished. Cyprus exited its economic adjustment program supported by the IMF and the European Stability Mechanism (ESM) in March 2016. Drawing only EUR 7.2 billion of the initially allocated EUR 10 billion financial assistance, and made an early repayment to the IMF of part of its loan in July 2017.

Economic growth keeps accelerating and unemployment continues to fall. Data for the first nine months of 2017 point to a real GDP growth of 3.8%. Growth is attributed to most economic sectors except for the banking sector due to ongoing loan deleveraging, which however contributes to the reduction of high private debt. In line with the encouraging macro developments, unemployment is currently (2017Q2) at around 10.6%, down from a peak of 17.6% in 2015Q1. The authorities put public finances on a healthy footing with primary surpluses among the highest in Europe, contributing to the reversal of the upward trend of the debt-to-GDP ratio. As a result, the fiscal balance has moved from a large deficit to a surplus as of 2016. The financial sector was stabilized and emergency bank liquidity has been fully repaid since January 2017. Bank deposits continue to rise, which shows that confidence in Cyprus' financial system has returned. This is also reflected in Cyprus' credit ratings. Cyprus managed to tap into international capital markets for the fifth time in June 2017.

The current strong economic growth is likely to persist and domestic demand will remain the main growth driver. In particular investment is an important growth driver, given the strong pipeline of projects in tourism, energy, education and health. Private sector investment projects amounting to over €3 billion, of which a large part is financed through foreign direct investment, are expected to be completed by 2020. Private consumption will be supported by growing employment and improving disposable incomes, which have declined dramatically during the crisis.

This leaves Cyprus in a robust position to address the remaining legacies of the crisis: high private sector debt and elevated non-performing loans. Despite progress made with resolving non-performing loans, Cyprus' NPL-to-GDP ratio remains among the highest in the Euro Area. Given the robust economic growth of recent years, the reduction of non-performing loans is considered by some to have been slower than expected. However, it is important to take into account that Cyprus has faced a deep recession following the 2012 crisis. The authorities expressed the view that, if non-performing loans were to be reduced in an excessively aggressive manner, a negative feedback loop on economic growth could materialize While gross debt of Cyprus' nonfinancial private sector is very high, deposit holdings are also sizable. Households' deposit holdings on aggregate even exceed total loan obligations. Households' real assets are also very high, driven by the excessive borrowing in the past. This suggests that at least a part of non-performing loans holders have the capacity to repay. Procedures to enforce commercial claims and foreclosure procedures are lengthy and there is a strong protection of primary residences, which allows people to hold out.

The authorities have actively developed strategies and tools to deal with non-performing loans. Some further refinements are underway, and it is expected that more decisive measures can be taken in 2018. However, rules and frameworks are only part of the solution. The banks too should accelerate their efforts and use all existing instruments to change the culture of weak payment discipline. The current environment of strong growth provides the right momentum. Meanwhile, the three major banks have recently struck joint ventures with foreign NPL specialist service companies with international experience in the management of bad loans.

The fiscal strategy of the authorities is aimed at supporting economic growth and reducing the level of public debt. The primary surplus is expected to reach 4 percent of GDP in 2017. The overall surplus is expected to average at around 1.4percent of GDP in the medium-term. Gross public debt is expected to fall below 100 percent of GDP by the end of the year, following early repayment of domestic held debt. Government spending will be kept in check, supported by the collective agreement with public sector unions and the recently adopted laws on government hiring and staff mobility. Moreover, the forthcoming NHS is intended to be fiscally neutral. Windfall revenue will be used to further reduce debt.

The authorities agree that efficiency-enhancing reforms are essential to ensure balanced and sustainable growth. Reform of the courts and strengthening the efficiency of commercial claims enforcement is high on the agenda. There are several efforts underway that will improve the investment climate in many sectors. The authorities believe that the increase in construction activity is positive and risks are limited.