INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/337

CYPRUS

November 2018

2018 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 2018 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 November 28, 2018, 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 November 28, 2018, following discussions that ended on October 5, 2018, 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 8, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Cyprus.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
December 3, 2018

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

IMF Executive Board Concludes 2018 Article IV Consultation with Cyprus

On November 28, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Cyprus.

Cyprus is recovering strongly following the 2012–13 crisis. GDP grew by 4 percent (yoy) in the first half of 2018, driven by tourism, professional services and foreign investment in construction as well as continued strength in private consumption. The unemployment rate continued to decline to 7.4 percent in September from 10.2 percent a year earlier. Inflationary pressures remain low. Supported by subdued unit labor costs, Cyprus has maintained its export competitiveness, although the current account deficit widened last year as strong domestic demand pushed up imports. Fiscal performance has strengthened on the economic recovery with the primary surplus widening to 4.3 percent of GDP in 2017. Banks are making progress in cleaning up their balance sheets. Nevertheless, the banking sector still faces one of the highest non-performing loan ratios in Europe, while both private and public sectors have a large debt overhang.

The near-term outlook for the economy is favorable, with growth expected to remain at around 4.2 percent in 2018–19, supported by the services sector and largely foreign-financed investments. Over the medium term, economic growth is projected to slow to its long-run potential rate of around 2½ percent, as the transitory effects of the investment boom gradually dissipate. Fiscal performance is expected to improve with a primary surplus of around 5 percent in 2018–19. Public debt is thus expected to be on a firm declining path, falling below 70 percent of GDP by 2023, despite a sharp increase earlier this year following the resolution of the Cyprus Cooperative Bank. The economic outlook could weaken if implementation of NPL resolution is delayed, while public debt sustainability could be undermined by realization of contingent liabilities or erosion of fiscal discipline.

[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 welcomed the strong post-crisis economic recovery, which has supported large fiscal surpluses and lowered the unemployment rate. Directors also welcomed the recent reforms undertaken to address key vulnerabilities in the banking sector, including the resolution of a large systemic state-owned bank. Directors observed, however, that private and public debt remain large while NPL ratios are still among the highest in Europe. They encouraged the authorities to make further efforts to address these legacy problems and strengthen economic growth over the medium term.

Directors emphasized the importance of further measures to facilitate a steady decline in NPLs on a durable basis. They called for steadfast implementation of the amended legislative framework on foreclosure, insolvency, sale of loans, and securitization, supplemented by a strengthening of the court system and removal of uncertainties related to title deeds. Directors also stressed the need to enhance the governance and supervisory framework for the recently-established asset management company. They recommended that to limit moral hazard, the proposed *Estia* scheme aimed at encouraging distressed borrowers to begin servicing their loans be better targeted and based on appropriate assessment of borrowers' capacity to repay.

Directors highlighted the need for banks to continue efforts to strengthen their balance sheets. They urged banks to diversify income sources and consolidate operations to improve cost-income ratios and better position themselves against increased competition. Directors recommended strengthening regulatory guidance on loan restructuring and exercising vigilance over bank lending policies, the adequacy of provisioning, and debt-to-asset swap policies.

Directors welcomed Cyprus's robust fiscal performance and emphasized that strict spending discipline should be maintained. They cautioned against relying on transitory revenues from cyclical gains and one-off measures to finance permanent spending initiatives, and took positive note of the authorities' commitment to cap expenditure increases, including the public wage bill, in line with the medium-term GDP growth rate, in order to create room for growth-enhancing spending. Directors noted that the transition to public insurance in the health sector should be carefully managed. They agreed that fiscal structural reforms are needed, and recommended strengthening public financial management, monitoring risks from local governments and the state-owned sector, and improving the corporate governance of commercial state-owned enterprises.

[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.

Directors stressed the need to undertake institutional reforms and further enhance the investment climate and raise medium-term growth potential. They agreed that reforms to increase the efficiency of the courts, speed up the enforcement of commercial claims, and clear the backlog of cases should continue. They also recommended expediting legislation to strengthen the governance and autonomy of the Central Bank of Cyprus and encouraged further efforts to mitigate AML/CFT risks. Directors noted that active labor market policies and investment in higher value-added sectors can help reduce high youth unemployment and skills mismatch, thereby promoting more inclusive growth.

Cyprus: Selected Economic Indicators, 2015–19

	2015	2016	2017	Projections 2018	Projections 2019
Output/Demand					
Real GDP	2.0	4.8	4.2	4.2	4.1
Domestic demand	3.9	6.1	8.2	0.7	7.5
Consumption	1.9	3.5	3.9	3.0	2.8
Private consumption	2.4	4.5	4.1	4.0	3.1
Public consumption	-0.5	-0.8	3.1	0.3	1.7
Gross capital formation	18.1	21.9	30.4	-8.8	28.8
Foreign balance 1/	-1.8	-1.2	-3.9	3.6	-3.4
Exports of goods and services	5.2	4.6	6.0	3.7	-2.0
Imports of goods and services	8.4	6.6	12.2	-1.8	3.4
Potential GDP growth	1.2	1.7	2.1	2.4	2.7
Output gap (percent of potential GDP)	-7.1	-4.3	-2.3	-0.6	0.7
Prices					
HICP (period average, percent)	-1.5	-1.2	0.7	0.9	1.8
HICP (end of period, percent)	-0.5	0.1	-0.4	2.4	2.0
Employment					
Unemployment rate (EU standard, percent)	14.9	13.0	11.1	8.5	7.0
Employment growth (percent)	-1.3	1.4	4.6	3.9	2.5
Public Finance					
General government balance	-0.3	0.3	1.8	2.7	2.5
Revenue	39.0	38.0	39.0	39.7	39.0
Expenditure	39.3	37.7	37.3	37.0	36.5
Primary Fiscal Balance	2.7	3.0	4.3	5.1	5.0
General government debt	108.0	105.5	96.1	106.1	99.7
Balance of Payments					
Current account balance	-1.5	-5.1	-8.4	-4.1	-7.8
Trade Balance (goods and services)	0.8	-0.6	-3.5	-0.2	-3.8
Nominal GDP (billions of euros)	17.7	18.5	19.6	20.7	21.9

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

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

November 8, 2018

KEY ISSUES

Macroeconomic context. Cyprus is recovering strongly from the 2012–13 crisis. GDP growth is projected to remain above 4 percent in 2018–19, buoyed by services and foreign-financed construction. Unemployment is rapidly declining while large fiscal primary surpluses are putting public debt back on a declining path. Nevertheless, crisis legacies continue to weigh on the banking system. In early 2018, difficulties in the Cyprus Cooperative Bank led the authorities to intervene, albeit at a significant fiscal cost. In the process, a package of legislative measures strengthening the insolvency and foreclosure regime was also approved, which is now catalyzing the cleanup of bank balance sheets. These developments have led to a sovereign ratings upgrade, restoring Cyprus's investment grade status.

Policy challenges. Even after the recent offloading of NPLs, the banking sector still faces one of the highest NPL ratios in Europe, pressuring bank profitability. While the environment is now more favorable, stronger collateral execution, durable NPL workouts and improved borrower payment discipline are still needed. Debt vulnerabilities remain substantial, given high debt levels and external financing needs. With growth heavily dependent on foreign financing, achieving faster and more sustainable medium-term growth will require increased productivity and diversification into higher value-added sectors.

Policy priorities. The key policy priorities are therefore to achieve further private and public balance sheet repair by (i) steadfastly implementing the recently amended legal tools to lower NPLs and the private debt overhang; (ii) safeguarding fiscal space and reducing risks to public debt sustainability by maintaining strict spending discipline; and (iii) enacting structural reforms, especially in the judiciary and public administration, to attract further investment and enhance productivity. These policies are critical to reduce vulnerabilities and reinvigorate medium-term growth potential. The current phase in the electoral and economic cycle provides an opportunity to advance this policy agenda.

Approved By	
Philip Gerson (EUR) and Nathan Porter (SPR)	Discussions took place in Nicosia from September 24 to October 5, 2018. The mission team comprised Ms. Anita Tuladhar (head), Messrs. Hajime Takizawa and Seung Mo Choi (all EUR), Mmes. Dora Douglass Kochman (SPR), Greta Michell Casselle (MCM), and Nadia Rendak (LEG), and Ms. Maria Heracleous and Mr. Aristoklis Avgousti (Resident Representative office in Nicosia). Mr. Vincenzo Guzzo, Ms. Tingyun Chen and Ms. Dilcia Noren (EUR) supported the mission from headquarters. Mr. Dries Cools (office of the Executive Director) joined most of the meetings.

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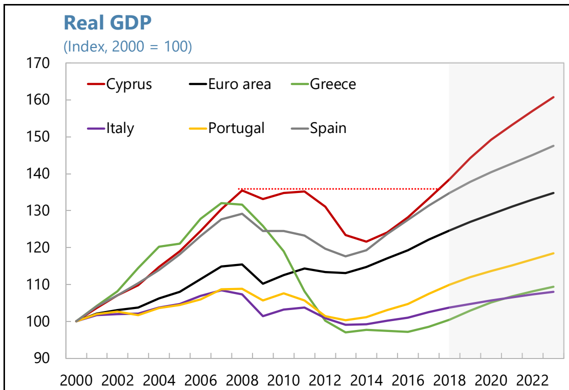
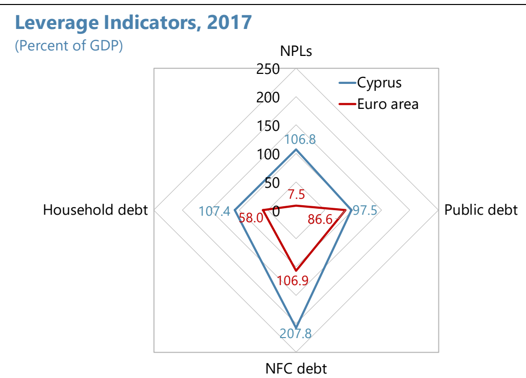
ANNEXES

CONTEXT[1]

1. Cyprus is recovering strongly following the 2012–13 crisis, while making some progress in tackling its crisis legacies. Real GDP has now returned to its pre-crisis peak level. Fiscal performance has been strengthening. Nevertheless, the banking sector still faces one of the highest non-performing loan ratios in Europe, while both private and public sectors have a large debt overhang. Reducing NPLs with minimum cost to the public purse is a key priority but has been politically difficult. Following the February 2018 Presidential election, amidst growing pressures to deal with a troubled bank, the authorities started making important strides in addressing these challenges and cleaning up bank balance sheets (Annex I). These efforts have boosted confidence and earned Cyprus a sovereign credit rating upgrade to investment grade. Looking ahead, implementing these newly-enacted financial reforms, safeguarding fiscal space and pursuing structural reforms, especially in the judiciary and public administration, where reforms have been delayed, will be crucial to reducing risks, improving investment sentiment and productivity, and strengthening growth potential. Cyprus remains under the Fund's Post-Program Monitoring.



Source: WEO.

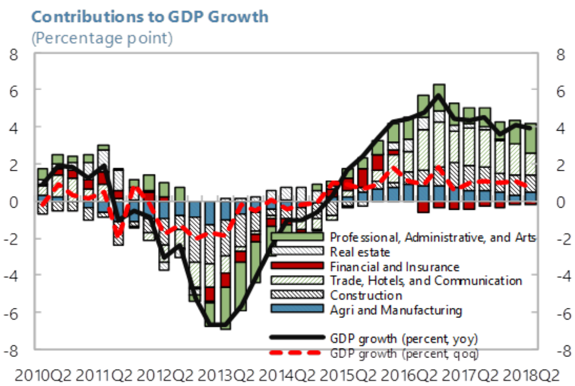


Sources: ECB, Haver Analytics, WEO and IMF staff calculations.

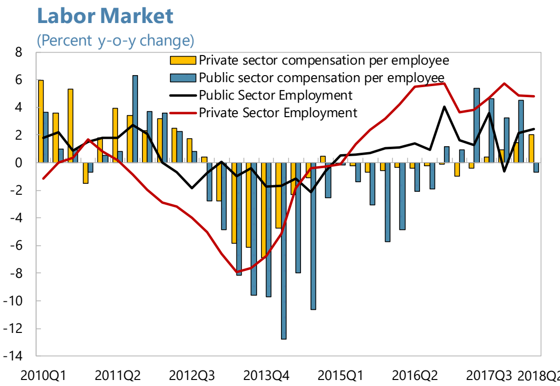
RECENT DEVELOPMENTS

2. Growth momentum remains strong (Figure 1). Real GDP grew by 4 percent (yoy) in 2018:H1, following an increase of 4.2 percent in 2017. Growth was primarily driven by higher foreign investment in the construction sector, including through the Citizenship by Investment scheme (CbI), as well as continued strength in professional and tourism services. Higher disposable incomes from the labor market recovery and delays in the repayment of bank loans also helped sustain private consumption. Public consumption has also risen as the government hiring and wage freeze was relaxed. High frequency indicators suggest these trends broadly continue.

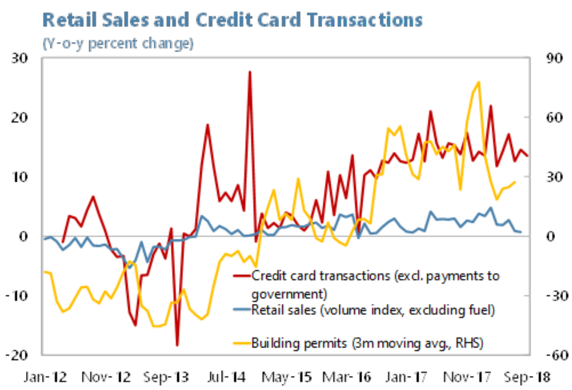
[1] This report does not cover areas of Cyprus not under the effective control of the Republic of Cyprus and assumes no change in the status quo.



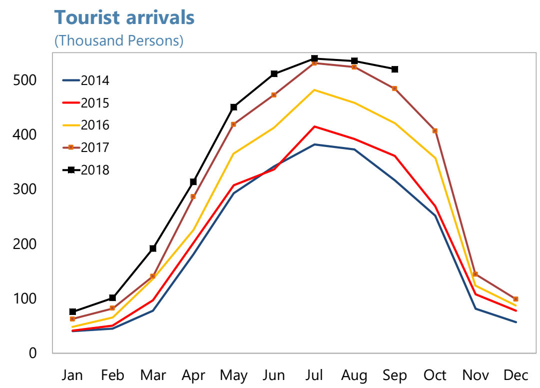
Sources: Cystat; and IMF staff estimates.



Sources: Eurostat and IMF staff calculations.

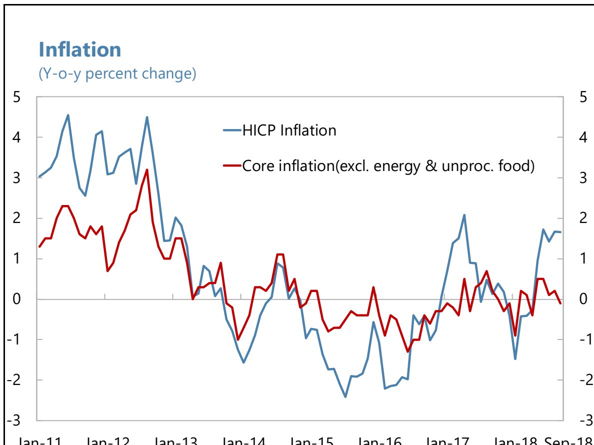


Sources: Cystat; JCC payments; and IMF staff calculations.

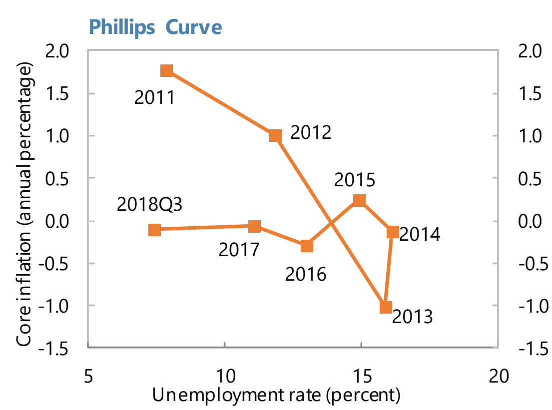


Source: Cystat.

3. Despite the narrowing output gap, inflationary pressures remain subdued (Figure 2). HICP inflation reached 1.7 percent (yoy) in September mainly reflecting stronger energy prices. However, core inflation dipped back into negative territory to -0.1 percent (yoy), consistent with weak wage pressures and continued labor market slack. While public sector wages are starting to pick up, spillovers to the private sector remain limited. The unemployment rate continued to decline to 7.4 percent in September from 10.2 percent a year earlier. However, the share of newly-created jobs that are part-time remains high and vacancy rates have remained broadly stable.



Sources: Haver Analytics; and IMF staff calculations.



Sources: CySTAT; Haver Analytics; and IMF staff calculations.

4. Although Cyprus has maintained export competitiveness, the underlying current account deficit has widened, and the external position remains weaker than warranted by fundamentals and desirable policy settings (Figure 3 and Annex II, External Sector Assessment)**.** The current account deficit rose to 8.4 percent of GDP last year, as the growth of imports (driven by strong domestic demand) outpaced that of exports and the primary income deficit widened. Adjusting for the effects of special purpose entities[2] and one-off purchases of airplanes, however, the deficit was much smaller, at 2.6 percent of GDP. Exports as a share of GDP remained at post-crisis highs for the four quarters through 2018:Q2, consistent with Cyprus's continued export competitiveness. Unit labor costs are subdued, the CPI and ULC-based REERs are near post-crisis lows, and export market shares are stable. The Fund's EBA-lite CA model suggests the external position is weaker than implied by fundamentals and desirable policy settings. This mainly reflects Cyprus's still large positive credit gap—a phenomenon that emerged because of the rapid expansion of credit in the lead-up to the crisis and has persisted amidst an overhang of NPLs—that contributes to high domestic absorption.[3]

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: -0.48)
CA[1]	0.9	-2.6	-3.5	7.2
ES[2]	-2.3	-2.6	-0.3	0.6
REER	…			14.7

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 corresponds to an external position that is weaker than implied by fundamentals and desirable policy settings.
2/ In the case of the External Sustainability approach, the "CA Norm" indicates the CA that would stabilize the net international investment position at -35 percent of GDP by 2023.

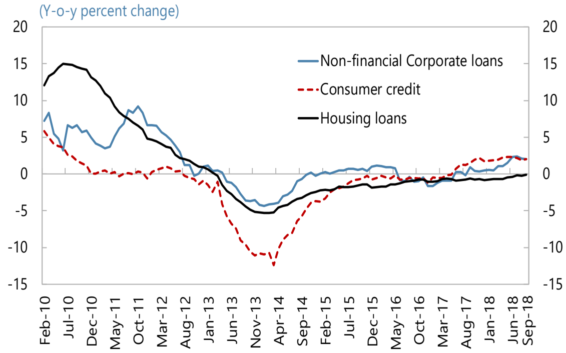
5. Overall net credit growth is weak, partly reflecting ongoing deleveraging and NPL write-offs (Figure 4). Outstanding credit to the non-financial private sector declined by almost 60 percentage points of GDP in September (yoy), to 149 percent of GDP, reflecting GDP denominator effects as well as write-offs, and sale or transfer of loans (see Box 1).[4] Net credit transactions, defined as pure new loans and accrued interest net of repayments (before write-offs), picked up by 1.9 percent for NFCs and 0.6 percent for households in September (yoy). In gross terms, annual growth in pure new loans has also been weak through September; however, pure new loans to households have increased, albeit from a low base. Bank liquidity remains ample. Customer deposits declined earlier in the year owing to deposit outflows in Cyprus Cooperative Bank (CCB) but have now broadly stabilized following recent government measures (Figure 5, Box 1, ¶12).

[2] SPEs have a limited footprint but introduce considerable volatility into import and export data. For more details on the impact of SPEs on external accounts, see 2017 Article IV external assessment.

[3] The assessment is based primarily on the CA model. The REER model, which relies on a CPI-based REER does not reflect the even more sizable depreciation of the ULC-based REER since the crisis (roughly twice as large as that of the CPI-based REER). Insights from the External Sustainability approach are limited due to recent sectoral trends in the net IIP data that appear to be driven by the central bank's holdings of foreign assets.

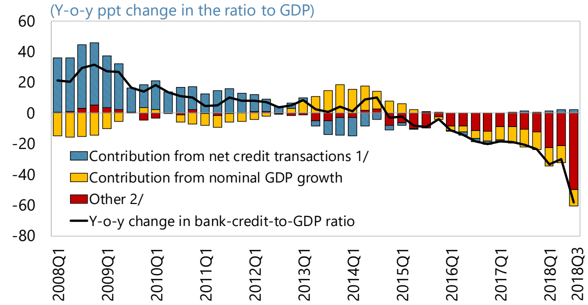
[4] Data on deposits, loans and debt include SPEs, unless noted otherwise.

Credit to Private Sector–Residents
(Y-o-y percent change)



Sources: Haver Analytics; and IMF staff calculations.

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

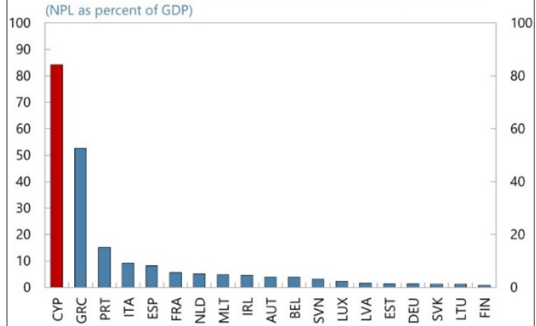


Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ "Net credit transactions" are pure new loans (excluding renegotiations) and interests accrued net of repayments (including debt-to-asset/equity swaps).
2/ Includes the contribution from write-offs.

6. The private sector debt overhang persists despite some deleveraging (Figure 4). Household gross debt declined by almost 15 percentage points of GDP last year, but remains very high at 100 percent of GDP in 2018:Q2. Nonfinancial corporate debt, which includes about 76 percent of GDP from SPEs, has also declined from 218 percent of GDP to 197 percent of GDP in 2018:Q2. The decline reflects GDP denominator effects, and increasingly, a combination of NPL write-downs, repayments and debt-to-asset swaps. Given substantial financial asset holdings, especially by households, net debt-to-GDP for households and NFCs stood at a much lower 72 percent of GDP in 2018:Q2 (excluding SPEs), a decline of 27 percentage points of GDP (yoy).

7. NPLs remain very high, in part due to weak enforcement and strategic debtor behavior, although they are now declining rapidly as bank balance sheet cleanup efforts pick up (Annex V). NPLs declined by €11.5 billion (of which €8.0 billion in corporate, mainly large enterprises, and €2.6 billion in households), lowering the size of NPLs from 161 percent of GDP (48 percent of loans) in 2014 to 84 percent of GDP (39 percent of loans) in 2018:Q2. The reduction reflects write-offs, restructuring, repayments with cash and debt-to-assets swaps, as well as new tools such as sale of loans.[5] The NPL ratio is set to decline further as they are removed from bank balance sheets, although they remain high and will be a burden on the economy until fully resolved. With the resolution of the CCB, NPLs which were initially left behind in a residual entity were moved to the newly-established Cyprus Asset Management Company, implying a substantial aggregate reduction in the NPL ratio of nearly 35 percent of GDP in 2018:Q3 (¶13, Box 1). Additional sales of NPLs to credit-acquiring companies have already begun. Nevertheless, NPL workouts remain challenging due to weaknesses in the legal framework for foreclosure and weak enforcement. As a result, the recovery rate has been low and the redefault rate among restructured loans has increased lately.

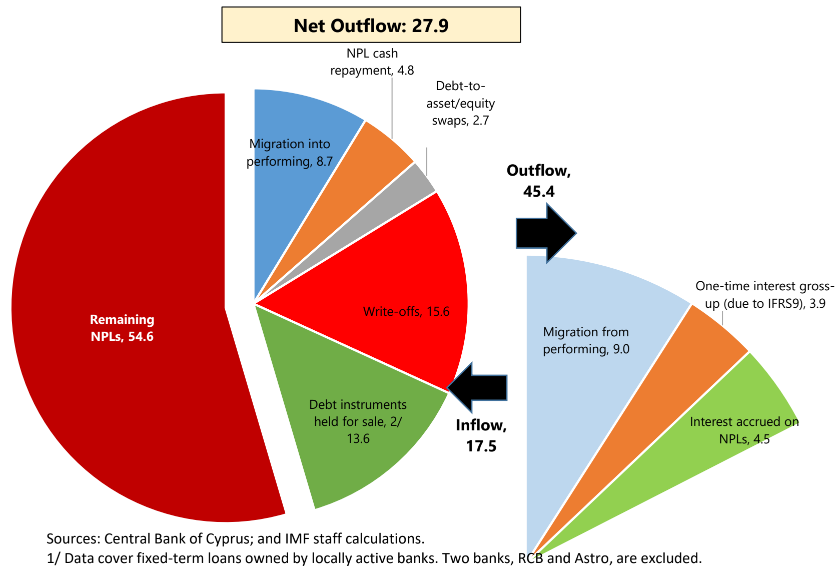
NPL-to-GDP Ratio in Euro Area Countries, 2018Q2
(NPL as percent of GDP)



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

[5] A sale by Bank of Cyprus of NPLs worth nearly 14 percent of GDP in 2018:Q2 accounted for nearly a third of the NPL outflows over the past year. The transaction currently is pending supervisory approval.

Cyprus: Flows of Non-Performing Loans 1/
(Q3:2017-Q2:2018. 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.
2/ The transaction currently is pending supervisory approval.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

8. **The near-term outlook for the economy is favorable.**[6] In the baseline scenario, growth is expected to remain at around 4.2 percent in 2018–19, driven by the continued strength of the tourism sector, largely foreign-financed investments in residential properties, education, health and tourism infrastructure, higher household disposable incomes and a slight easing of the fiscal policy stance. Inflation is projected to accelerate to close to 2 percent, pushed by rising food and energy prices and a closing output gap. The current account deficit is expected to widen, reflecting continued high construction-related imports and moderation in tourism revenues owing to the recent depreciation in some competitor and source markets, as well as slower growth of some trading partners.

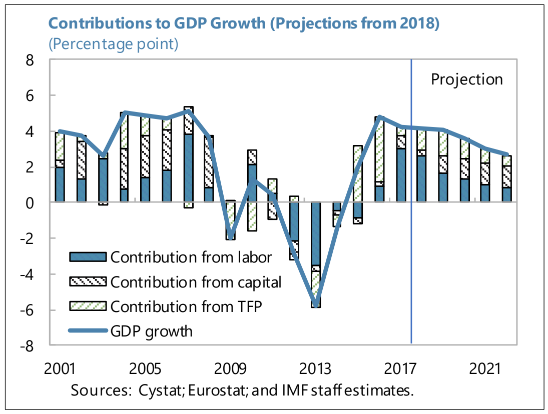
Cyprus: Selected Economic Indicators

	2017 Actual	2018 Proj.	2019 Proj.	2020 Proj.	2023 Proj.
Output					
Real GDP growth (%)	4.2	4.2	4.1	3.6	2.4
Prices					
Inflation rate (%)	0.7	0.9	1.8	1.9	2.0
General Government Finances					
Primary Fiscal Balance (% GDP)	4.3	5.1	5.0	5.0	4.8
Public Debt (% GDP)	96.1	106.1	99.7	90.3	68.1
Balance of Payments					
Current Account (% GDP)	-8.4	-4.1	-7.8	-7.4	-6.2

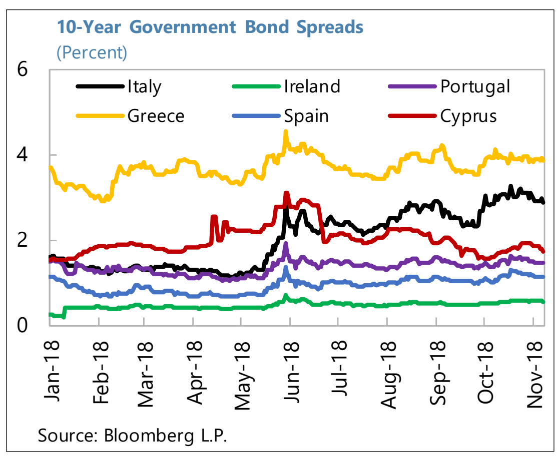
Sources: Central Bank of Cyprus; Ministry of Finance; CYSTAT; and IMF staff estimates.

[6] In late July, Moody's upgraded Cyprus's sovereign rating to Ba2 with stable outlook. In September and October, S&P and Fitch upgraded Cyprus's sovereign rating to BBB- (investment grade) with stable outlook, respectively

9. Over the medium term, economic growth is projected to slow to its long-run potential rate of around 2½ percent, as the transitory effects of the investment boom and strong euro area cyclical growth gradually dissipate. The current account deficit would narrow correspondingly on lower imports, while exports would remain relatively buoyant reflecting Cyprus's favorable external competitiveness. The baseline assumes gradual structural reforms and stronger enforcement to resolve NPLs. In particular, the recent approval of the amended legal framework for foreclosure and sales of loans is expected to incentivize NPL resolution and improve investor confidence by lowering systemic financial risks, supporting investment and longer-term growth, despite some slowdown in private consumption due to households' stepped up servicing of loans.[7] Implementation of the structural reform agenda is crucial for increasing investment and TFP growth and achieving the envisaged medium-term sustainable growth (¶12 and ¶25).



10. Risks to the outlook are tilted to the downside (Annex III. RAM). On the domestic front, implementation delays in NPL resolution could undermine investment prospects and growth and negatively affect the capital position of the banking system. An increase in moral hazard and realization of contingent liabilities from publicly supported schemes could exacerbate risks to debt sustainability arising from the sovereign-bank nexus (Annex IV. DSA). Increasing political pressure to unwind crisis-era fiscal measures could similarly slow the pace of debt reduction, increasing the sovereign risk premium and refinancing costs. High dependence on the construction sector, particularly financed through the CbI scheme, could undermine sustainability of growth. On the external side, risks arising from financial distress in other markets could have spillover effects for Cyprus given its high debt and external financing needs, although Cypriot sovereign bond yields have been driven largely by idiosyncratic shocks so far. Similarly, a sharp tightening of global financial conditions could induce capital outflows, raise interest rates and increase the stress on already highly-leveraged firms and households. Rising protectionist trade policies, a sharper-than-expected slowdown in euro area growth or a hard Brexit could also affect export revenues and FDI. On the upside, exploitation of offshore gas deposits could boost growth over the longer term. Faster progress in dealing with NPLs could attract additional FDI, increase credit flows, and strengthen economic growth.



[7] During major deleveraging episodes, the negative effect on private consumption tends to be larger than for output, reflecting an increase in net exports. For more detailed analysis, see the Selected Issues Paper accompanying the 2017 Article IV Staff Report, "Too Much of a Good Thing? Cyprus's Private Debt and a Path to Deleveraging," ¶15.

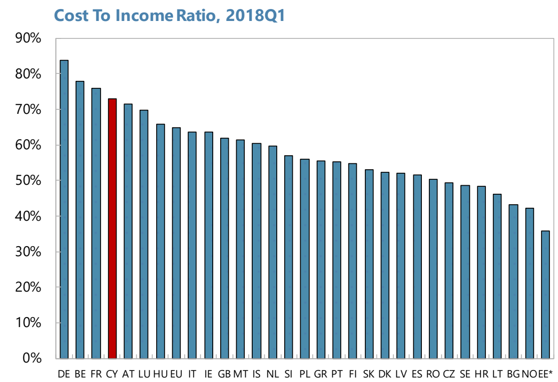
Authorities' Views

11. **The authorities considered medium-term growth prospects to be somewhat stronger and more resilient than staff projections** given the strong investor interest and a pipeline of investment projects in diverse fields in energy, tourism, health, and education. While NPLs are a risk to the financial sector, they are largely a legacy problem, which has not affected investor confidence drastically. They agreed that enhancing productivity will be key to sustaining higher growth, while labor market constraints on growth are less binding given Cyprus' high share of migrant workforce. They broadly agreed with the source of risks. Fiscal costs from the CCB transaction are already booked in public debt, and additional risks from contingent liabilities are contained. Given the high reliance on tourism from the UK, a hard Brexit poses risks through its impact on the exchange rate, although Cyprus has thus far benefitted from relocation of some companies. Increased trade protectionism and higher interest rates also pose additional external risks. The underlying current account deficit is expected to remain sustainable, supported by increasing export diversification, as well as the significant gains in price competitiveness since the crisis.

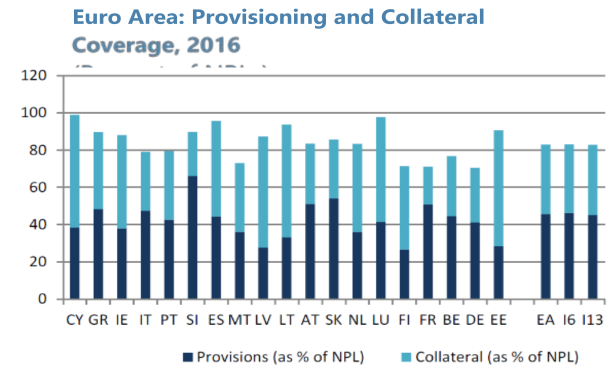
B. Financial Policies

12. **Legacies from the banking crisis continue to weigh on financial stability (Figure 5).** Narrow interest margins and higher NPL provisioning needs[8] are creating pressures on profitability, which is being further weighed down by an inefficient cost structure with excess staffing levels and too large branch networks in the banking system. Cyprus's provisioning level, at 49 percent of NPLs as of 2018:Q2, is around the EU average. The level of collateralization is high; however, foreclosure against collateral is cumbersome, undermining recovery values. Repairing bank balance sheets by lowering operational costs and strengthening collateral execution for NPL recovery is therefore a key policy priority, particularly as banks could come under increasing pressures for loss recognition as part of the NPL sales and workout process. In view of redefault of restructured loans, more specific regulatory guidance for banks is needed to achieve sustainable loan restructuring plans (i.e., loans with a low longer-term re-default probability) that maximize sustainable repayment capacity. In the face of increased competitive pressures and upcoming regulatory changes, continued vigilance over bank lending policies, adequacy of provisioning coverage and debt-to-asset swaps policy is also needed.

[8] New forward-looking provisioning rules (IFRS9), bail-in-able debt requirements (MREL) as well as the common minimum coverage levels of the European Commission and the ECB's supervisory expectation for prudential provisioning will also require additional capital and provisions. SSM's on-site inspections are scheduled later this year.



Sources: ECB (Structural Financial Indicators), Eurostat and ECB calculations.



Source: European Central Bank

13. To reduce vulnerabilities and catalyze NPL resolution, the authorities recently took two key steps:[9]

- In September, the assets (primarily performing loans) and all customer deposits of the troubled second-largest, government-owned bank (CCB) were sold to Hellenic Bank, leaving the bulk of the NPLs in a residual entity (see Box 1), which has evolved into a government-owned Asset Management Company (AMC).

- In July, the Parliament adopted a package of amendments to strengthen the legal framework for NPL resolution. Amendments to the sales of loans law, foreclosure law, bankruptcy law, company law, personal insolvency laws, and the regulation on insolvency practitioners (IPs) seek to strengthen incentives for creditors and debtors to engage in loan restructuring. A long-awaited securitization law was also adopted. Tax legislation was amended to extend exemptions from certain taxes and fees—previously only available for debt-to-asset swaps with banks—to cases where the borrower sells his house on the market as part of a debt restructuring or NPL repayment. To further facilitate NPL resolution through burden sharing, a subsidy scheme, *Estia*, was approved by the cabinet to support repayments by eligible debtors on loans collateralized by primary residence. (¶16).

14. Despite some shortcomings, approval of this legislative package marks an important step towards improving payment discipline and steadfast implementation will be key. The strengthened foreclosure and insolvency frameworks should discourage strategic defaults and help entice eligible borrowers to engage in durable loan workouts. These amendments include extending provisions on non-consensual personal repayment plans, clarifying the application of the new foreclosure procedure to legacy cases, simplifying debtor notification rules, and allowing the introduction of electronic foreclosure auctions.[10] At the same time, the amendments do not fully

[9] As agreed with the European Commission in the government's commitment list.

[10] See, e.g., *Cyprus—Second Post-Program Monitory Discussions*, IMF Country Report No. 18/153 (pp. 15–16), *Reforming the Legal Framework to Support Private Debt Restructuring* in Selected Issues Papers, IMF Country Report No. 17/376 (pp.43–44).

address other provisions that undermine incentives for debt restructuring.[11] Protections for guarantors—which were previously limited to legacy guarantees that were issued before the crisis[12]—have been rolled over and extended to guarantees issued post-2015. Little progress has been made toward fundamentally addressing the problems in the issuance and transfer of title deeds, further complicating potential restructuring or collection of the corresponding NPLs. Efforts to carry out judicial reforms (¶25) and to outsource the restructuring of NPLs to third-party loan services are also critical to the successful implementation of the legislative agenda.

15. It is essential to put in place a governance, operational and supervisory structure for the recently-established state-owned AMC to support payment discipline, maximize loan recovery and minimize fiscal costs. To avoid warehousing of assets and maximize returns, the entity should have a clear mandate accompanied by operational targets, a supervisory board consisting of a majority of independent members acting in the interest of the company first, and run by skilled management that is compensated based on performance. The mandate of the entity should be limited to managing the CCB's assets with a clear sunset clause to minimize fiscal costs. Transparent reporting will also be crucial for public accountability. More broadly, a regulatory and supervisory framework for the newly-established credit-acquiring companies, focusing on reporting requirements, on-site inspections and off-site monitoring, needs to be developed (Annex VI).

16. The subsidy scheme aimed at encouraging vulnerable borrowers to start servicing their loans could be better targeted. Although designed to ensure that the subsidy is contingent on performance, with a one-time backdated test date, the *Estia* scheme could be better calibrated to the individual borrower's repayment capacity and its eligibility criteria tightened.[13] Better targeting would help reduce moral hazard and avoid benefitting debtors who are able to service their obligations. The scheme should also help ensure a comprehensive debt solution to the borrower's excessive debt and should complement the insolvency framework without undermining it.

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[11] See Box 2 in *Reforming the Legal Framework to Support Private Debt Restructuring* in Selected Issues Papers, IMF Country Report No. 17/376. For example, protection of non-viable debtors that can be granted by the courts was not eliminated but rather reduced not to exceed one year in total. Also, the preferential right of the debtor to buy the property at the foreclosure sale was limited but only regarding debtors who are receiving assistance under the new subsidy schemes for primary residence mortgages.

[12] See Box 4 in *Reforming the Legal Framework to Support Private Debt Restructuring* in Selected Issues Papers, IMF Country Report No. 17/376.

[13] While still under discussion, key parameters for eligibility to the scheme include household income not exceeding €50K, market value of the primary residence not exceeding €350K, remaining net household wealth not exceeding 125 percent of the market value of the primary residence. No threshold exists for the size of the property. The subsidy payment is fixed at one-third of the borrower's installment for all eligible households. The state subsidy will be paid at the end of each year, once a confirmation is received from the bank that borrower has been current on his/her obligations, and with clawback provisions for redefaults. The scheme is estimated to cost 0.1-0.2 percent of GDP annually.

Box 1. The Sale of the Cyprus Cooperative Bank (CCB)

The CCB's poor asset quality is one of the main legacies from the banking crisis. Restructuring efforts began in 2014, but the bank has struggled in tackling its NPLs given its heavy exposure to residential mortgages. In March, the state-owned bank initiated a search for private investors. To strengthen its asset quality and funding structure in preparation for the sale, the government initially placed €2.35 billion of bonds and cash (with an additional €1.15 billion being placed at a later stage) matched by a corresponding amount of deposits.

In June, the acquisition of the "performing assets" and all customer deposits of the CCB by Hellenic Bank (HB), the third largest bank in the country, was approved and subsequently deemed compatible with state aid rules by DG COMP. On July 8, the Parliament also approved two asset protection schemes (APS) included in the transaction. The assets involved are worth €10.3 billion and consist of government bonds, loans including a relatively small amount of NPLs, and cash, matched with customer deposits on the liability side. The deal also entailed a capital increase of €150 million for the acquirer. With the HB's (old) assets worth €6.7 billion, this acquisition has led to a bank with assets worth about €17 billion, the second largest bank behind the Bank of Cyprus whose assets are €23.4 billion. "Bad assets" of €8.3 billion in gross terms have been left in the residual entity, together with the government deposits on liability side. Servicing of these assets will be outsourced to a private company. The residual entity has since evolved into an asset management company.

Transaction of the CCB
(Billions of euro)

(A) Portfolio acquired by HB

Assets	**10.3**	**Liabilities**	**9.8**
Government bonds	4.1	Customer deposits	9.7
Loans, net of provisions	4.6	Others	0.1
o.w. NPLs, net of provisions	0.4		
Cash	1.6	**Equity**	**0.5**

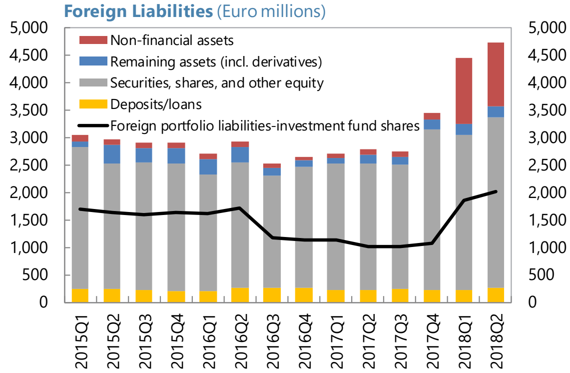
(B) Residual Entity

Assets		**Liabilities**	
NPLs (gross book value)	7.0	Government deposits	3.5
Performing loans	0.5		
Immovable property and other assets	0.9		

The fiscal cost of the CCB deal is expected to be around €3.5 billion (17 percent of GDP) plus contingent liabilities. The direct and contingent cost includes (i) a total of nearly €3.5 billion of bonds and cash placed by the government to support the bank; (ii) APS covering unexpected losses of a portfolio with a net value of €2.6 billion, although the authorities expect that contingent liabilities related to these APSs will be limited to €155 million, based on an assessment by an independent auditor; (iii) exchange of previously-issued bonds for shorter maturity bonds to be paid out over the next five years, increasing annual gross financing needs by €0.5–0.75 billion; and (iv) redundancy payments to about one-third of the 2,600 staff, estimated at €128 million. Staff's baseline debt sustainability analysis (DSA) assumes neither a guarantee call on the APS schemes, nor any recovery from the NPLs in the AMC. However, even if a significant share of APS contingent liabilities are realized, with little recovery from assets, the impact would be less than the assumed contingent liability shock in the DSA.

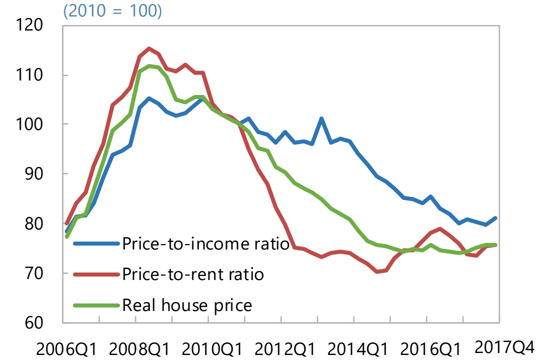
17. Risks arising from the property market appear to be limited for now but warrant close monitoring (Figure 6). Overall property prices are rising only moderately, although the luxury segment is picking up more rapidly with the support of the CbI scheme as are investment fund flows into non-financial assets. An unsustainable increase in construction activity in the luxury segment should be avoided. 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. If construction in the luxury market were to become reliant on domestic credit, tightening macroprudential measures would be appropriate. Reinstating the immovable property tax (IPT) and raising the transfer duty on immovable property would provide additional countercyclical tools. Compliance with AML/CFT standards by the sectors involved in the CbI scheme and supervision of those sectors for compliance with requirements should be ensured

Investment Funds - Assets Under Management and Foreign Liabilities (Euro millions)



Source: Central Bank of Cyprus.

Residential Prices: Standard Metrics (2010 = 100)



Sources: IMF Real Estate Markets Module.

Authorities' Views

18. The authorities agreed with staff that NPLs are yet to be resolved in an economic sense, while noting that a more enabling environment is now in place. The strengthened legal tools will allow banks to incentivize sustainable restructuring of loans by creating a credible threat of foreclosure, or to execute on the collateral if no viable restructuring can be achieved. With the removal of a sizable share of NPLs from the banking system following the CCB transaction as well as recent sales of NPLs by credit institutions and banks equipped to offload further NPLs from their balance sheets, the Cypriot authorities considered that their resolution should be able to progress without the pressure to increase provisions and capital requirements within a limited amount of time. Further sales of NPLs by banks are expected. However, a gradual approach in the resolution of NPLs is needed on account of the magnitude of this legacy problem. They agreed that given the pressure on bank profitability, banks' risk management needs to be closely supervised, focusing on restructuring and on the management of real estate assets, and operational efficiency should be improved.

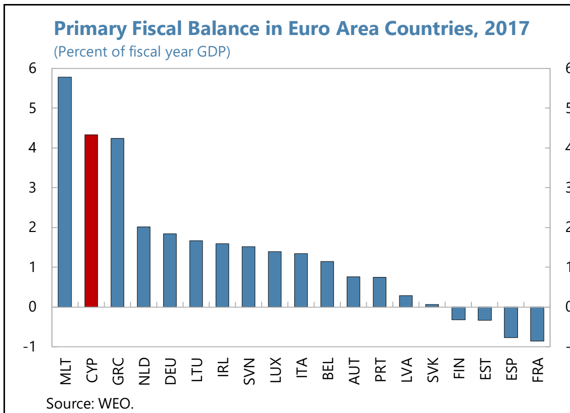
19. The Ministry of Finance underscored that that the proposed burden sharing subsidy scheme, *Estia*, is an important catalyst for resolving a difficult segment of the NPL portfolio. It has already helped forge a political consensus for strengthening the foreclosure and insolvency regime and would support banks against the reputational risk of foreclosing on primary homes.

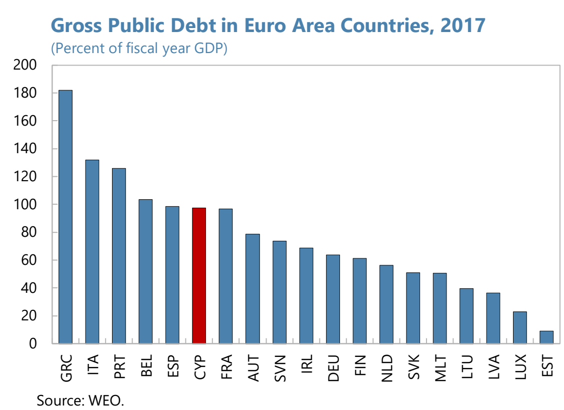
Nevertheless, following discussions with the IMF and EU Institutions, options to tighten the eligibility criteria will be considered by the authorities.

20. The Central Bank of Cyprus agreed on the need to complete the regulatory and supervisory framework for the newly-licensed credit-acquiring companies and the governance framework for the state-owned AMC. For the latter, a new board and management are expected to be in place by year-end. Potential dividend upsides from the AMC exist over the long-run, but the objective would be to recover the loans at a steady pace in order to respect financial stability considerations. The property market is only now recovering after a sharp downturn following the crisis and upward price pressures remain contained. The national authorities have already placed limits on the CbI scheme that benefits the luxury market segment.

C. Fiscal Sector

21. Fiscal performance has been strong, largely reflecting the economic recovery (Figure 7). The general government primary balance improved from 3.0 percent of GDP in 2016 to 4.3 percent of GDP in 2017. Public debt has declined by 9 percentage points to a still-high 96.1 percent of GDP. Fiscal performance through August shows strong revenue overperformance driven by VAT collections while spending remains contained. Staff projects further improvement of the primary balance to 5.1 percent of GDP in 2018, broadly in line with the authorities' projections, due to stronger-than-expected revenues, mainly VAT, and subdued expenditures, despite a reversal of crisis-era public wage cuts starting from July, and a decline in other revenues (text table).[14] The fiscal support for the CCB is expected to lead to a one-off spike in public debt this year.[15]





22. Under the baseline scenario, the fiscal structural balance is expected to weaken slightly next year and to stabilize thereafter. Although social contributions will rise with the legislated increase in contribution rates in 2019, the structural primary balance is projected to

[14] In its latest assessment, the EC indicated that Cyprus is projected to be compliant with the requirements of the preventive arm of the Stability and Growth Pact for 2018 and 2019 with the structural balance well above the medium-term objective (MTO).

[15] Treatment of the support in the fiscal account has yet to be decided by the Eurostat.

worsen by ½ percent of potential GDP, reflecting the planned cut in the interest levy, the introduction of the *Estia* scheme, a decline in EU transfers, and likely increases in health expenditures following the rollout of the National Health System starting next year.[16,17] The gradual reversal of crisis-era wage cuts that started in 2018 is expected to halt the 5-year decline in the wage bill measures as a percentage of GDP. Over the medium term, the structural primary surplus is expected to remain broadly unchanged and the primary surplus to stabilize at around 5 percent of GDP.

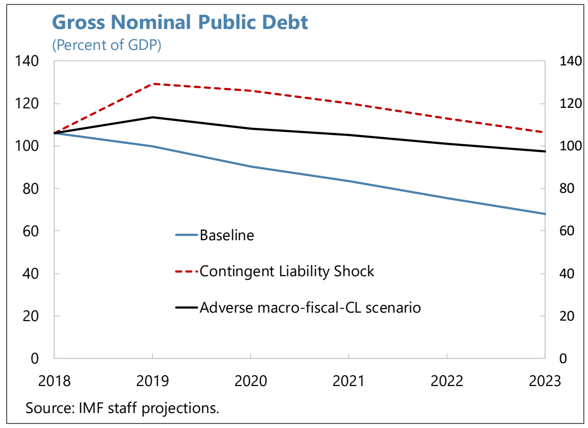
Cyprus: Fiscal Targets, 2017–23

	2017	2018	2019	2020	2021	2022	2023
	Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
2019 Draft Budget Plan			(Percent of GDP)				
Total revenue	39.0	39.8	39.4	...	...	...	...
Total expenditure	37.3	36.9	36.3	...	...	...	...
Overall balance	1.8	2.9	3.1	2.9	2.8	...	...
Primary balance	4.3	5.4	5.6	...	...	...	...
Gross public debt	95.7	104.2	97.2	90.8	84.6	...	...
Structural balance (Percent of potential GDP)	1.4	1.9	1.7	1.2	0.9	...	...
Staff projections							
Total revenue	39.0	39.7	39.0	38.2	38.1	38.1	38.0
Total expenditure	37.3	37.0	36.5	35.5	35.3	35.3	35.2
Overall balance	1.8	2.7	2.5	2.6	2.8	2.8	2.8
Primary balance	4.3	5.1	5.0	5.0	5.0	4.9	4.8
Gross public debt	96.1	106.1	99.7	90.3	83.3	75.4	68.1
			(Percent of potential GDP)				
Primary balance	4.2	5.1	5.0	5.1	5.1	5.0	4.8
Revenue	38.1	39.5	39.2	38.7	38.7	38.6	38.4
Cyclically-adjusted tax revenue	33.7	34.8	34.9	34.6	34.6	34.6	34.6
Cyclical tax revenue	-0.8	-0.2	0.3	0.5	0.6	0.5	0.4
Other revenue	5.2	4.9	4.1	3.6	3.6	3.5	3.5
Primary expenditure	33.9	34.4	34.2	33.7	33.6	33.6	33.6
Cyclically adjusted primary expenditure	33.8	34.3	34.2	33.7	33.6	33.7	33.6
Cyclically-adjusted primary balance	5.1	5.3	4.7	4.5	4.5	4.5	4.4
Structural primary balance	4.6	4.7	4.3	4.5	4.5	4.4	4.4
Output gap (percent of potential GDP)	-2.3	-0.6	0.7	1.5	1.6	1.4	1.0
Memorandum							
Primary balance implied by the expenditure rule		5.1	4.9	4.6	4.7	4.7	4.7

[16] Key measures and costs include cut of interest levy (-.2 percent of GDP), public wage cut reversal (by about -.2 percent of GDP *per year* in 2019–23), *Estia* scheme (-.2 percent of GDP), and increase in social security contribution rate (+.4 percent of GDP). Staff also assumes increased social transfers (-.1 percent of GDP) associated with NHS introduction.

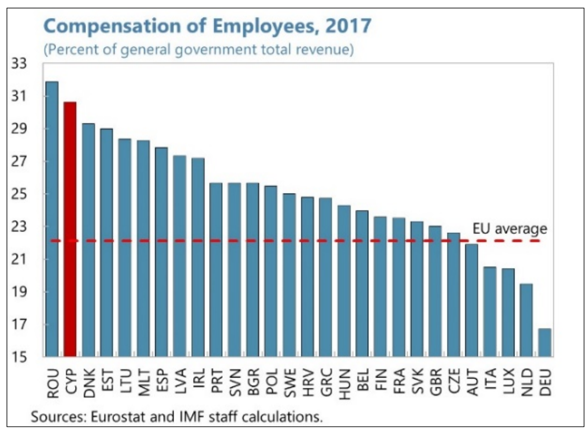
[17] The revenues and social transfers under the new NHS, which the authorities expect to be deficit neutral, is not included in the fiscal accounts. However, staff has incorporated a modest additional spending (+.1 percent of GDP) for 2019–21 given risks from the need for the adjustment of public hospitals to a new market environment (Annex VII).

23. Strict spending discipline should be maintained to ensure a firmly declining debt path. Under the baseline scenario, public debt is expected to decline to below 70 percent of GDP by 2023, from a peak of 106 percent of GDP in 2018 (Annex IV. DSA). Nevertheless, contingent liabilities in the banking sector, including those related to the sale of the CCB, add to the risks to debt sustainability.[18] Additional key risks arise from increases in the wage bill, court cases related to public wage cuts and unfunded liabilities of SOEs. The introduction of the National Health System would likely increase public spending pressures and risk of arrears. An adverse scenario with lower-than-projected economic growth, erosion of the primary surplus, and realization of further contingent liabilities from the banking sector would significantly worsen the public debt dynamics (Annex IV). Limiting expenditure growth to medium-term economic growth—which implies maintaining a primary surplus above 4¾ percent of GDP over the medium term—will thus be crucial to ensure a firm decline in debt and sustained market confidence. More specifically,



Gross Nominal Public Debt
(Percent of GDP)
Source: IMF staff projections.

- ***wage bill*** growth should be firmly kept below nominal GDP growth by containing annual increments, staffing, COLA and general wage increases, while the civil service reform should be enacted.



Compensation of Employees, 2017
(Percent of general government total revenue)
Sources: Eurostat and IMF staff calculations.

- With the introduction of ***public health insurance*** (*National Health System*), a strict monitoring and regulatory framework is needed, including for assessing health treatments and controlling the cost of services. Provider payment mechanisms need to adequately manage incentives, given the expected pickup in demand (Annex VII).

- ***Public financial management reforms*** would help strengthen spending control (¶25). Proceeds from the NPL recovery in the CCB's residual entity should primarily pay down debt rather than finance new spending. In view of the higher financing needs owing to the CCB transaction, higher cash buffers would help guard against market volatility.

Authorities' Views

24. The Ministry of Finance agreed on the need to maintain strict spending discipline to avoid procyclical policies. Cyprus remains firmly committed to keeping expenditure growth below

[18] The fiscal impact of the inclusion of the AMC in fiscal accounts is yet uncertain.

the medium-term GDP growth rate. The gradual reversal of the crisis-era wage cuts, in effect until 2023, will also be implemented within the current policy of a ceiling of nominal GDP growth on the wage bill. They noted, however, that risks to the budget from contingent liabilities from NPLs are limited as any calls on the APS guarantees would be met fully through the AMC without drawing on the budget. Potential dividends from the AMC would be used towards reducing the debt burden, although the MOF has maintained conservative assumptions of no such revenues. In the health sector, they agreed on the need to closely monitor fiscal risks from the new health insurance but considered that a global budget should help contain such risks and an actuarial assessment will be undertaken every 3 years following the implementation of the NHS, as required by law.

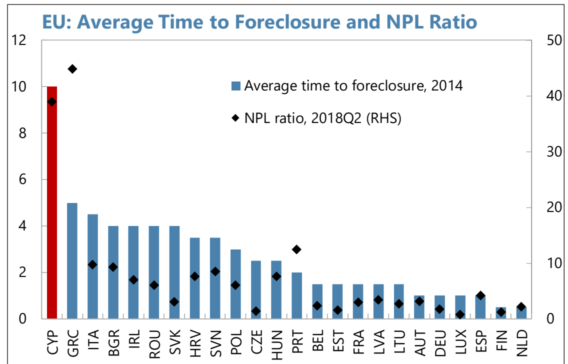
D. Structural Reforms

25. Structural institutional reforms are needed to improve competitiveness, the investment climate and long-run potential growth (Figure 8). Business climate indicators suggest key challenges in enforcing contracts owing to lengthy judicial processes[19] and weaknesses in government effectiveness reflecting administrative inefficiencies.

Advancing Judicial Reform and Commercial Claims Enforcement:

- **Greater judicial efficiency is key to reducing the cost of capital and improving access to financing and investment.** The effectiveness of the recently approved amendments to the foreclosure and insolvency legal frameworks hinges on reforming judicial processes. A recent functional review of courts has identified significant deficiencies in management, structure and infrastructure as well as in processes and procedures leading to major delays and backlogs in the courts. Several measures are crucial to accelerate judicial reform: the introduction of a dedicated commercial court with specialized judges to deal with large commercial cases; reform of the civil procedure code; rationalizing appeals; clearing the backlog of cases; and introduction of e-justice system. Continued efforts to strengthen other institutional frameworks, including the Insolvency Service and Insolvency Professionals, are also important. A system of timely issuance and transfer of title deeds to immovable property should be put in place, while clearing the existing backlog expeditiously.

EU: Average Time to Foreclosure and NPL Ratio



Sources: Central Bank of Cyprus; EBA; and Aiyar and others (2015).

Strengthening Public Sector Governance and Government Effectiveness:

- *Fiscal governance and public administration reforms:* Public financial management could be strengthened through better internal controls for financial management and monitoring of risks

[19] It takes more than a thousand days to enforce a contract in Cyprus—nearly twice the euro area average. The backlog of cases is among the highest in the EU and rising. See 2017 SIP for further details.

from local government and public bodies including SOEs. In particular, improving corporate governance of commercial state-owned enterprises, including through strengthening financial oversight, implementing a more effective planning and reporting framework with greater disclosure and transparency, and introducing a code of conduct consistent with OECD principles are key to improving the efficiency of commercial SOEs. Pending legislation to reform the assessment of candidates for appointments and promotions and review the civil service structure would facilitate greater mobility and enhance efficiency. Local government reform would also help improve service delivery.

- *Central bank governance*: Legislative efforts currently underway would strengthen the governance and autonomy of the Central Bank of Cyprus (CBC). The amendments seek to improve the CBC's governance by establishing an Executive Committee as an additional governing body, strengthen the personal autonomy of the members of the Executive Committee and the Board members, and enhance its financial autonomy by prescribing automatic recapitalization below a certain capital threshold.

- *AML Reforms:* Efforts to effectively mitigate existing inherent AML/CFT risks are a key priority, also as part of their preparation for the upcoming MONEYVAL AML/CFT assessment. These inherent AML/CFT risks, as well as any subsequent negative assessment report if risks would not be effectively mitigated, could both have a macro-critical impact (e.g. CBR pressures). These inherent AML/CFT risks cover a broad range of issues, related among others to the absence of a common EU-wide AML/CFT supervisory framework, and gaps in preventive measures, transparency of beneficial ownership, international cooperation, financial intelligence and investigations.

26. Policies should be geared to ensure more inclusive growth (Figure 9). While youth unemployment has declined since 2013, it remains high at about 19 percent in 2018:Q2. Despite high tertiary educational attainment, the employment rate for recent tertiary graduates remains below the EU average mainly due to mismatches. Furthermore, the high unemployment rate, compared to pre-crisis levels, may also reflect loss of skills due to long-term unemployment. Several Active Labor Market Policies (ALMPs) targeting the youth, as well as vulnerable groups have been launched. Proper monitoring and evaluation would help ensure their effectiveness. In addition to efforts to diversify the economy toward higher value-added sectors, strengthening the education system to provide more intensified individual support, labor-market-oriented curricula, and dual-education apprenticeships better linking work-based and school-based programs could help reduce youth unemployment.

Authorities' Views

27. The authorities agreed that advancing structural reforms is a key priority. Hiring of new judges and broader court reforms that would reduce delays in the adjudication of commercial claims and further facilitate the implementation of insolvency and foreclosures framework to support NPL resolution are underway. They acknowledged that progress has been slower in dealing with the problems with unissued and un-transferred title deeds, including due to judicial interpretation of the law to facilitate title deeds transfers. Reforms in local government should help improve efficiency of service delivery, including the issuance of building permits. Efforts are also underway to improve government efficiency through partial privatization of some state-owned enterprises and their stronger financial oversight. In the labor market, they also pointed out that youth unemployment has halved since its peak and only constitutes around 2 p.p. of the total unemployment rate. Nevertheless, they agreed that skills mismatch remains a challenge and that economic diversification and growth in high skills service sectors are needed to address these challenges.

STAFF APPRAISAL

28. The Cypriot economy continues its rapid recovery and the near-term outlook remains favorable. Growth has been strong over the past three years and is expected to exceed 4 percent in 2018–19, driven by domestic demand. Over the medium term, as the transitory effects of the investment boom and solid euro area cyclical growth gradually dissipate, growth is expected to slow to potential. Sustaining high medium-term growth will require progress in structural reforms, which are crucial for lowering systemic financial risks and catalyzing productivity-enhancing investments. The external position remains weaker than warranted by fundamentals and desirable policy settings.

29. Important strides were made in addressing key vulnerabilities in the banking sector. Notwithstanding the economic recovery, the Cypriot economy has been weighed down by very high private and public debt. NPL ratios, while declining, are still among the highest in Europe. The recent sale of the assets of the government-owned CCB, which was Cyprus's second-largest bank, and the passage of a long-delayed legislative package to strengthen the insolvency and foreclosure frameworks, have reduced near-term risks to financial stability, albeit at a high cost to the public purse.

30. Steady declines in NPLs and in high corporate and household debt remain a priority in order to address the large debt overhang and the weak external position. The amendments to the foreclosure and insolvency legislation, the sales of loans law, and the adoption of a law on securitization all enhance the toolkit available to borrowers and creditors to address NPLs on a durable basis. Steadfast implementation of the enhanced frameworks will be key to facilitate this process and ensure timely enforcement. The new frameworks should be supplemented by structural reforms aimed at strengthening institutions, especially the court system, and removing uncertainties related to title deeds.

31. The supervisory and governance framework for credit-acquiring companies—which includes the recently-established CAMC—needs strengthening. Sales of NPLs to credit-acquiring companies have already begun, making it urgent for the central bank to develop a regulatory and supervisory framework for these institutions. The governance framework for the government-owned CAMC needs to adequately balance operational independence with public accountability and transparency.

32. The proposed *Estia* scheme to encourage distressed borrowers to begin servicing their loans should be better targeted to limit moral hazard risks from strategic defaults. Tighter eligibility criteria and appropriate assessment of a borrower's capacity to repay the restructured debt on a sustained basis will be important to be sure that those in need of assistance emerge from the process able to make good on their new obligations. Banks should maintain provision coverage at adequate levels and promptly utilize the foreclosure and insolvency framework to address re-defaults.

33. Efforts to strengthen bank balance sheets should continue. Diversifying income sources and consolidating operations are needed to improve cost-income ratios and better position banks in anticipation of regulatory changes and higher competitive pressures. Furthermore, a focus on bank lending policies, sustainability of restructurings, adequacy of provisioning coverage and debt-to-asset swap policies would encourage sound bank risk management practices.

34. With public debt already elevated, strict spending discipline should be maintained. While fiscal performance is expected to remain robust with large primary fiscal surpluses, caution is needed to guard against procyclical fiscal pressures. Transitory revenues arising from cyclical gains and one-off measures should not be relied upon to finance permanent spending initiatives, while expenditure rises should be capped by the rate of medium-term GDP growth. Keeping the rise of the public wage bill envelope within the rate of nominal GDP growth will be especially crucial to cap overall spending growth and create room for growth-enhancing spending. The transition to public insurance in the health sector will need to be carefully managed.

35. Fiscal structural reforms are needed to lower risks to the budget and strengthen service delivery. Public financial management could be strengthened through better internal controls for financial management and monitoring of risks from local government and state-owned sector. Improving corporate governance of commercial state-owned enterprises is also key to improving the efficiency of the state-owned sector. Legislative efforts to strengthen the governance and autonomy of the Central Bank of Cyprus should also be expedited, and AML/CFT risks should be mitigated.

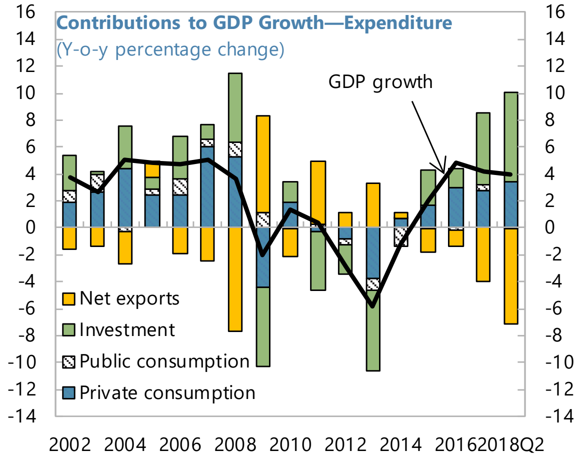
36. Institutional reforms are needed to further enhance the investment climate, and bolster productivity and medium-term growth potential. Reforms to increase the efficiency of courts, clear the backlog of cases, and speed up enforcement of commercial claims should be pursued to reduce cost of capital and improve access to financing and investment. Persistent delays with issuance and transfer of title deeds should be addressed expeditiously, focusing on clearing the backlog but also on avoiding a recurrence of similar problems in the future.

37. Ensuring inclusive growth is crucial not just to equity but also to the sustainability of the recovery. Polices to address the high youth unemployment and skills mismatch such as through ALMPs and investments in higher value-added sectors are needed.

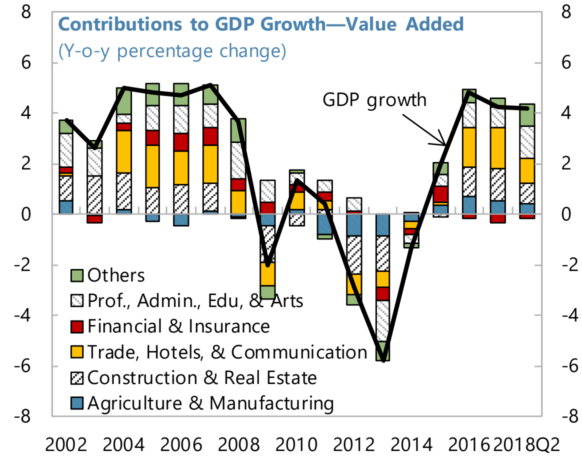
38. It is recommended that Cyprus remains on the standard 12-month Article IV consultation cycle.

Figure 1. Cyprus: Macroeconomic Performance

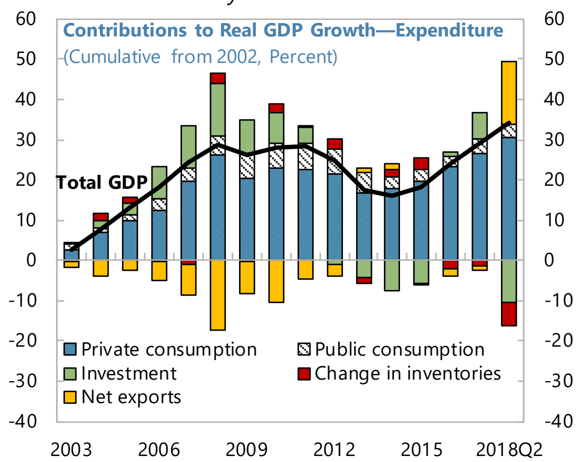
Economic recovery has been strong….



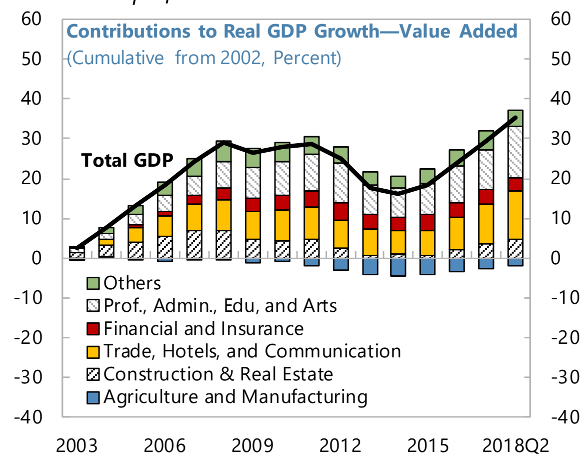
…supported by tourism, professional services and construction and real estate.



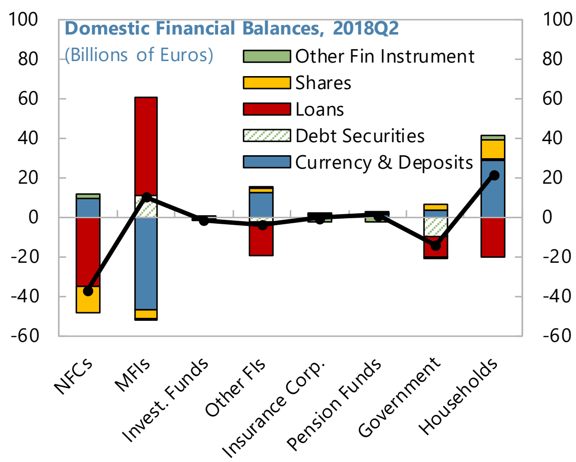
In cumulative terms, private consumption has contributed the most to the recovery….



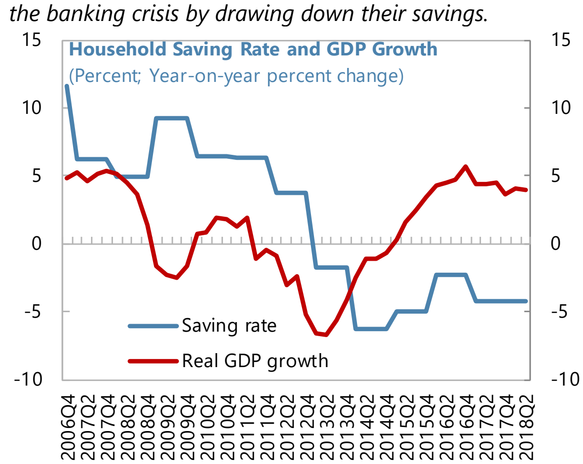
…while on the production side, the main drivers have been tourism and professional services.



Households' financial net worth is positive…



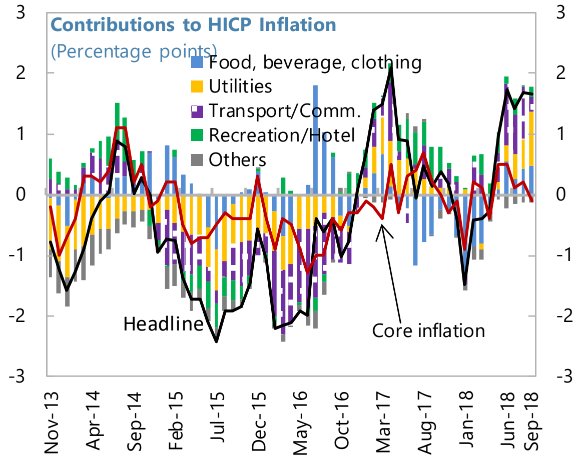
…which has allowed households to counter the impact of the banking crisis by drawing down their savings.



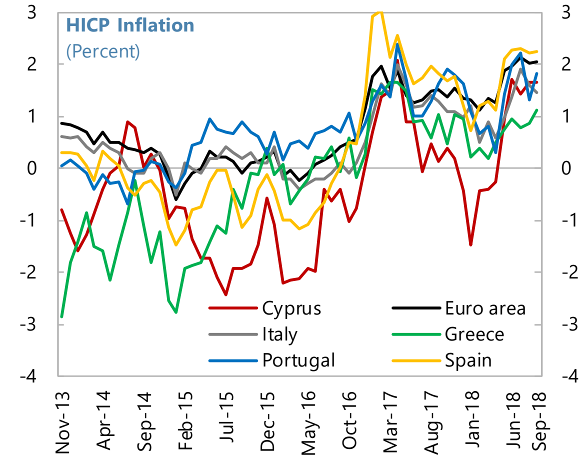
Sources: Central Bank of Cyprus, ECB, Eurostat, Haver Analytics, and IMF staff calculations

Figure 2. Cyprus: Inflation and Labor Market

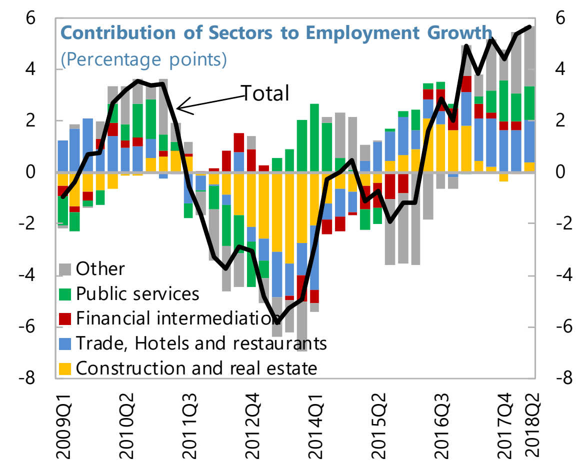
Inflation turned positive, but core CPI inflation is still muted...



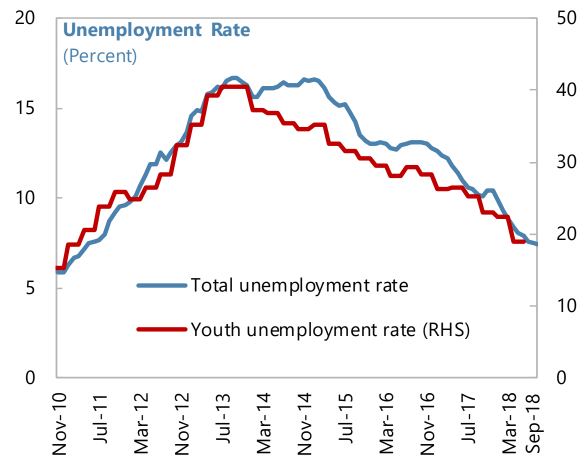
...and CPI inflation remains lower than in other euro area countries.



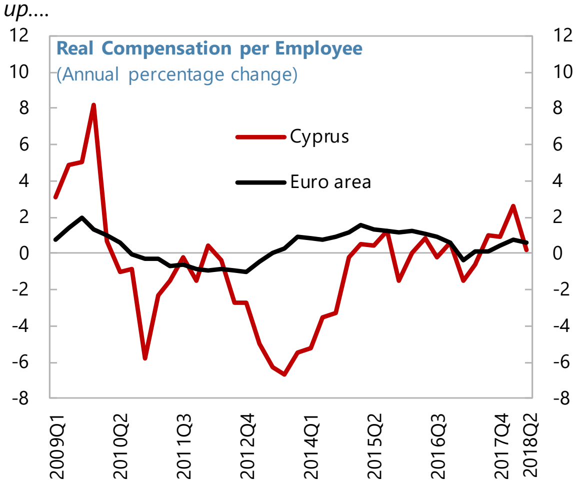
Employment has been rising especially in the tourism sector...



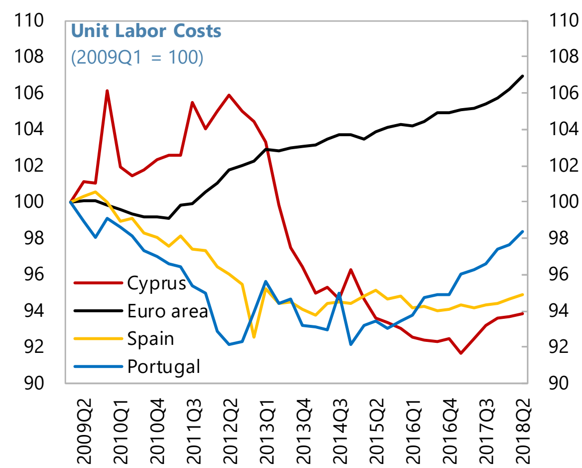
...pushing the unemployment rate down.



Compensation of employees only recently started picking up....



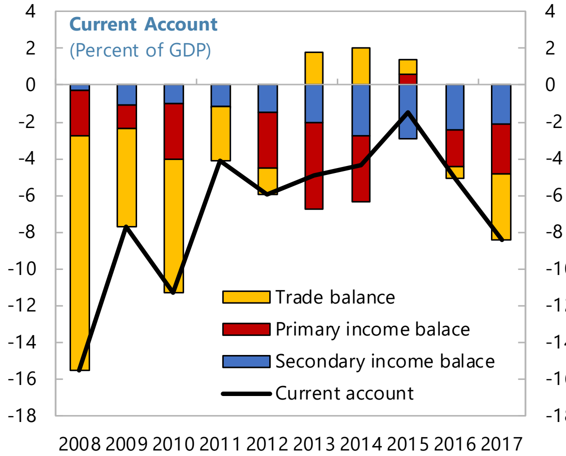
...keeping unit labor cost in check.



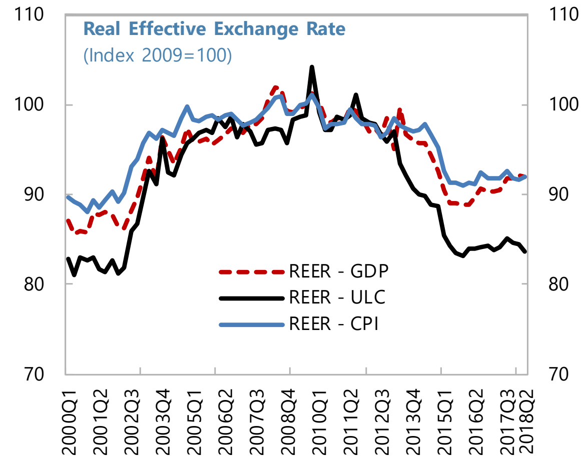
Sources: Cystat; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 3. Cyprus: External Indicators

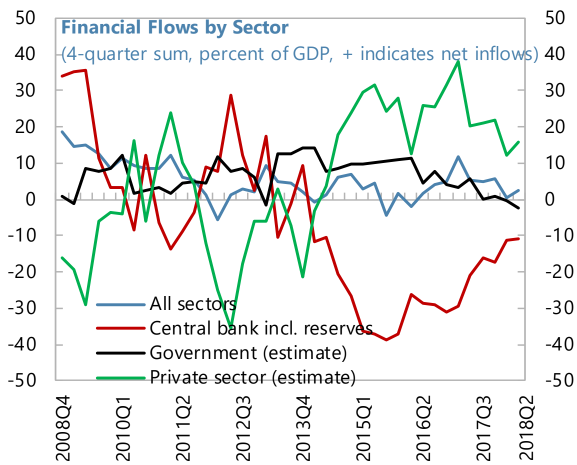
The overall current account deficit has been widening in step with trade and primary income balances.



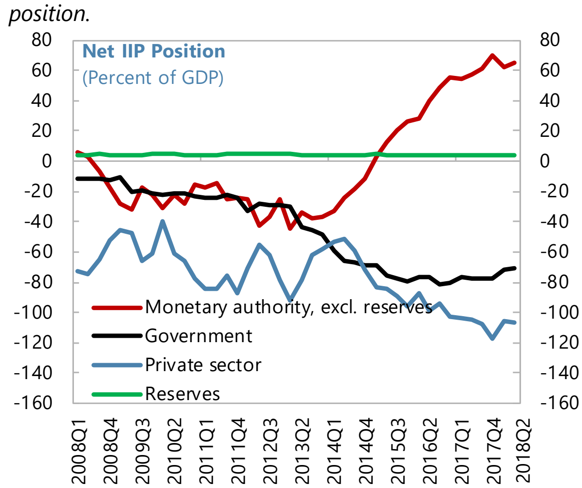
The real effective exchange rates are near post crisis lows.



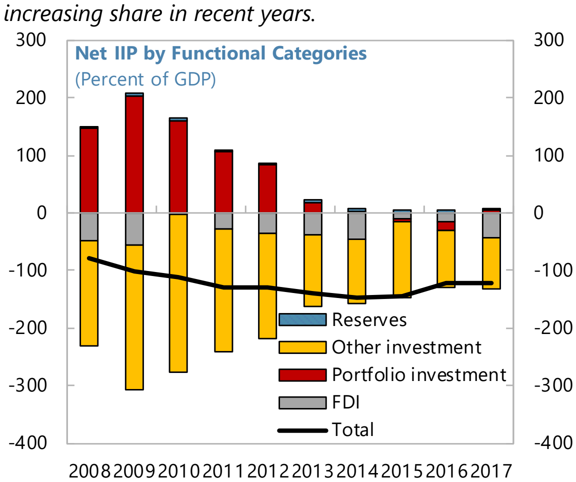
Both capital inflows to the private sector and capital outflows from the CBC have been large.



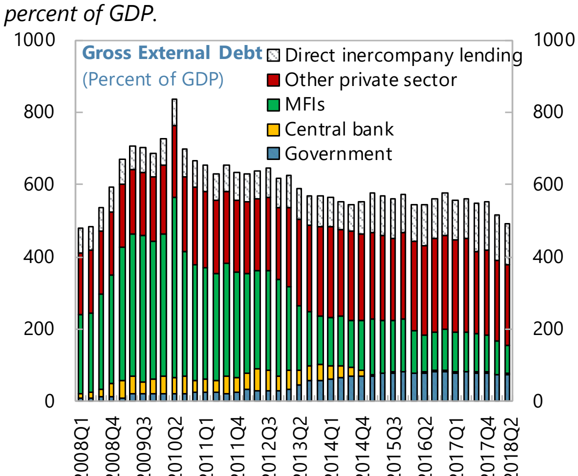
The CBC has a large positive net IIP position while the private sector (including SPEs) has a large negative position.



Net IIP remains highly negative with FDI having an increasing share in recent years.



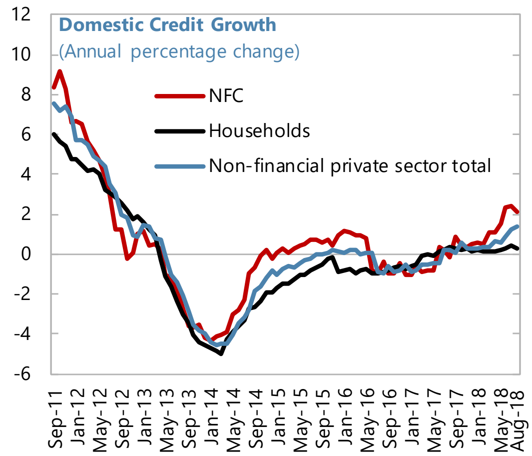
Led by MFIs, gross external debt has fallen to below 600 percent of GDP.



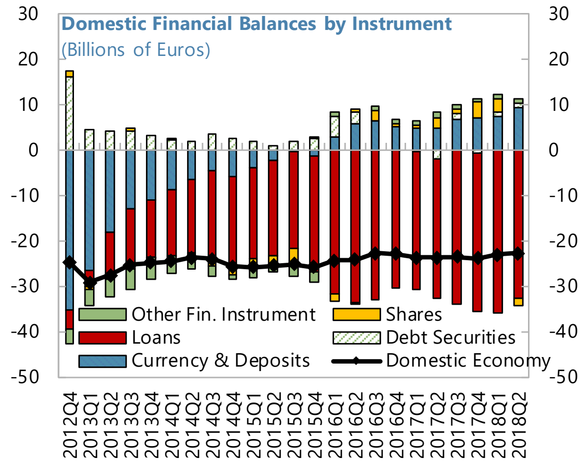
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Credit and Balance Sheets

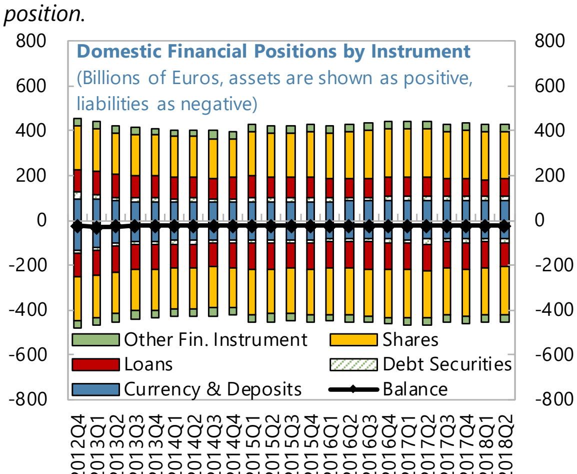
Domestic credit points to early signs of modest expansion…



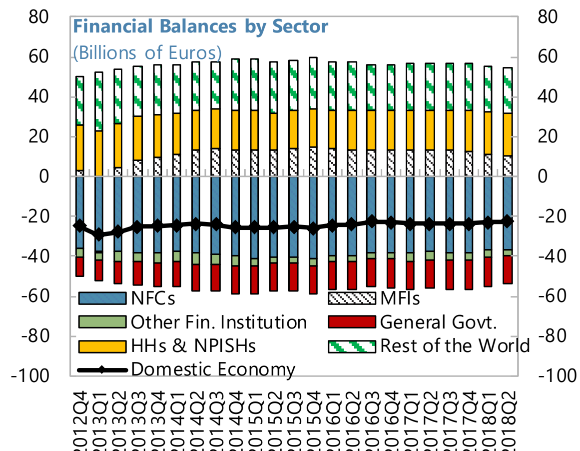
…as highlighted more clearly by the net financial balances.



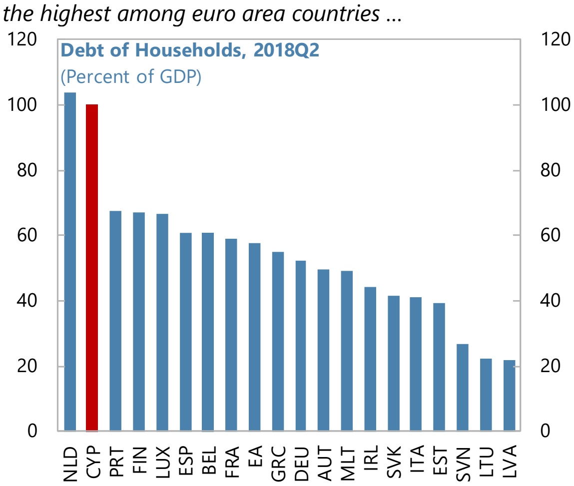
Loans explain most of the current negative financial position.



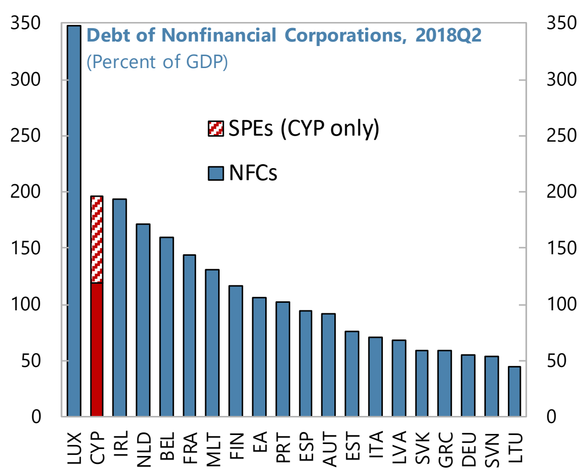
NFCs and the general government are the main borrowers.



Household debt as a percentage of GDP continues to be the highest among euro area countries …



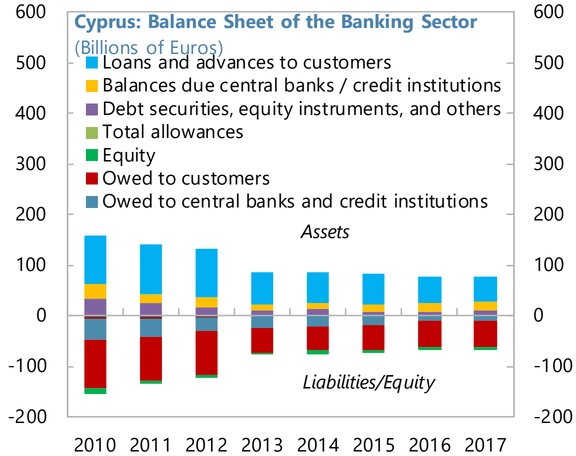
…while NFC debt even accounting for SPEs is also high.



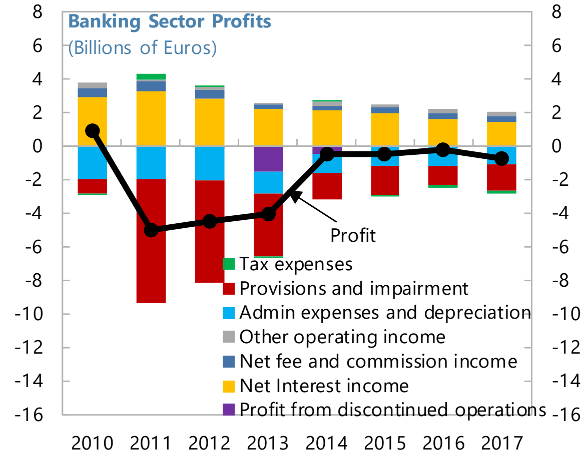
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 5. Cyprus: Banking Sector

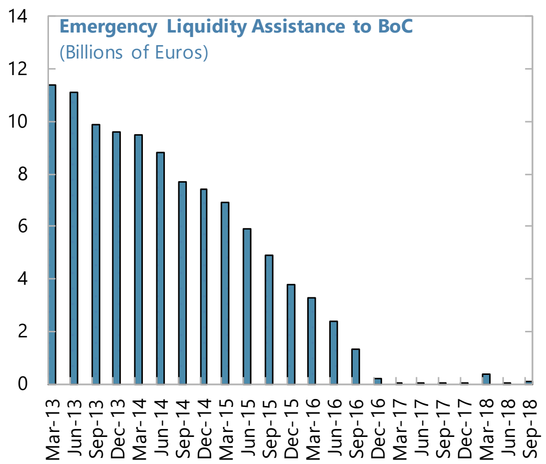
The banking sector has downsized significantly since the crisis…



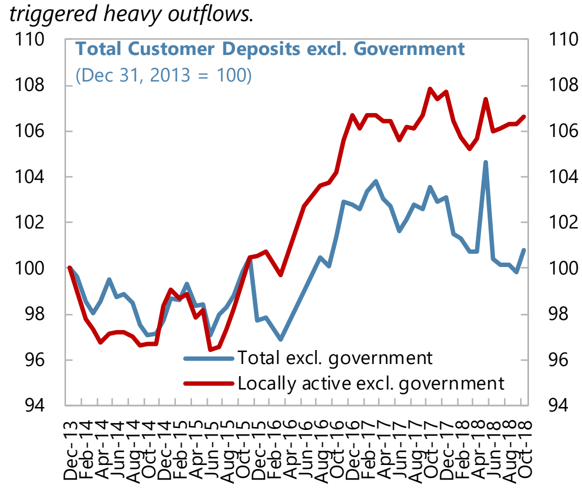
…but narrow interest margins and NPL provisioning needs exert pressures on profitability.



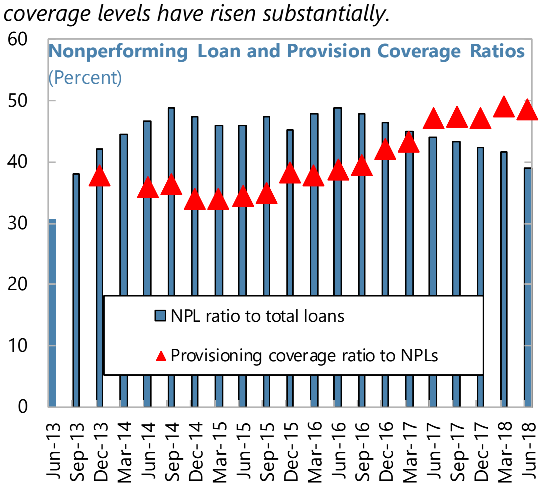
Emergency bank liquidity assistance has been fully repaid…



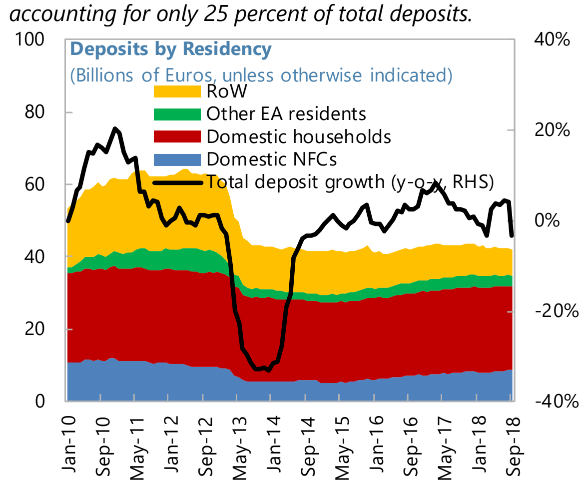
…while customer deposits have been rising until recently when uncertain prospects for the Cyprus Cooperative Bank triggered heavy outflows.



The NPL ratio remains elevated but provisioning and coverage levels have risen substantially.



Foreign deposits have decreased sharply since 2013, now accounting for only 25 percent of total deposits.

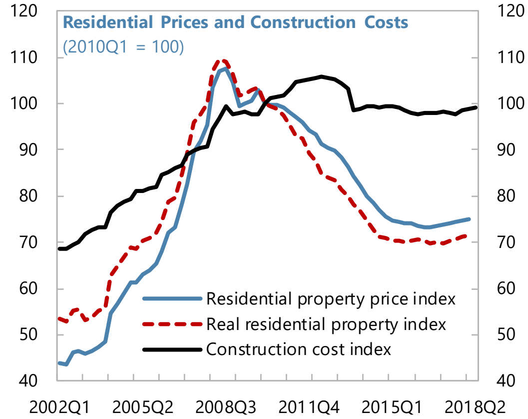


Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff calculations.

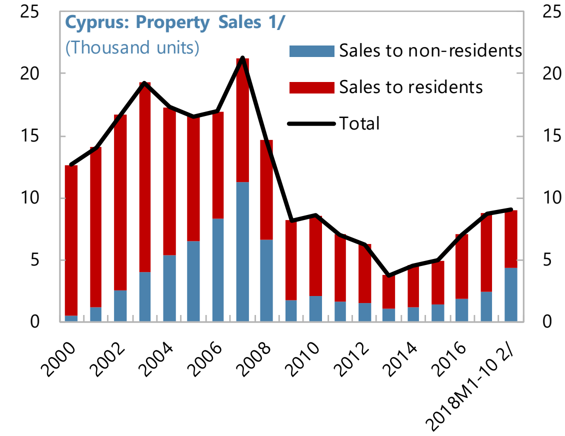
Notes: At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Housing Market

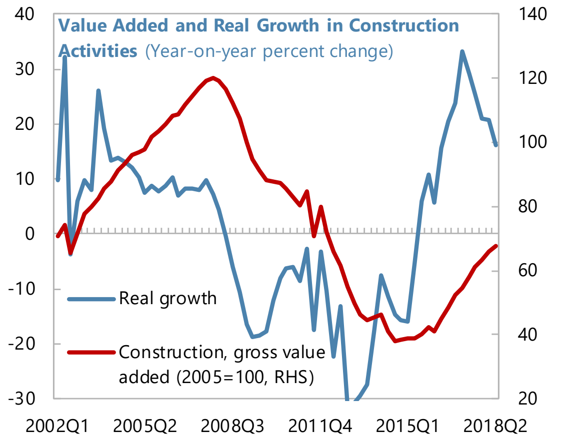
Following a sharp fall, property prices are now rising marginally. Construction cost pressure remains low.



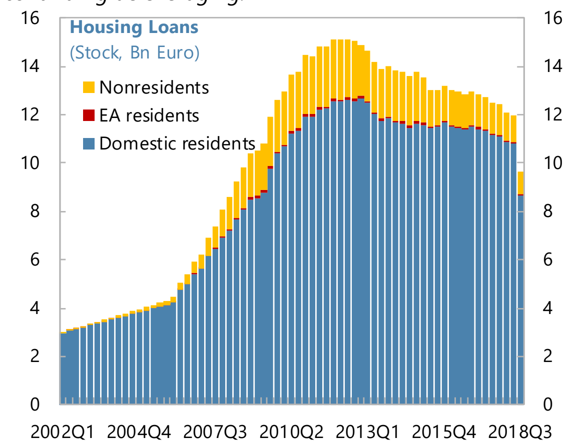
Property sales are recovering, with an increasing share accounted for sales to non-residents.



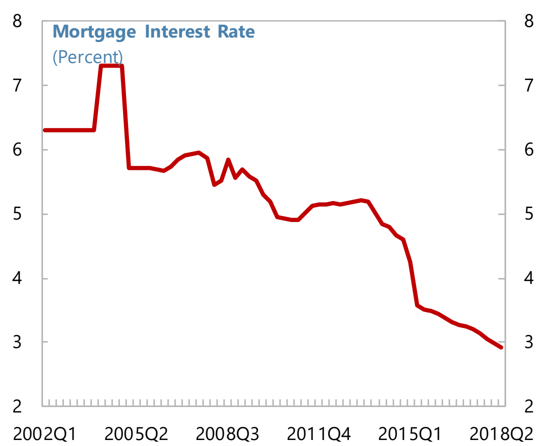
Growth in construction activity has been very strong, albeit from a low base…



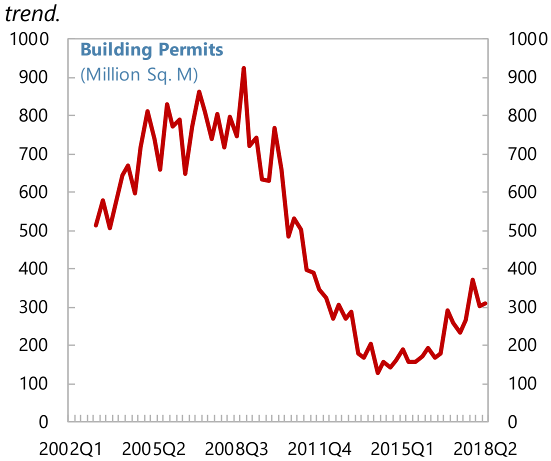
…while the stock of housing loans is declining due to continuing deleveraging.



Mortgage interest rates are on a downward trend…



…and the issuance of building permits is on an upward trend.



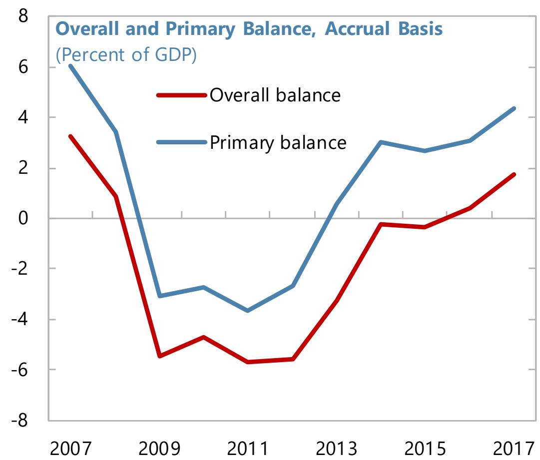
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.

1/ Post-2018 and pre-2018 data on sales to no-residents are not directly comparable as the methodology to compile data has changed.

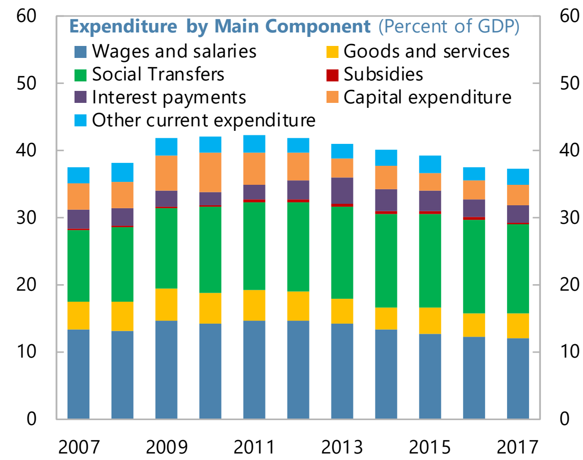
2/ Annualized.

Figure 7. Cyprus: Fiscal Developments

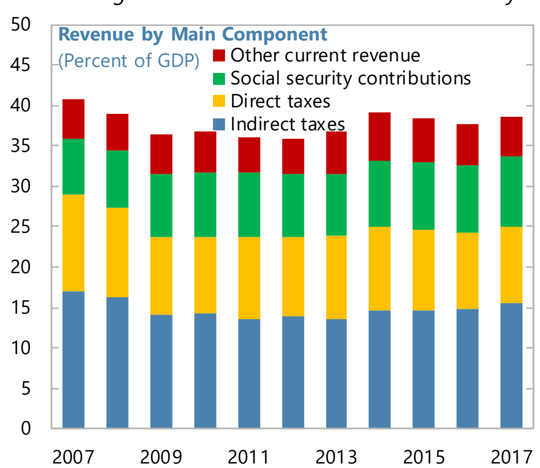
The primary fiscal balance has improved markedly…



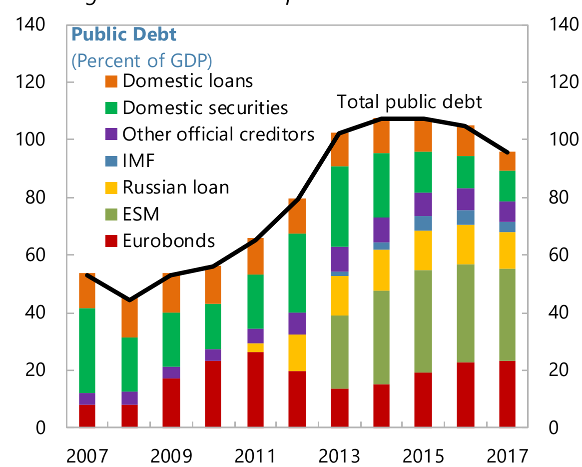
…reflecting contained expenditures…



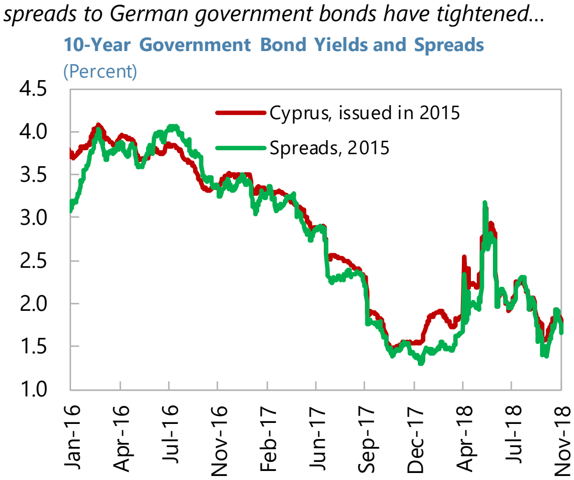
…and strong revenue collection on the brisk recovery…



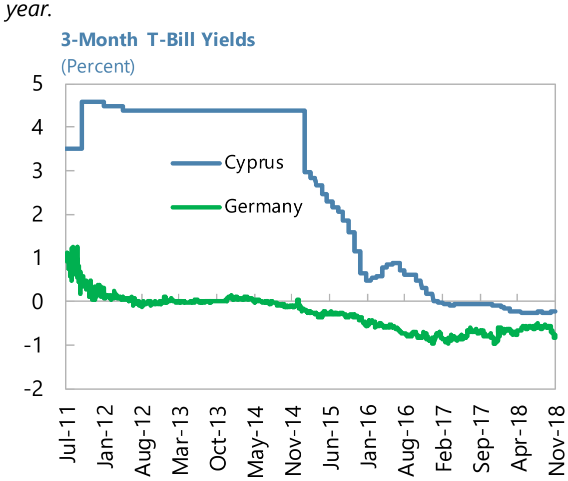
…leading to a decline in the public debt ratio in 2017.



Yields on Cypriot Eurobonds have fallen to low levels and spreads to German government bonds have tightened…



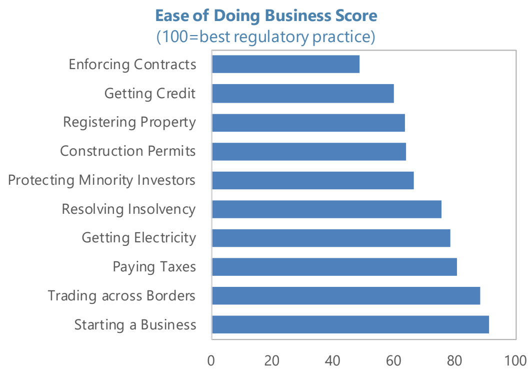
…while 3-month T-bill yields have been negative for over a year.



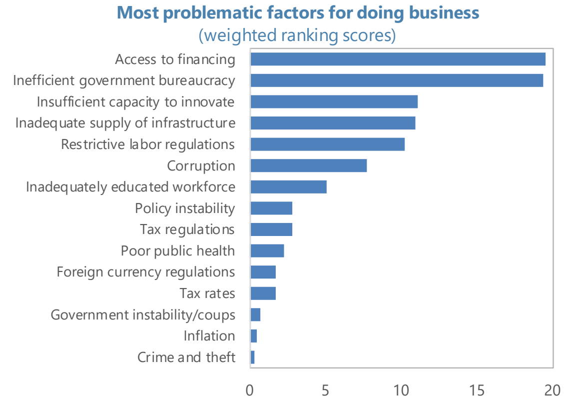
Sources: Bloomberg L.P.; Ministry of Finance; and IMF staff calculations.

Figure 8. Cyprus: Competitiveness and Business Climate Developments

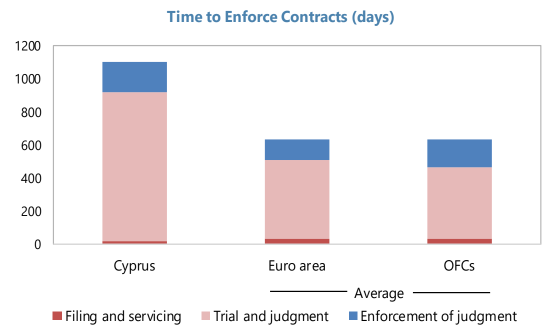
Among business climate metrics, contract enforcement stands out as a key weakness.



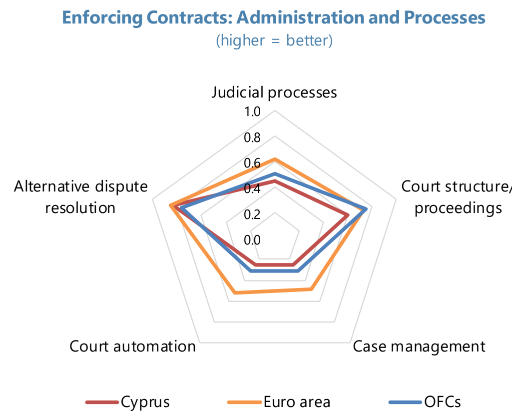
Access to financing and government bureaucracy also are perceived to be constraints.



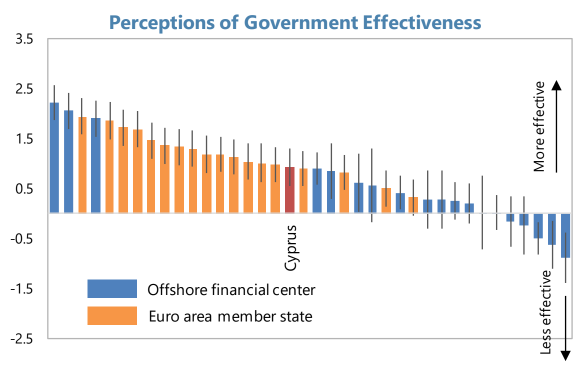
Enforcing contracts takes nearly double the time of peer groups, largely reflecting trial and judgment period.



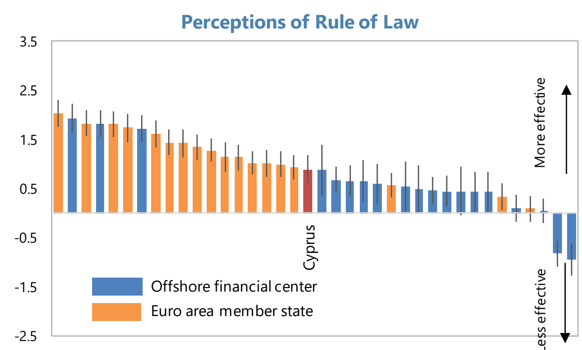
Court automation and case management are some areas where Cyprus lags euro area peers.



Perceptions of government effectiveness compare less favorably to that of most other euro area members.



Rule of law, including the quality of contract enforcement and the courts, is also perceived to be weaker relative to much of the rest of the monetary union.

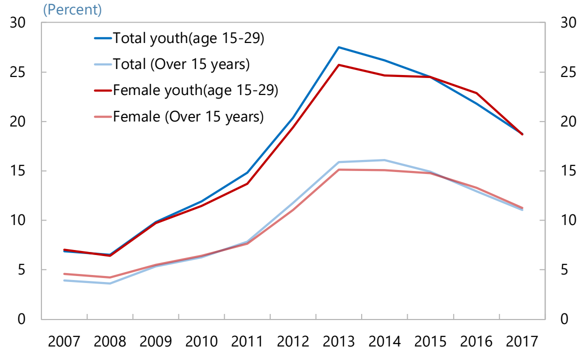


Sources: World Bank Doing Business, 2019; World Economic Forum Global Competitiveness Index 2017–18 edition; Worldwide Governance Indicators, 2018; IMF staff calculations.
Note: WGI's government effectiveness indicator reflects the quality of public services, the quality of civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Rule of law reflects the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforment, property rights, the policy, and the courts, as well as the likelihood of crime and violence. Ranges reflect a 90 percent confidence interval.

Figure 9. Cyprus: Growth Inclusiveness Indicators

Unemployment rate is declining. However, youth unemployment remains very high, recording one of the largest increases in the EU since pre-crisis levels.

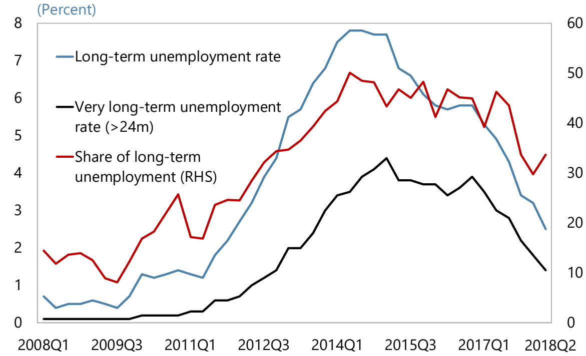
Unemployment Rate
(Percent)



Source: Eurostat, Haver Analytics, and IMF staff calculations.

The share of long-term unemployed has more than doubled.

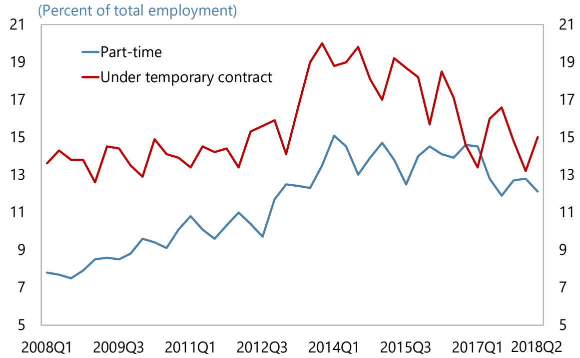
Long-Term Unemployment
(Percent)



Sources: Eurostat; and Haver Analytics.

...while an increasing share of employed are working part-time...

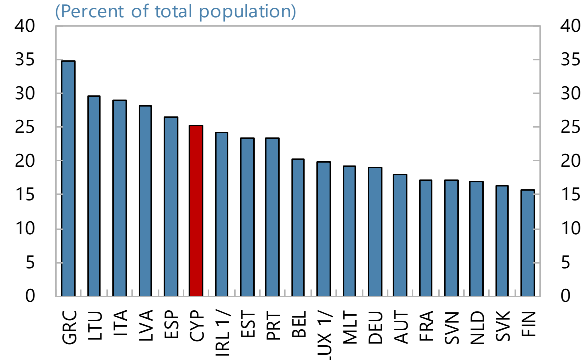
Part-Time and Temporary Contract
(Percent of total employment)



Sources: Cystat; and Eurostat.

...increasing the risk of poverty from already relatively high levels.

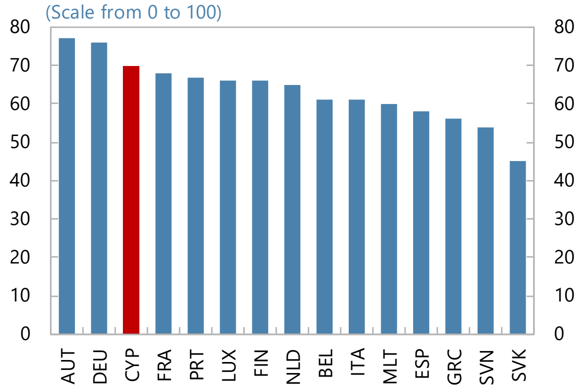
At-Risk-Poverty Rate, 2017
(Percent of total population)



Source: Eurostat.

Wealth and income inequality is relatively high by European standards.

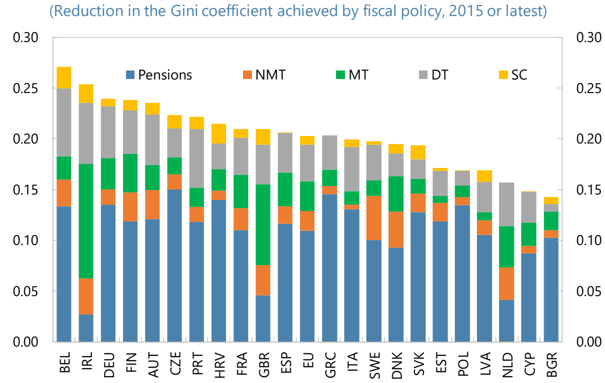
Gini Coefficient Based on Wealth, 2013
(Scale from 0 to 100)



Source: European Commission.

Policies should focus on protecting the vulnerable.

Decomposing Fiscal Redistribution by Instrument 2/
(Reduction in the Gini coefficient achieved by fiscal policy, 2015 or latest)



Sources: Euromod; and IMF staff calculations.
Note: Pension spending includes old age, disability and survivors. MT: means- tested spending, NMT: non-means-tested spending, DT: Direct taxes, SC: Social contributions.

1/ 2016 value is used.
2/ See "Inequality and Poverty Across Generations in the European Union", IMF Staff Discussion Note, 2018.

Table 1. Cyprus: Selected Economic Indicators, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Real Economy				(Percent change, unless otherwise indicated)					
Real GDP	2.0	4.8	4.2	4.2	4.1	3.6	3.0	2.7	2.4
Domestic demand	3.9	6.1	8.2	0.7	7.5	4.0	3.4	3.0	2.8
Consumption	1.9	3.5	3.9	3.0	2.8	2.5	2.3	2.2	2.2
Private consumption	2.4	4.5	4.1	4.0	3.1	2.8	2.6	2.5	2.5
Public consumption	-0.5	-0.8	3.1	0.3	1.7	1.2	1.1	1.0	1.0
Gross capital formation 1/	18.1	21.9	30.4	-8.8	28.8	9.7	7.0	5.5	4.5
Foreign balance 2/	-1.8	-1.2	-3.9	3.6	-3.4	-0.6	-0.5	-0.5	-0.5
Exports of goods and services	5.2	4.6	6.0	3.7	-2.0	3.6	3.5	3.5	3.5
Imports of goods and services 1/	8.4	6.6	12.2	-1.8	3.4	4.3	4.0	4.0	4.0
Potential GDP growth	1.2	1.7	2.1	2.4	2.7	2.8	2.9	2.9	2.8
Output gap (percent of potential GDP)	-7.1	-4.3	-2.3	-0.6	0.7	1.5	1.6	1.4	1.0
HICP (period average)	-1.5	-1.2	0.7	0.9	1.8	1.9	1.9	2.0	2.0
HICP (end of period)	-0.5	0.1	-0.4	2.4	2.0	1.9	1.9	2.0	2.0
GDP deflator	-1.2	-0.6	1.5	1.4	1.8	3.2	2.9	3.2	3.1
Unemployment rate (percent)	14.9	13.0	11.1	8.5	7.0	6.0	5.5	5.2	5.1
Employment growth (percent)	-1.3	1.4	4.6	3.9	2.5	2.0	1.5	1.2	1.0
Labor force	-2.6	-0.9	2.3	1.0	0.9	0.9	0.9	0.9	0.9
Public Finance				(Percent of GDP, unless otherwise indicated)					
General government balance	-0.3	0.3	1.8	2.7	2.5	2.6	2.8	2.8	2.8
Revenue	39.0	38.0	39.0	39.7	39.0	38.2	38.1	38.1	38.0
Expenditure	39.3	37.7	37.3	37.0	36.5	35.5	35.3	35.3	35.3
Primary Fiscal Balance	2.7	3.0	4.3	5.1	5.0	5.0	5.0	4.9	4.8
General government debt	108.0	105.5	96.1	106.1	99.7	90.3	83.3	75.4	68.1
Balance of Payments									
Current account balance	-1.5	-5.1	-8.4	-4.1	-7.8	-7.4	-7.0	-6.5	-6.2
Trade Balance (goods and services)	0.8	-0.6	-3.5	-0.2	-3.8	-3.3	-3.0	-2.4	-2.0
Exports of goods and services	64.5	64.5	65.0	64.8	61.0	60.0	59.5	59.1	58.9
Imports of goods and services	63.7	65.1	68.6	65.0	64.7	63.3	62.5	61.5	60.9
Goods balance	-16.7	-21.0	-24.3	-21.0	-24.2	-23.8	-23.6	-23.2	-23.1
Services balance	17.5	20.4	20.8	20.8	20.5	20.5	20.6	20.8	21.1
Primary income, net	0.6	-2.0	-2.7	-2.0	-2.2	-2.2	-2.1	-2.1	-2.2
Secondary income, net	-2.9	-2.4	-2.1	-1.9	-1.8	-1.9	-1.9	-2.0	-2.0
Capital account, net	0.3	0.2	0.5	0.5	0.5	0.4	0.3	0.3	0.4
Financial account, net	-1.6	-4.7	-5.6	-3.6	-7.2	-7.0	-6.7	-6.2	-5.9
Direct investment	47.4	-9.8	-23.2	-6.9	-8.4	-8.0	-7.8	-7.5	-7.2
Portfolio investment	-11.6	-17.5	0.2	-4.0	-3.3	1.0	-0.9	0.8	2.3
Other investment and financial derivatives	-37.3	22.7	17.5	7.2	4.4	0.0	2.1	0.5	-0.9
Reserves (+ accumulation)	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 3/	5.7	0.7	-1.4	0.0	0.0	-0.2	-0.7	-0.6	-0.5
Errors and omissions	-0.4	0.2	2.3	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	11.5	12.6	12.5	13.8	14.2	15.6	16.7	17.5	18.0
Government	2.4	3.1	4.8	5.7	5.5	5.6	5.8	5.7	5.8
Non-government	9.1	9.5	7.8	8.1	8.8	10.0	10.9	11.8	12.2
Gross capital formation	13.0	17.7	20.9	17.9	22.0	23.0	23.7	24.0	24.2
Government	2.8	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Private	10.2	14.8	17.9	14.9	19.0	20.0	20.7	21.0	21.3
Foreign saving	-1.5	-5.1	-8.4	-4.1	-7.8	-7.4	-7.0	-6.5	-6.2
Memorandum Item:									
Nominal GDP (billions of euros)	17.7	18.5	19.6	20.7	21.9	23.4	24.8	26.3	27.8
External debt	572.6	576.5	554.5	518.9	506.9	486.7	470.2	453.4	441.9
Net IIP	-145.0	-123.0	-121.5	-118.7	-119.2	-118.5	-118.4	-117.9	-117.5

Sources: Statistical Service of the Republic of Cyprus, Eurostat, Central Bank of Cyprus, and IMF staff estimates.

2/ Contribution to real GDP growth.

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

Table 2. Cyprus: Fiscal Developments and Projections, 2015–23 1/

(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Revenue	39.0	38.0	39.0	39.7	39.0	38.2	38.1	38.1	38.0
Current revenue	38.4	37.8	38.6	39.4	38.7	38.1	38.0	38.0	38.0
Tax revenue	24.6	24.3	25.0	25.7	25.5	25.2	25.2	25.2	25.2
Indirect taxes	14.7	14.8	15.6	16.3	16.3	16.2	16.2	16.2	16.2
Direct taxes	9.9	9.5	9.4	9.3	9.2	9.1	9.0	9.0	9.0
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	8.4	8.4	8.7	9.1	9.4	9.4	9.4	9.4	9.4
Other current revenue	5.5	5.2	4.8	4.7	3.8	3.4	3.4	3.4	3.4
Capital revenue	0.6	0.2	0.5	0.3	0.2	0.1	0.1	0.1	0.1
Expenditure	39.3	37.7	37.3	37.0	36.5	35.5	35.3	35.3	35.2
Current expenditure	36.6	34.9	34.3	34.0	33.5	32.6	32.3	32.3	32.3
Wages and salaries	12.8	12.2	12.0	11.9	11.8	11.9	11.9	12.0	12.1
Goods and services	3.9	3.5	3.6	3.6	3.5	3.4	3.4	3.4	3.4
Social Transfers	13.9	13.9	13.4	13.1	12.8	12.6	12.4	12.4	12.4
Subsidies	0.4	0.5	0.3	0.3	0.5	0.5	0.5	0.5	0.5
Interest payments	3.0	2.6	2.6	2.4	2.5	2.4	2.2	2.2	2.0
Other current expenditure	2.6	2.2	2.4	2.8	2.4	1.9	1.9	1.9	1.9
Capital expenditure 2/	2.8	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Overall balance 3/	-0.3	0.3	1.8	2.7	2.5	2.6	2.8	2.8	2.8
Statistical discrepancy	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-0.8	0.4	1.8	2.7	2.5	2.6	2.8	2.8	2.8
Net financial transactions	-0.8	0.4	1.8	2.7	2.5	2.6	2.8	2.8	2.8
Net acquisition of financial assets	-0.4	-5.2	-3.6	17.9	2.0	-0.4	1.1	-0.5	-0.5
Currency and deposits 4/	-0.5	-5.2	-3.6	17.9	2.0	-0.4	1.1	-0.5	-0.5
Securities other than shares 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	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	0.3	-5.6	-5.4	15.1	-0.5	-3.0	-1.7	-3.2	-3.3
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	-4.7	-5.2	0.4	21.5	2.2	-0.4	1.3	-2.8	-2.9
Loans	5.1	-0.4	-5.8	-6.4	-2.7	-2.6	-3.0	-0.4	-0.4
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Output Gap	-7.1	-4.3	-2.3	-0.6	0.7	1.5	1.6	1.4	1.0
Primary balance (ESA2010) 3/	2.7	3.0	4.3	5.1	5.0	5.0	5.0	4.9	4.8
Cyclically adjusted primary balance 3/	5.5	4.6	5.2	5.4	4.7	4.5	4.4	4.4	4.4
Structural primary balance 3/	6.6	4.4	4.7	4.8	4.3	4.5	4.5	4.4	4.4
Structural overall balance 3/	3.6	1.7	2.1	2.4	1.8	2.1	2.3	2.2	2.4
Public debt	108.0	105.5	96.1	106.1	99.7	90.3	83.3	75.4	68.1
Public debt net of cash holding	104.2	100.1	92.7	100.2	92.2	83.6	76.0	69.0	62.5

Sources: Ministry of Finance; 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 2015 excludes recapitalization of the cooperative sector of €0.175 billion.

4/ The cash drawdown used to recapitalize the cooperative sector in 2015 is 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: General Government Financing Requirements and Sources, 2018–23

(Millions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023
	Projections					
Gross borrowing needs	1,643	1,839	1,739	1,386	1,777	1,294
Overall deficit	-565	-548	-617	-698	-729	-776
Primary surplus	-1,054	-1,086	-1,169	-1,249	-1,296	-1,333
Interest payments	490	538	552	552	568	557
Amortization	2,264	2,354	2,355	2,084	2,506	2,069
Medium- and long-term	2,064	2,054	2,018	1,617	2,054	1,617
Foreign	697	908	1,160	706	1,081	1,081
Eurobonds	0	199	458	0	1,000	1,000
Russia	625	625	625	625	0	0
Other	72	84	77	81	81	81
Domestic	1,367	1,146	858	910	973	536
Short-term	200	300	300	300	300	300
EU and IMF	0	0	38	167	152	152
Stock-flow adjustment 1/	-57	33	0	0	0	0
Gross financing sources	1,643	1,839	1,739	1,386	1,777	1,294
Privatization receipts	0	0	0	0	0	0
Market access	2,200	2,250	1,650	1,650	1,650	1,150
Medium- and long-term	1,900	1,950	1,350	1,350	1,350	850
Foreign	1,650	1,650	1,150	1,150	1,150	650
Domestic 2/	250	300	200	200	200	200
Short-term	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0
Use of deposits 3/	-557	-411	89	-264	127	144
Net placement	3,126	-104	-705	-434	-856	-1,071
Medium and Long Term Debt	3,026	-104	-668	-267	-704	-919
Domestic Securities 4/	2,845	-818	-629	-680	-742	-304
Eurobonds	1,500	1,301	542	1,000	0	-500
Domestic Loans	-772	-28	-29	-30	-31	-32
Foreign Loans	-547	-559	-552	-556	69	-84
Short term (Net increase)	100	0	0	0	0	0
EU and IMF	0	0	-38	-167	-152	-152
Memorandum item:						
Cash holding (eop)	1,221	1,633	1,544	1,808	1,681	1,537
General government debt (eop)	21,940	21,837	21,131	20,697	19,841	18,922
General government debt (eop, percent of GDP)	106.1	99.7	90.2	83.3	75.4	68.1
General government net debt (eop, percent of GDP) 5/	100.2	92.2	83.7	76.1	69.0	62.5

1/ Adjustments for consistency between estimated cash basis fiscal balance and debt data.
2/ €3.19 billion domestic debt issued to enhance the CCB balance sheet is not included as the transaction did not involve cash.
3/ Minus (-) sign represents accumulation of deposits.
4/ Includes €3.19 billion domestic debt issued to the CCB.
5/ General government debt minus cash holding.

Table 4. Cyprus: Balance of Payments, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Prel.	Projections					
	(Percent of GDP)								
Current Account Balance	-1.5	-5.1	-8.4	-4.1	-7.8	-7.4	-7.0	-6.5	-6.2
Trade Balance (Goods and Services)	0.8	-0.6	-3.5	-0.2	-3.8	-3.3	-3.0	-2.4	-2.0
Goods Balance	-16.7	-21.0	-24.3	-21.0	-24.2	-23.8	-23.6	-23.2	-23.1
Exports	16.2	14.0	13.4	13.3	7.9	7.6	7.4	7.1	7.0
Imports	33.0	35.1	37.7	34.3	32.1	31.4	30.9	30.4	30.0
Services Balance	17.5	20.4	20.8	20.8	20.5	20.5	20.6	20.8	21.1
Exports	48.3	50.5	51.7	51.5	53.1	52.5	52.2	52.0	51.9
Imports	30.8	30.1	30.9	30.7	32.6	32.0	31.5	31.1	30.8
Primary Income	0.6	-2.0	-2.7	-2.0	-2.2	-2.2	-2.1	-2.1	-2.2
Secondary Income	-2.9	-2.4	-2.1	-1.9	-1.8	-1.9	-1.9	-2.0	-2.0
Capital Account	0.3	0.2	0.5	0.5	0.5	0.4	0.3	0.3	0.4
Financial Account (- financing)	-1.6	-4.7	-5.6	-3.6	-7.2	-7.0	-6.7	-6.2	-5.9
Direct Investment	47.4	-9.8	-23.2	-6.9	-8.4	-8.0	-7.8	-7.5	-7.2
Portfolio Investment	-11.6	-17.5	0.2	-4.0	-3.3	1.0	-0.9	0.8	2.3
Financial Derivatives	-4.9	1.9	1.0	1.0	0.9	0.8	0.8	0.7	0.7
Other Investment	-32.4	20.8	16.5	6.3	3.5	-0.8	1.3	-0.3	-1.7
Reserves (+ accumulation)	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	-0.4	0.2	2.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Program Financing 1/	5.7	0.7	-1.4	0.0	0.0	-0.2	-0.7	-0.6	-0.5
Private Net Capital Flows 2/	-27.9	-31.5	-22.0	…	…	…	…	…	…
o/w Portfolio Investment	-12.8	-20.9	-4.6	…	…	…	…	…	…
o/w Other Investment	-57.6	-2.8	4.8	…	…	…	…	…	…
o/w MFIs	-38.1	7.2	-1.9	…	…	…	…	…	…
o/w Non-MFIs	-19.5	-10.0	6.8	…	…	…	…	…	…
Gross External Debt	572.6	576.5	554.5	518.9	506.9	486.7	470.2	453.4	441.9
o/w Short-term Debt	197.0	180.3	150.5	136.4	133.1	129.1	124.8	121.0	122.5

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

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

2/ Private net capital flows (- inflows, + outflows) are defined to exclude the public-sector flows (the central-bank flows and part of the general-government flows). It is not possible to exclude all 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 5. Cyprus: External Financing Requirements and Sources, 2015–23 1/

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

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
GROSS FINANCING REQUIREMENTS	**45,010**	**42,963**	**43,255**	**38,527**	**38,458**	**39,902**	**40,818**	**42,041**	**43,018**
Current account deficit ("-" = CA surplus)	259	935	1,643	848	1,700	1,734	1,737	1,714	1,732
Medium- and long-term debt amortization	8,065	7,073	8,001	8,223	8,567	8,975	8,686	9,184	9,296
Public sector	1,392	276	609	697	908	1,160	706	1,081	1,081
Banks	1,146	887	761	636	618	613	608	604	601
Other private	5,527	5,910	6,630	6,890	7,042	7,203	7,371	7,499	7,614
Short-term debt amortization	36,686	34,956	33,345	29,456	28,191	29,155	30,231	30,994	31,841
Public sector	2,874	222	293	313	222	167	125	94	70
Central Bank	2,874	201	275	296	222	167	125	94	70
General government and SOEs	0	20	18	17	0	0	0	0	0
Banks	19,593	22,493	17,997	17,174	14,967	14,817	14,670	14,524	14,415
Other private	14,219	12,241	15,055	11,968	13,003	14,172	15,436	16,376	17,356
EU and IMF	0	0	267	0	0	37	165	150	150
SOURCES OF FINANCING	**44,000**	**42,838**	**43,255**	**38,527**	**38,458**	**39,902**	**40,818**	**42,041**	**43,018**
Capital account (net)	49	37	103	104	116	93	84	89	98
Foreign direct investment (net)	-8,415	1,804	4,540	1,418	1,831	1,881	1,935	1,961	2,002
Cypriot investment abroad	15,752	5,632	5,243	5,725	5,707	6,004	6,316	6,645	6,993
Foreign investment in Cyprus	7,337	7,436	9,782	7,142	7,538	7,884	8,250	8,606	8,995
New borrowing and debt rollover	44,572	43,371	38,494	38,047	39,252	40,019	40,743	41,658	43,701
Medium and long-term borrowing	9,617	10,026	9,038	9,856	10,097	9,789	9,750	9,817	9,634
General government	2,062	125	850	1,650	1,650	1,150	1,150	1,150	650
Banks	112	390	257	559	599	594	590	592	636
Other private	7,443	9,510	7,931	7,647	7,848	8,044	8,010	8,076	8,348
Short-term borrowing	34,956	33,345	29,456	28,191	29,155	30,231	30,994	31,841	34,067
Public sector	222	293	313	222	167	125	94	70	53
Central Bank	201	275	296	222	167	125	94	70	53
General government and SOEs	20	18	17	0	0	0	0	0	0
Banks	22,493	17,997	17,174	14,967	14,817	14,670	14,524	14,415	15,267
Other private	12,241	15,055	11,968	13,003	14,172	15,436	16,376	17,356	18,747
Other	7,793	-2,373	118	-1,042	-2,741	-2,090	-1,944	-1,667	-2,783
Of which: Net errors and omissions	-74	32	441	0	0	0	0	0	0
FINANCING GAP	**1,010**	**125**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	600	0	0	0	0	0	0	0	0
IMF	410	125	0	0	0	0	0	0	0
ROLLOVER RATES (percent)									
General government 1/	150	48	138	231	182	99	163	106	60
Central bank	7	137	108	75	75	75	75	75	75
Private	104	103	92	99	105	105	104	104	108
Banks	109	79	93	87	99	99	99	99	106
Non-financial corporates	100	135	92	110	110	110	107	107	109

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.
1/ External statistics were revised in line with the BPM6 methodology.

Table 6. Cyprus: Monetary Indicators, 2010–17
(Billions of Euros, unless otherwise indicated, end of period)

	2010	2011	2012	2013	2014	2015	2016	2017
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	86.5	80.5
Claims on Central Bank of Cyprus	2.3	2.9	3.9	2.7	4.2	7.2	9.0	11.8
Claims on Cypriot resident Other MFIs	5.6	5.0	4.6	3.3	4.1	4.5	5.6	0.3
Claims on Cypriot resident non MFIs	54.0	58.2	60.6	55.0	53.5	54.1	48.1	46.6
General government	4.5	5.3	6.5	5.4	4.5	3.4	3.3	3.9
Private sector excluding SPEs 1/	46.5	48.6	49.3	46.5	45.2	44.5	41.9	39.6
Households	22.5	23.5	23.9	22.3	21.9	21.5	20.8	19.8
Non-Financial Corporations	23.3	24.1	24.4	23.4	21.8	21.9	20.0	18.8
Non-Bank Financial Intermediaries	0.7	1.0	1.0	0.8	1.6	1.1	1.2	1.0
SPEs	3.0	4.4	4.8	3.1	3.7	6.2	2.9	3.2
Claims on non-residents	69.3	61.3	55.9	25.3	25.6	21.6	19.1	16.5
Other assets	3.8	3.9	3.2	3.9	3.8	3.6	4.7	5.2
Liabilities	135.0	131.6	128.1	90.3	91.1	91.0	86.6	80.3
Liabilities to the Central Bank of Cyprus	5.5	5.5	9.8	11.2	8.5	4.7	0.9	0.9
Liabilities to Cypriot resident Other MFI	5.5	4.9	4.5	3.1	3.6	4.2	5.1	0.3
Deposits of Cypriot resident non MFIs	45.4	43.7	43.3	33.0	32.3	32.9	36.6	37.8
General government	0.5	0.5	0.5	0.4	0.5	0.5	1.0	1.1
Private sector excluding SPEs	36.8	37.4	37.5	29.9	29.3	29.9	32.4	34.0
Households	25.4	26.0	26.4	23.3	22.3	22.4	23.1	23.6
Non-Financial Corporations	6.7	6.7	5.7	3.9	3.8	4.6	5.7	6.7
Non-Bank Financial Intermediaries	4.7	4.6	5.4	2.7	3.2	2.9	3.5	3.6
SPEs	8.1	5.8	5.3	2.6	2.5	2.4	3.2	2.8
Deposits of non-residents	60.6	56.5	51.3	24.5	24.1	25.5	20.9	19.5
Debt securities	2.4	2.6	1.7	0.5	0.4	0.7	0.3	0.6
Capital and reserves	12.8	11.3	15.1	16.4	20.8	21.7	21.5	19.8
Other liabilities	2.8	7.1	2.4	1.6	1.5	1.3	1.4	1.4
Money and Credit								
Net foreign assets	4.0	-1.4	-1.0	-5.5	0.2	0.6	8.2	9.4
Monetary Financial Institutions	6.3	2.2	3.0	0.3	1.3	-4.6	-2.1	-3.5
Central Bank of Cyprus	-2.3	-3.7	-4.0	-5.8	-1.1	5.2	10.2	12.9
Net domestic assets	51.7	53.9	56.4	52.0	49.6	48.2	44.8	42.7
General government sector credit, net	5.2	5.3	7.2	5.5	4.3	3.6	2.9	3.1
Private sector credit excluding SPEs	46.5	48.6	49.3	46.5	45.3	44.5	41.9	39.6
SPEs credit	3.0	4.4	4.8	3.1	3.7	6.2	2.9	3.2
Other items,net	-12.3	-11.8	-15.6	-15.1	-19.4	-19.9	-17.8	-15.9
Cypriot Resident Broad money (M2)	46.6	45.0	44.6	34.5	34.1	35.0	38.1	39.4
Cypriot Resident Narrow money (M1)	10.6	11.1	11.5	10.4	11.4	12.8	15.1	16.6
				(Percent of GDP)				
General Government sector credit, net	27.1	26.6	36.7	30.4	24.4	20.5	15.8	15.9
Private sector credit excluding SPEs	241.0	246.6	252.8	256.4	257.1	250.9	230.2	206.2
SPEs credit	15.7	22.1	24.5	17.0	21.0	34.7	16.0	16.5
Cypriot Resident Broad money (M2)	241.2	228.0	229.0	190.0	193.6	197.0	209.0	204.9
Cypriot Resident Narrow money (M1)	55.2	56.4	58.9	57.3	65.0	72.4	82.9	86.2
				(Annual percentage change)				
General Government sector credit, net	-1.6	0.4	36.2	-22.9	-22.2	-15.1	-20.9	5.9
Private sector credit excluding SPEs	8.8	4.6	1.3	-5.6	-2.7	-1.7	-5.8	-5.5
Gross Household and non-financial corporations credit excluding SPEs	8.5	4.2	1.2	-5.3	-4.5	-0.6	-6.0	-5.2
SPEs credit	2.3	44.0	9.9	-35.6	19.9	66.8	-52.7	8.6
Cypriot Resident Broad money (M2)	10.4	-3.4	-0.8	-22.8	-1.1	2.5	9.0	3.4
Cypriot Resident Narrow money (M1)	2.3	4.4	3.2	-9.4	10.0	12.3	17.6	9.7
Memorandum items:								
Credit to deposits Ratio, Cypriot residents (in percent)	108.9	120.9	124.5	151.9	153.6	155.8	123.8	114.0
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	4.8
SPEs Deposits (y-o-y percent change)	33.8	-28.3	-9.4	-50.3	-5.3	-1.8	31.3	-13.0

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

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017
Capital Adequacy								
Regulatory capital ratio	12.3	8.6	7.3	13.5	15.3	16.6	16.8	16.3
Tier I capital ratio	10.9	7.4	6.3	12.3	14.6	16.0	16.4	15.4
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	42.5
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	43.7
Provisions to NPLs	...	...	...	...	33.9	38.3	42.3	47.2
Restructured loans classified as NPLs to total NPLs	...	...	...	28.0	33.9	40.1	40.8	40.9
Earnings and Profitability								
Return on assets 4/	...	-3.7	-5.4	-14.7	-0.1	0.6	1.4	-4.3
Return on equity 4/	...	-54.5	-83.5	-100.5	-4.6	2.4	19.8	-34.6
Net interest income to gross income ratio	75.9	82.3	78.9	86.2	78.4	81.2	75.3	70.7
Net fees and commissions income to gross income ratio	13.5	13.9	16.0	13.4	11.6	13.8	14.6	16.4
Net interest margin	2.0	2.4	2.3	2.4	2.9	2.8	2.6	2.3
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	27.9
Others								
Total loans and advances to total assets ratio	71.5	76.1	82.9	83.6	73.4	73.6	69.1	64.1
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	75.7

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.

Table 8. Cyprus: Indicators of Fund Credit, 2013–26 1/

(Millions of SDRs)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Disbursement	222.8	148.5	321.8	99.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service	1.6	3.8	7.5	13.1	236.2	11.4	12.2	43.5	149.0	134.0	131.4	91.9	53.2	9.1
Repurchase	0.0	0.0	0.0	0.0	222.4	0.0	0.0	31.3	138.2	125.8	125.8	88.7	51.6	8.3
Charges	1.6	3.8	7.5	13.1	13.8	11.4	12.2	12.2	10.8	8.2	5.5	3.2	1.7	0.9
Total debt service, in percent of														
Quota	1.0	2.4	4.8	4.3	77.7	3.8	4.0	14.3	49.0	44.1	43.2	30.3	17.5	3.0
GDP	0.0	0.0	0.1	0.1	1.4	0.1	0.1	0.2	0.7	0.6	0.6	0.4	0.2	0.0
Exports of goods and services	0.0	0.0	0.1	0.1	2.2	0.1	0.1	0.4	1.2	1.0	1.0	0.6	0.4	0.1
Outstanding stock	222.8	371.3	693.0	792.0	569.6	569.6	569.6	538.3	400.1	274.3	148.5	59.8	8.3	0.0
In percent of quota	140.8	234.7	438.1	260.7	187.5	187.5	187.5	177.2	131.7	90.3	48.9	19.7	2.7	0.0
In percent of GDP	1.4	2.5	5.0	5.5	3.5	3.3	3.1	2.8	2.0	1.3	0.6	0.2	0.0	0.0
In percent of exports of goods and services	2.3	4.1	7.7	8.5	5.3	5.1	5.2	4.6	3.3	2.1	1.1	0.4	0.1	0.0

Source: IMF staff estimates.
1/ Effective february 2016, the new Quota of SDR 303.8 million is applied.

Annex I. Authorities' Response to Past Policy Recommendations

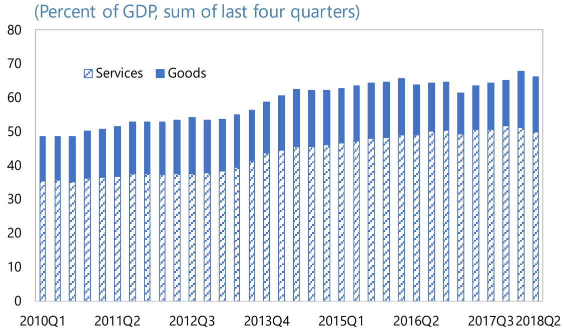
Past Policy Recommendations	Policy Actions
Strengthen Financial Sector Policies	
Reduce private sector debt and high NPLs, including by: (i) addressing impediments in the foreclosure and insolvency frameworks and asset sales legislation; (ii) relying on a broad set of tools that includes burden sharing and keeps banks well provisioned and capitalized; and (iii) outsourcing NPL management to third parties with specialized restructuring skills and at arm's length relationship with borrowers.	(i) A package of amendments to strengthen the legal framework for NPL resolution was adopted (2018); and (ii) a securitization law was also adopted (2018), but their implementation largely hinges on a broader reform of the judicial system. (iii) A subsidy scheme aimed at encouraging vulnerable borrowers to start servicing their loans through burden sharing has been approved, but its coverage is rather broad. The three large domestic banks have outsourced NPL management to third parties in 2017 and early 2018.
Ensure Fiscal Sustainability and Avoid Procyclicality	
Cap fiscal spending by medium term GDP growth to avoid procyclical policies, prevent structural loosening and mitigate risks stemming from the high level of public debt.	Some fiscal loosening took place during 2017-2018. A more durable mechanism to keep the public-sector wage bill in check has not been adopted by Parliament.
Closely monitor the costs of the National Health Service (NHS).	A NHS review based on the report of an external consultant is still pending.
Focus on implementing key reforms in public financial management (PFM) and revenue administration (RA); pass the law on creation and functioning of SOEs.	PFM and RA reforms are being implemented, supported by Fund technical assistance. The law on SOEs remains to be adopted.
Implement Structural Reforms	
Strengthen the enforcement of commercial claims and the efficiency of the courts.	The legislation for the establishment of a commercial court is currently undergoing legal vetting. An action plan is being drawn based on issues identified in a functional review of the Cyprus's Court System prepared by the Irish Institute of Public Administration.
Restart the privatization program and undertake a central bank governance reform.	Privatization efforts have largely stalled. The amending legislation to strengthen the governance and autonomy of the CBC is undergoing legal vetting.
Implement concrete actions to improve the business environment.	A comprehensive action plan has been drawn up, but implementation has been slow.
Decouple the CbI scheme's eligibility requirements from real estate and ensure full compliance with AML/CFT standards by all sectors involved in scheme.	The Council of Ministers put a cap on the number of citizenships granted under the CbI scheme to 700 a year and decided the establishment of a Committee for Supervision and Control as well as a Registry of Service Providers for the CbI scheme.

<table>
<tr><td>Current account</td><td colspan="10">Background. In 2017, the overall current account (CA) deficit was -8.4 percent of GDP overall (with underlying balance of -2.6 percent of GDP, adjusted for SPEs and one-off effects of imports of aircrafts due to the commencement of a new airline). Since 2015, Cyprus's underlying trade balance moved to surplus and in 2017, it was 1 percent of GDP, while the income balance (adjusted for SPEs) was -3.6 percent of GDP, reflecting large negative NIIP and outward remittances.
Assessment. Staff assesses that the CA gap in 2017 was -3.5 percent of GDP, which corresponds to an assessment that the external position was weaker than warranted by fundamentals and desirable policy settings. Policy gaps, reflecting deviations of current policy settings in Cyprus and the rest of the world (ROW) from their desired settings, contribute 0.1 percentage point. This net effect can be decomposed into the contribution from (i) the private credit gap[2] (-1.1 percentage point) reflecting Cyprus's still large credit gap relative to the ROW's, and (ii) fiscal policy (1.1 percentage point) that is due to the ROW as Cyprus's cyclically-adjusted fiscal balance is considered appropriate.</td><td rowspan="8">Overall Assessment:
The external position of Cyprus in 2017 was weaker than warranted by fundamentals and desirable policy settings. This conclusion is reached, notwithstanding the sharp narrowing of the CA deficit and reduction in the REER since the global financial crisis and the Cypriot banking crisis and after adjusting for one-offs and effects of SPEs. In 2018, the CA balance is projected to improve somewhat reflecting both stronger trade and primary income balances.
Potential policy responses:
Continued efforts to unwind the credit gap, including through further deleveraging by banks, would decrease domestic absorption, raise the current account, and lower net IIP liabilities. Structural reforms targeting a more diversified economy would help to ensure balanced and sustainable growth. Maintaining a prudent fiscal policy that avoids procyclicality would help safeguard the downward path of public debt and create space to absorb possible contingent fiscal shocks.</td></tr>
<tr><td></td><td>Actual CA</td><td>-8.4%</td><td>One-off factors</td><td>-5.8%</td><td>Underlying CA</td><td>-2.6%</td><td>CA norm</td><td>0.9%</td><td>CA gap</td><td>-3.5%</td></tr>
<tr><td></td><td colspan="8"></td><td>o/w policy gap</td><td>0.1%</td></tr>
<tr><td>Real exchange rate</td><td colspan="10">Background. The CPI- and ULC-based average REERs appreciated slightly in 2017 (around 0.4 and 0.3 percent, respectively) but remained -7 percent and -15 percent lower than 2011 levels, mainly reflecting post-crisis wage declines. Compared to their 2017 averages, the CPI- and ULC-based REERs depreciated 0.2 percent and 0.4 percent, respectively, in H1 2018 despite public sector wages starting to reverse their downward trend. Exporters' producer price indices remain mostly subdued.
Assessment. The REER EBA-lite model points to REER overvaluation with the REER gap estimated at just under 15 percent, of which the policy gap mostly reflects the private sector credit gap (2.4 percent), as well as the real interest rate (1 percent). The EBA-lite CA model points to an overvaluation of around 7.2 percent. In light of the greater applicability of the CA model for Cyprus,[3] staff's assessment is an REER overvaluation of around 7 percent.</td></tr>
<tr><td>Foreign asset & liability position and trajectory</td><td colspan="10">Background. The net international investment position (NIIP) was -122 percent in 2017, compared to -130 percent in 2011. Additionally, the composition of foreign liabilities improved, with the share of FDI increasing by 15 percentage points over the same period and the share of other investment and derivatives declining. Excluding the contribution of SPEs' foreign financial positions,[1] NIIP declined from -64 percent to -43 percent of GDP over the same period. On a sectoral basis, the government's NIIP deteriorated from -24 percent to -77 percent of GDP, reflecting the cost of the crisis, while the non-SPE private sector's NIIP declined to -39 percent of GDP[4] as capital inflows returned. TARGET2 claims and portfolio holdings associated with the Asset Purchase Program resulted in the central bank's NIIP improving from -19 percent to around 70 percent of GDP.
Assessment. A CA balance of -3.9 percent of GDP would stabilize the SPE-adjusted NIIP at its 2017 current level. This is 1.3 percentage points larger than the 2017 estimated underlying CA deficit. Reaching a NIIP position of -35 percent of GDP—the level indicated by the European Commission as a threshold for their assessment of macroeconomic imbalances—by 2023 would require sustaining a CA of -2.3 percent of GDP, a deficit 0.3 percentage points smaller than the 2017 underlying CA.[5]</td></tr>
<tr><td>Capital & financial accounts: flows & policy measures</td><td colspan="10">Background. Net capital inflows slowed in 2017, amounting to 22 percent of GDP for the private sector (including SPEs), from 32 percent in 2016. Net FDI inflows accelerated to 23 percent of GDP, while private net portfolio inflows slowed to 5 percent of GDP as residents increased their acquisition of foreign assets. Net outflows from the central bank continued, pushing its TARGET2 balance to 38 percent of GDP at end-2017. These trends persisted in 2018, with net capital inflows to the private sector decelerating to 16 percent of GDP for the four quarters through Q2 2018 despite even higher net FDI inflows as private net portfolio inflows slowed further and MFIs continued to reduce non-resident deposits.[4]
Assessment. With sizable external debt of the public and private sectors, Cyprus remains exposed to financial market risks.</td></tr>
<tr><td>FX intervention & reserves level</td><td colspan="10">Background. The euro has the status of a global reserve currency.
Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td>Technical Background Notes</td><td colspan="10">1/ As discussed in the 2017 Article IV Consultation for Cyprus (IMF Country Report No. 17/375), SPEs—which have large gross external financial assets and liabilities and a net liability position, but a limited economic footprint—are treated as nonresidents.
2/ While the credit gap is usually defined in terms of gross bank loans, it is defined here 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. This approach also reflects that, 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. For Cyprus, the ratio of net credit to GDP that prevailed in 2006 is seen as appropriate and sustainable, implying a credit gap of 26 percent of GDP in 2017.
3/ The REER model relies on a CPI-based REER and thus does not reflect the even more sizable depreciation of Cyprus's ULC-based REER since the crisis (more than twice as large as the depreciation in the CPI-based REER).
4/ Staff estimates, derived from external sector statistics published by the CBC.
5/ Although this result would correspond to an assessment that the external position is broadly consistent with fundamentals and desirable policy settings, sectoral trends in NIIP data render the External Sustainability approach less informative for Cyprus. The SPE-adjusted NIIP had improved to around -35 percent of GDP by Q2 2018, while the NIIP for the overall economy improved to -109 percent of GDP.</td></tr>
</table>

Cyprus: Export Competitiveness Developments

Services drove the post-crisis growth in exports…

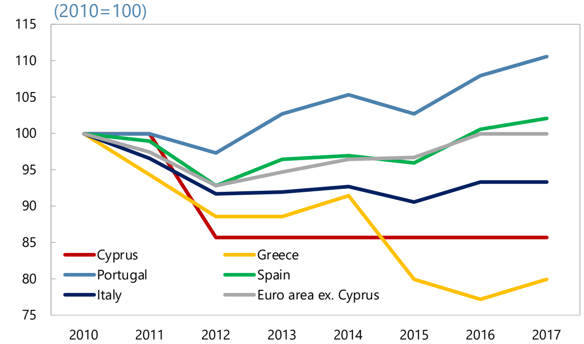
Exports of Goods and Services
(Percent of GDP, sum of last four quarters)



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

…while Cyprus's export market share has remained stable.

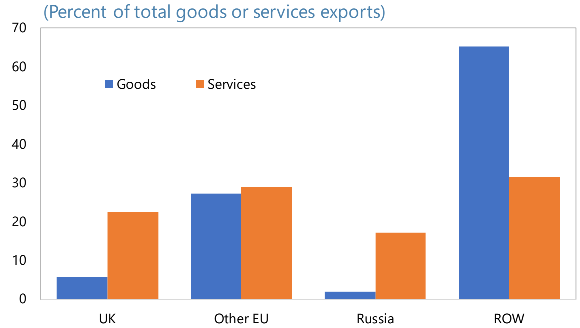
Evolution of Export Shares
(2010=100)



Source: Eurostat.

Destinations for goods exports are relatively diffuse, while roughly 40 percent of services exports are destined for the UK and Russia…

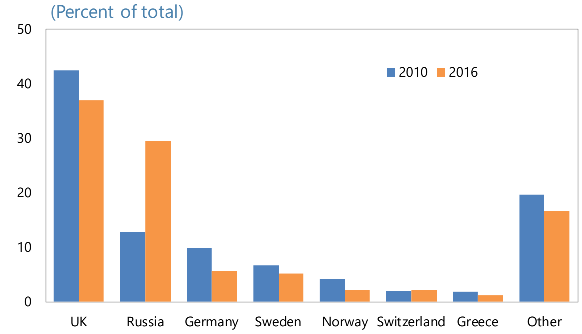
Main Export Destinations
(Percent of total goods or services exports)



Sources: CYSTAT, Eurostat, and IMF staff calculations.

…with the latter representing an increasingly sizable share of tourist arrivals.

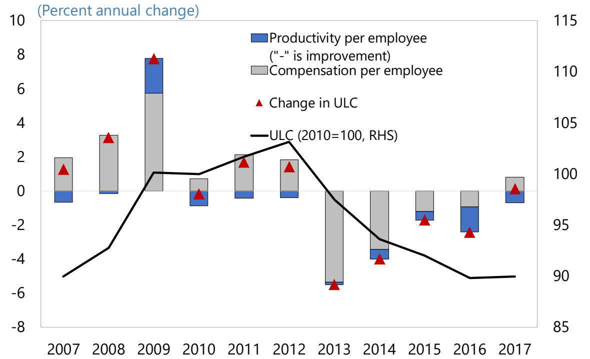
Tourist Overnight Stays by Country of Origin
(Percent of total)



Sources: CYSTAT and IMF staff calculations.

Post-crisis declines in compensation drove ULC compression…

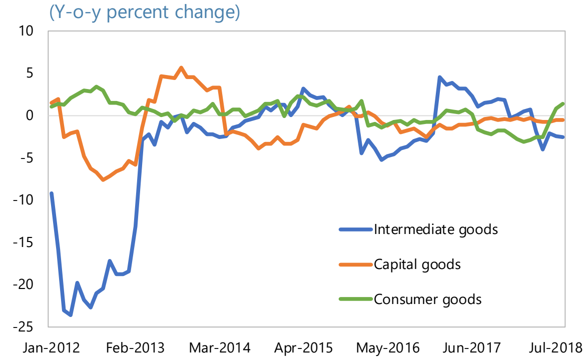
Unit Labor Cost Developments
(Percent annual change)



Sources: Eurostat and IMF staff calculations.

…and producer price indices for external markets have remained mostly subdued.

External PPI by Industrial Grouping
(Y-o-y percent change)



Source: Eurostat and IMF staff calculations.

Annex III. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Time Horizon	Expected Impact of Risks	Policy Response
External Risks			
High		Medium	
Rising protectionism and retreat from multilateralism: Escalating and sustained trade actions threaten the global trade system, regional integration, and labor mobility. In the short term, increased uncertainty about growth leads to increased financial market volatility. Negative consequences for growth are, in turn, exacerbated by adverse changes in market sentiment and investment.	ST, MT	The Cypriot economy is heavily dependent on foreign demand, including from the UK and Russia for tourism and business services and from Europe for goods exports. Weaker external demand would adversely affect long-term growth.	Seek to broaden sources of foreign demand. Restart structural reforms to make the economy more dynamic and flexible in response to demand shocks.
Medium			
Unsustainable macroeconomic policies: Policies in systemically important countries to boost near-term activity beyond sustainable levels exacerbate underlying vulnerabilities and, in some cases, backfire by hurting confidence and global growth.	ST, MT		
Medium			
Weaker-than-expected Euro Area growth: Progress on fiscal adjustment, on addressing legacy banking sector problems, and on other structural reforms slows or reverses, raising debt sustainability concerns, steadily pushing up borrowing costs, and undermining medium-term growth prospects.	MT		
High		Medium	
Sharp tightening of global financial conditions: Tighter financial conditions triggered by a sharper-than-expected increase in U.S. interest rates or the materialization of other risks could cause higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; and a broad-based downturn.	ST	Higher interest rates on Cypriot government borrowing would raise the cost of refinancing maturing official loans with market debt. Higher interest rates on private sector debt would raise debt service obligations, decreasing domestic demand and/or resulting in deteriorating loan quality.	Undertake additional fiscal consolidation to reduce borrowing needs. Incentivize private-sector borrowers to engage with banks by ensuring robust implementation of the strengthened framework for insolvency and foreclosure.

[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.

Domestic Risks			
High		**Medium, High**	
NPL management amid continued weak payment discipline: An approach aimed at merely relieving banks from NPLs, coupled with continued slow progress on restructuring, results in excessive reliance on debt-to-asset-swaps or in loans being warehoused in SPVs for a long time.	ST, MT	Perceived loan forbearance leads to further increase in strategic default and moral hazard, with negative implications for banks' ability to extend new credit, as well as higher direct and contingent liabilities for the state, including associated with the Asset Protection Scheme.	Intensify efforts to reduce NPLs in a decisive and durable manner by encouraging banks to remain adequately provisioned and capitalized, and ensuring robust implementation of the strengthened framework for insolvency and foreclosure.
Medium		**Medium**	
Renewed boom-bust cycle: Business cycle becomes increasingly dependent on construction activity leading to excess supply of luxury properties until eventually the CbI scheme is further scaled down or delinked from investment in real estate.	ST, MT	GDP growth slows down sharply weighing adversely on employment, tax revenue and banks' asset quality.	Enact a comprehensive reform agenda to improve prospects for more diversified growth and gradually decouple CbI scheme from real estate in a timely manner.

Annex IV. Debt Sustainability Analysis

The Public Debt Sustainability Analysis for Market-Access Countries indicates that in the baseline, public debt is on a rapid downward path after a sharp one-off increase in 2018. 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 or a combination of macro-fiscal shocks and a contingent liability were to materialize, public debt would rise to and remain at a very high level, particularly if market dislocation persists. Gross public financing needs have recently increased and could rise further under macro-fiscal and contingent liability shocks but are expected to remain below high vulnerability thresholds.

Baseline Scenario

1. **The debt issuance aimed at strengthening the balance sheet of the CCB for its sale has reversed the rapid downward path of Cyprus's public debt.** Rapidly-rising cash balances arising from the increasing primary surplus and strong growth enabled the government to make an early repurchase to the Fund in July 2017 and repay part of the debt owed to the CBC in November 2017. As a result, public debt declined sharply to 96.1 percent of GDP at end-2017 from 105.5 percent of GDP a year earlier. However, as part of the conditions to sell assets and liabilities (primarily customer deposits) of the CCB, the government placed €3.19 billion domestic bonds (15 percent of projected GDP in 2018) at the CCB in July 2018. This transaction contributes to the projected increase in public debt to about 106 percent of GDP at end-2018.

2. **However, from 2019, public debt is projected to resume a rapid decline.** Projected high primary surpluses and robust economic growth will support a durable decline in public debt to 68 percent of GDP by 2023.

3. **The placement of domestic bonds at the CCB has increased gross public financing needs (GPFN).** The debt issuance to the CCB was implemented through a private off-market placement of domestic bonds, which will be redeemed gradually over a five-year period beginning this year. Nevertheless, GPFN will remain about half the benchmark for advanced economies (20 percent of GDP) over the projection horizon, in part reflecting debt management operations in 2017 to eliminate a prior repayment hump in 2019–20. Specifically, in June 2017, the authorities issued €850 million in Eurobonds and bought back bonds scheduled to mature in 2019. They also made early repurchase to the Fund and repaid part of the debt owed to the CBC. 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 nine-month forward rolling basis.

Risk Assessment

4. **High NPLs poses a risk to the sustainability of public debt.** In addition to the domestic bonds placed at the CCB, the government has agreed to a contingent support for completing the transaction of the CCB in the form of an Asset Protection Scheme (APS) covering €2.6 billion

performing loan portfolio, although the eventual loss to which the government is exposed will likely be much smaller.[1] In addition to the NPLs at the CCB, broader risk from NPLs at other systemic banks could spill over to the government's balance sheet. On the other hand, the baseline scenario conservatively assumes zero recovery from the NPLs in the public AMC.

5. Cyprus's current high level of public debt also leaves it 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. The probability that public debt to GDP could remain high over the medium-term has diminished somewhat but is not negligible. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 100 percent until 2023 with a probability of 8 percent (fan chart in Annex Figure 1).[2]

6. Gross public financing needs are susceptible to a range of 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 jump several percentage points of GDP, although it remains below the 20 percent benchmark.

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

- Given 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 pressure if liabilities are not rolled over or flows reverse, although to a considerable extent, gross liabilities are matched by gross assets of a similar duration.

- About 73 percent of public debt is owed to non-residents. However, about 65 percent of this debt reflects official financing from the ESM and the IMF, a bilateral loan from Russia, and loans from the European Investment Bank and the 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 of debt, mitigates interest rate and financing risks.[3]

- Cyprus's sovereign credit has recently been upgraded to investment grade, reflecting lower levels of uncertainties owing to the resolution of the CCB and the passage of a long-delayed legislative package to strengthen the insolvency and foreclosure frameworks. The sovereign bond spread relative to German bonds—an indicator of market perception of sovereign risk—

[1] Independent estimates put likely fiscal cost at €155 million (0.8 percent of GDP).

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

[3] As of end-September 2018, the weighted average maturity of total debt is 6.1 years, while that of marketable debt is 3.7 years. The shares of debt that falls due within 1 year and 5 years are 10.0 percent and 48.4 percent, respectively.

was around 192 basis points on average in the past three months, below the lower risk-assessment benchmark.

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

Realism of Baseline Assumptions

8. 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).

Stress Tests and Alternative Scenarios

9. Various macro-fiscal and contingent liability shocks would postpone debt reduction:

- **Growth shock.** A one standard deviation (3.4 percentage points) decrease in growth during 2019–20, accompanied by (i) a 36 and 73 basis points (bps) rise in interest rates in 2019 and 2020, respectively (corresponding to 25 bps rise per one percentage point reduction in primary balance), 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 relative the baseline to 103 percent of GDP by 2020, before declining to 80 percent of GDP by 2023.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.6 percent of GDP during 2019–20, accompanied by 41 bps rise in interest rates (corresponding to 25 bps rise per one percentage point reduction in primary balance) and an increase in the real interest rate by 575 bps during 2019–23 would raise public debt marginally to 71 and 72 percent of GDP by 2023, respectively.

- **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 2020 before declining to 88 percent of GDP by 2023. Gross financing needs would peak at 14 percent of GDP in 2020 before falling back.

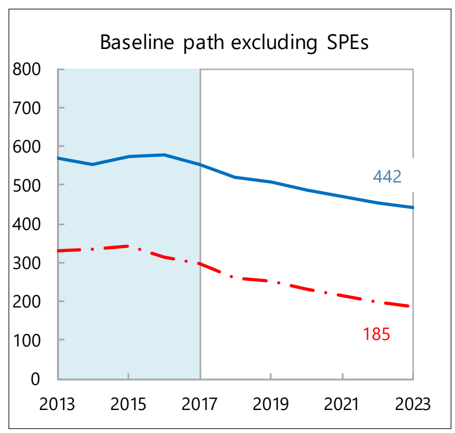
10. Under an alternative scenario of lower economic growth and primary fiscal balance combined with further realization of modest contingent liabilities from the banking sector (adverse macro-fiscal-contingent liability (CL) scenario), public debt and gross financing needs remain high. Real GDP growth and primary fiscal balance are assumed to be permanently lower than in the baseline by ½ standard deviation which could materialize from a productivity slowdown and an unforeseen fiscal loosening. These shocks are assumed to be accompanied by a decrease in inflation and a rise in interest rates. Further realization of contingent liabilities from the banking sector (3 percent of GDP) and outside the banking sector (7 percent of GDP) in 2019

(10 percent of GDP in total), on top of the support already provided to the CCB, is also assumed. Under this adverse scenario, public debt would rise to 114 percent of GDP in 2019 and would decline only slowly to 97 percent of GDP in 2023. Gross financing needs would also spike to 20 percent of GDP in 2019 before declining to 9 percent of GDP over the medium term.

11. Under a scenario of realization of large contingent liabilities accompanied by temporary shocks to macroeconomic variables and borrowing costs (contingent liability shock), public debt rises sharply. A one-off 25 percent of GDP increase in public debt in 2019 is assumed to lead to a temporary spike in the borrowing costs for the sovereign by 625 basis points in 2019 and to be accompanied by compression of output and a decline of inflation in 2019–20.[4] Under this scenario, public debt would reach 129 percent of GDP in 2020 before declining to 106 percent of GDP by 2023. However, such a spike in borrowing costs would likely preclude market access, with further detrimental implications for debt sustainability.

A. External Debt Sustainability Analysis

12. Under the baseline scenario, external debt is forecast to decline gradually over the medium term. Gross (net) external debt is projected to decline from around 519 (114) percent of GDP (€107 billion) in 2018 to 442 (52) percent (€123 billion) of GDP by 2023.[5] Government external debt as a share of GDP declines over the medium-term on the assumption of continued fiscal prudence. Banks are forecast to reduce external debt to around 64 percent of GDP, mostly reflecting further declines in nonresident deposits. External debt of private nonbank sectors is forecast to decline somewhat, as projected current account deficits are assumed to be mostly financed by FDI inflows, but remain high at more than 200 percent of GDP. Gross debt excluding that of SPEs is anticipated to fall to around 185 percent of GDP in 2023.



13. Nominal GDP growth is expected to remain the primary driver of the decline in the gross external debt ratio over the medium term. In the projection period, nominal GDP is forecast to grow by 6 percent on average, contributing to an annual external debt reduction of

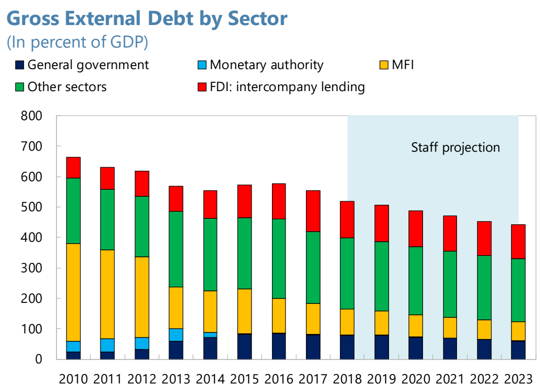
[4] Accompanying macroeconomic assumptions are: (i) a 1 standard deviation real GDP growth shock in 2019–20; and (ii) a 0.25 percentage point decline in inflation for every 1 percentage point decline in growth.

[5] 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.

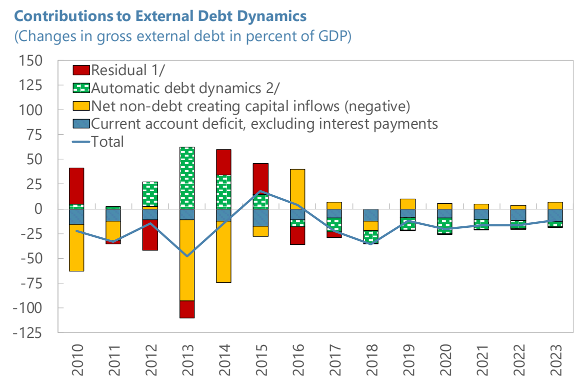
28 percentage points of GDP. At the same time, growth is expected to sustain the trade deficit (2.4 percent of GDP annually, on average), which together with net interest payments (6 percent of GDP annually, on average), is forecast to partially offset the denominator effect. The result would be an annual decline in external debt by 19 percentage points of GDP on average.

Cyprus: External Debt Developments and Forecast, Including SPEs

MFIs are expected to drive the decline in external debt, along with reductions in other private sector and public debt.



Continued economic growth will remain supportive of debt reduction over the medium-term.



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

Risks to External Debt Sustainability

14. Standard bounds tests indicate that the baseline 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 servicing costs and reduce the denominator effect on the debt-to-GDP ratio. On the other hand, standardized current account deficit shocks would have a more limited impact on the debt ratio.

- **Interest rates.** A two-percentage-point increase in average interest rates on external debt throughout the projection period would increase the debt ratio by 56 percentage points by 2023, 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 66 percentage points by 2023 compared to the baseline.

- **Current account deterioration.** The impact of a one-half standard deviation shock to the current account balance is more limited, pushing debt 9 percentage points higher by 2023 compared to the baseline.

- **Combination of shocks.** A combination of one-quarter standard deviation shocks to growth and the current account, along with a one-percentage-point increase in average interest rates, would raise the debt ratio by 66 percentage points by 2023 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 drive the debt ratio higher by about 150 percent of GDP by 2023. Most of this increase would be due to deflation and nearly stagnant nominal GDP. However, as the historical period reflects the Cypriot banking crisis episode, it could be considered an extreme scenario.

Gross Financing Needs

15. Gross external financing needs are projected to decline but remain elevated (over 150 percent of GDP) through the projection period. This reflects the stock of short-term debt of the private sector, which remains sizable even after declining roughly 30 percentage points of GDP in 2017 to 151 percent of GDP. Nearly 90 percent of external debt owed by banks is short-term, while about one-quarter of external debt owed by other private sector borrowers is short-term. In this context, Cyprus faces rollover risk in the event borrowers do not have sufficient liquid assets or if market funding becomes too costly. The projected reduction in the GFN largely reflects banks' reduced non-resident deposits, as well as declining non-financial private sector liabilities as deleveraging continues.

Conclusion

16. While external debt appears to be sustainable in the baseline, its high-level leaves Cyprus vulnerable to a variety of risks. The ongoing economic expansion, downsizing of the banking sector, and fiscal consolidation effort have been supportive of efforts to reduce external debt, but Cyprus's role as a regional financial center suggests its gross external debt will remain high. Staff assumes that the expansion in gross external debt due to SPEs slows over the medium term under the baseline, however there is substantial uncertainty given limited information on its activities and the implications of developments in home countries of beneficial owners.

17. The Cypriot economy remains exposed to liquidity and other risks as a result of continued large gross financing needs, the impact of which could be difficult to manage given still-high non-performing loans and private debt overhang and elevated public debt. Sound financial sector policies and structural reforms targeting a more diversified economy would help to ensure balanced and sustainable growth and limit risks of a new boom-bust cycle. Maintaining a prudent fiscal policy that avoids procyclicality would help safeguard the downward path of external public debt and create space to absorb possible contingent fiscal shocks. It also will remain important to closely align the maturity and currency of external assets and liabilities.

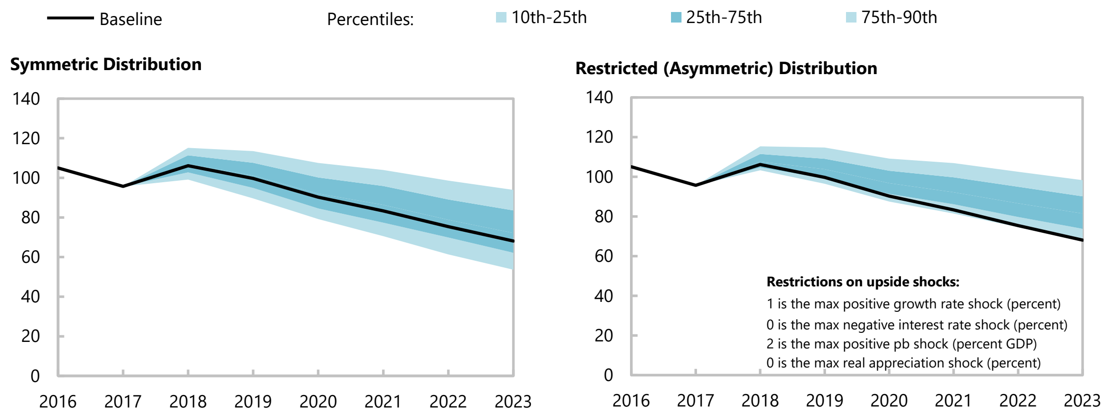
Cyprus: Public DSA Risk Assessment

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

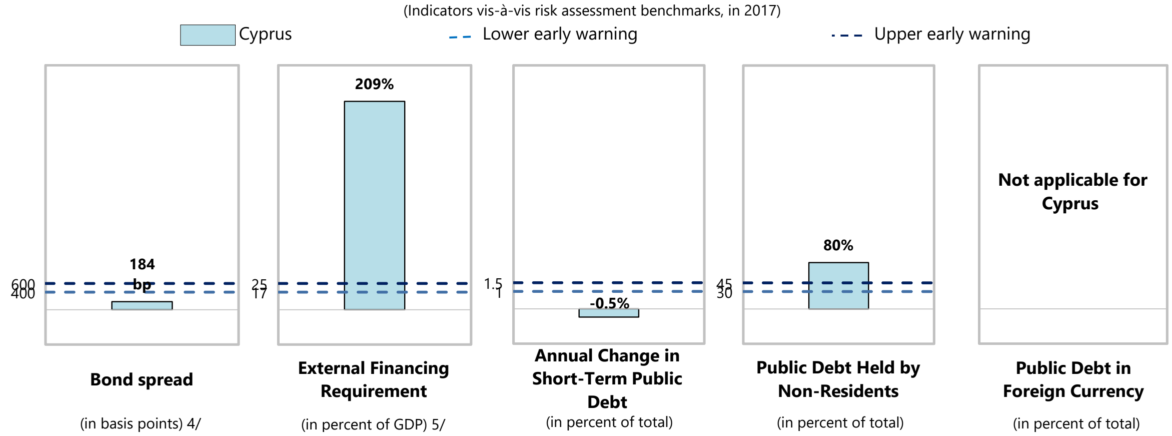
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



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.

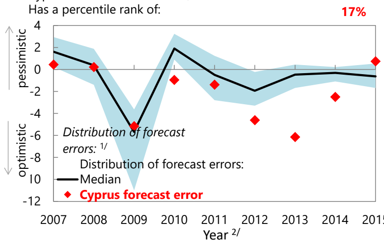
4/ Long-term bond spread over German bonds, an average over the last 3 months, 09-Aug-18 through 07-Nov-18.

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.

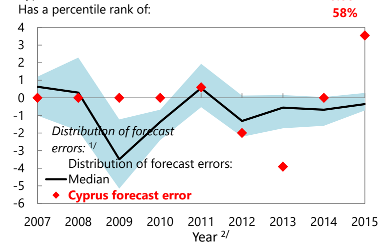
Cyprus: Public DSA—Realism of Baseline Assumptions (Continued)

Forecast Track Record, versus program countries

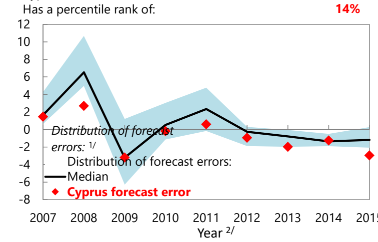
Real GDP Growth
(in percent, actual-projection)
Cyprus median forecast error, 2007-2015: -1.39
Has a percentile rank of: 17%



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

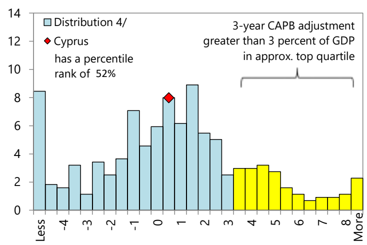


Inflation (Deflator)
(in percent, actual-projection)
Cyprus median forecast error, 2007-2015: -0.94
Has a percentile rank of: 14%

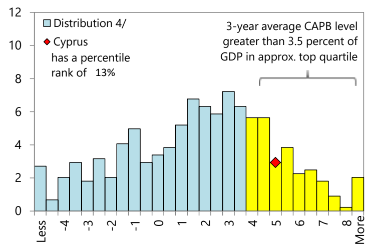


Assessing the Realism of Projected Fiscal Adjustment

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

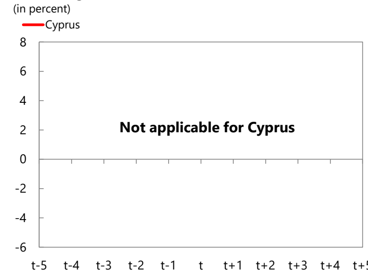


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



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)

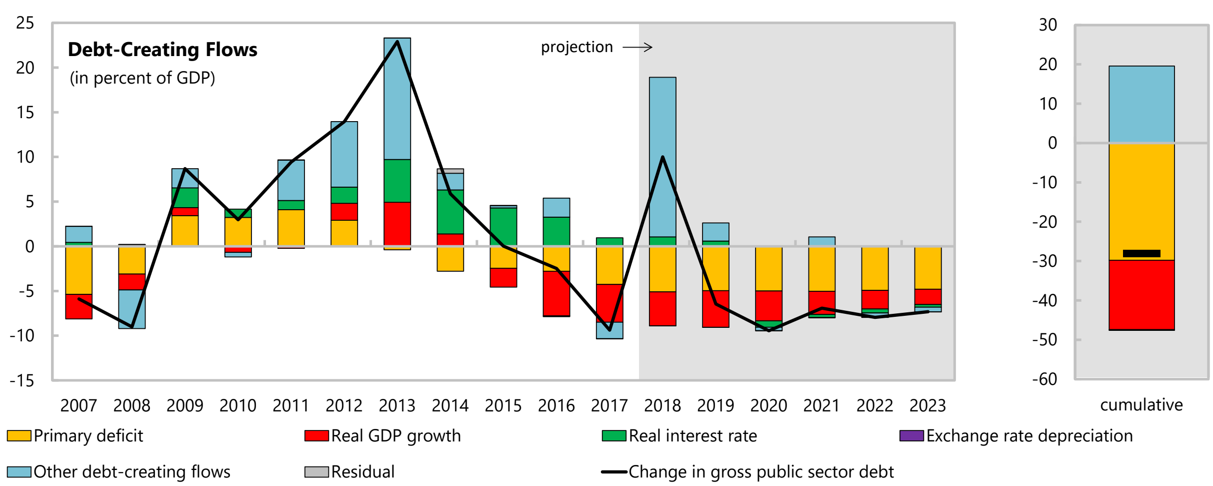
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	74.3	105.5	96.1	106.1	99.7	90.2	83.3	75.4	68.1
Public gross financing needs	13.5	8.9	9.8	8.2	8.3	7.4	5.6	6.8	4.7
Real GDP growth (in percent)	0.0	4.8	4.2	4.2	4.1	3.6	3.0	2.7	2.4
Inflation (GDP deflator, in percent)	1.2	-0.6	1.5	1.4	1.8	3.2	2.9	3.2	3.1
Nominal GDP growth (in percent)	1.3	4.2	5.8	5.6	6.0	6.9	6.1	6.0	5.6
Effective interest rate (in percent) [4/]	4.2	2.5	2.6	2.6	2.5	2.5	2.6	2.8	2.8

As of November 07, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		166
5Y CDS (bp)		132
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	5.4	-2.5	-9.4	10.0	-6.4	-9.4	-6.9	-7.9	-7.3	-28.1	
Identified debt-creating flows	5.4	-2.4	-9.4	10.0	-6.4	-9.4	-6.9	-7.9	-7.3	-28.0	
Primary deficit	0.0	-2.8	-4.3	-5.1	-5.0	-5.0	-5.0	-4.9	-4.8	-29.8	-2.5
Primary (noninterest) revenue and grants	37.8	37.9	39.0	39.7	39.0	38.2	38.1	38.1	38.0	231.0	
Primary (noninterest) expenditure	37.7	35.1	34.7	34.6	34.0	33.2	33.1	33.1	33.2	201.2	
Automatic debt dynamics [5/]	2.5	-1.7	-3.3	-2.7	-3.5	-4.1	-2.9	-2.5	-2.0	-17.8	
Interest rate/growth differential [6/]	2.5	-1.7	-3.3	-2.7	-3.5	-4.1	-2.9	-2.5	-2.0	-17.8	
Of which: real interest rate	2.3	3.3	1.0	1.0	0.6	-0.7	-0.3	-0.4	-0.3	-0.2	
Of which: real GDP growth	0.2	-5.0	-4.2	-3.8	-4.1	-3.3	-2.6	-2.1	-1.7	-17.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	3.0	2.1	-1.8	17.9	2.0	-0.4	1.1	-0.5	-0.5	19.6	
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	3.0	2.1	-1.8	17.9	2.0	-0.4	1.1	-0.5	-0.5	19.6	
Residual, including asset changes [8/]	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	

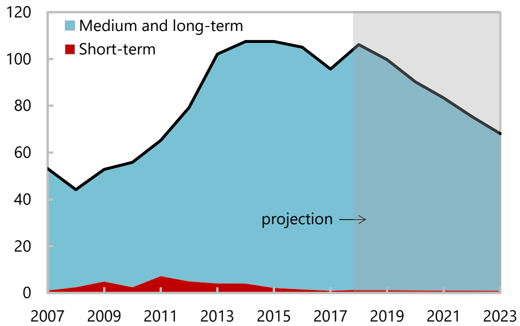


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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.

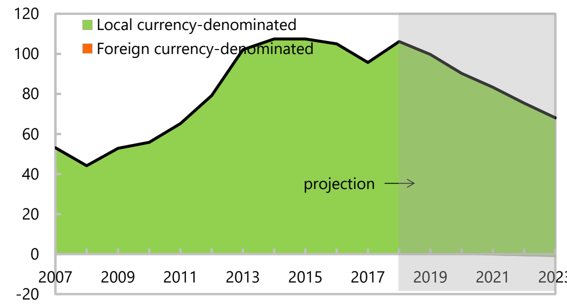
Cyprus: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



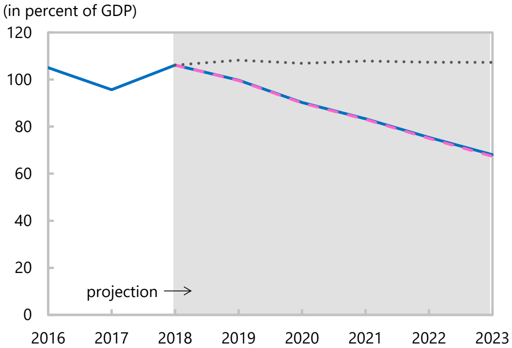
By Currency
(in percent of GDP)



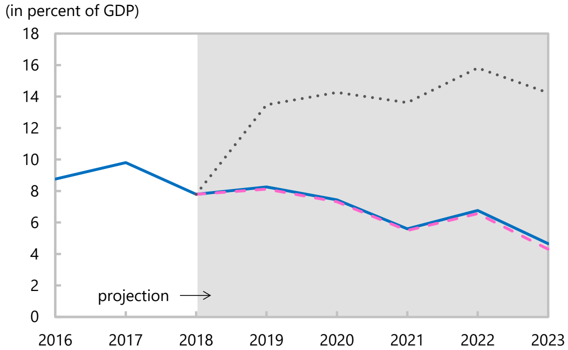
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

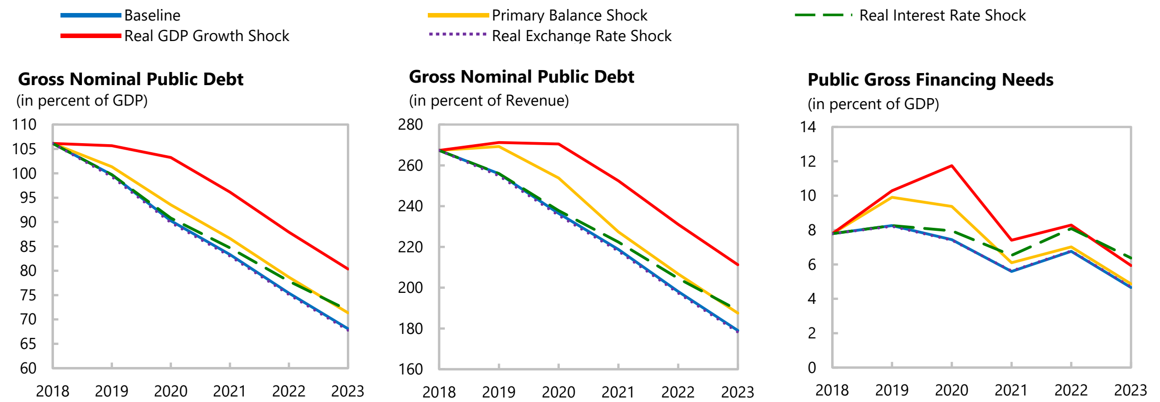
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.2	4.1	3.6	3.0	2.7	2.4
Inflation	1.4	1.8	3.2	2.9	3.2	3.1
Primary Balance	5.1	5.0	5.0	5.0	4.9	4.8
Effective interest rate	2.6	2.5	2.5	2.6	2.8	2.8
Constant Primary Balance Scenario						
Real GDP growth	4.2	4.1	3.6	3.0	2.7	2.4
Inflation	1.4	1.8	3.2	2.9	3.2	3.1
Primary Balance	5.1	5.1	5.1	5.1	5.1	5.1
Effective interest rate	2.6	2.5	2.5	2.6	2.8	2.8

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.2	0.4	0.4	0.4	0.4	0.4
Inflation	1.4	1.8	3.2	2.9	3.2	3.1
Primary Balance	5.1	0.2	0.2	0.2	0.2	0.2
Effective interest rate	2.6	2.5	3.0	3.4	3.9	4.3

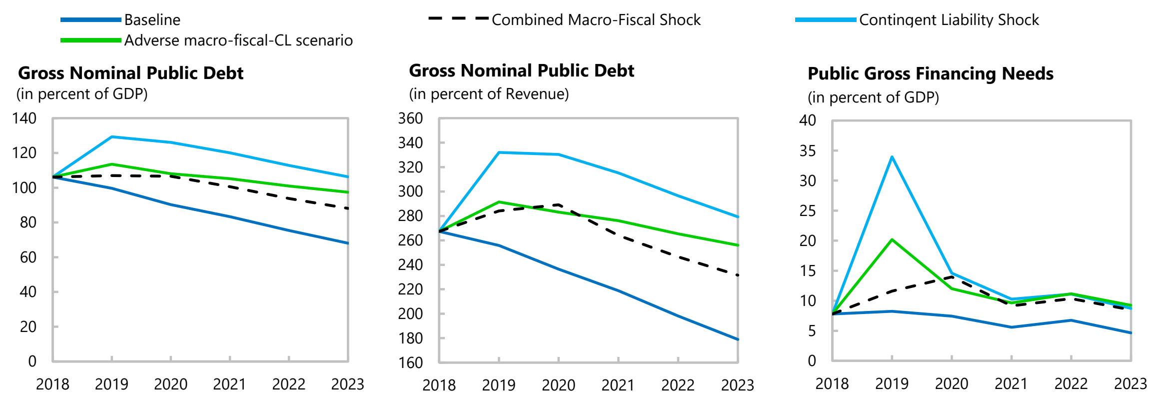
Source: IMF staff.

Cyprus: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

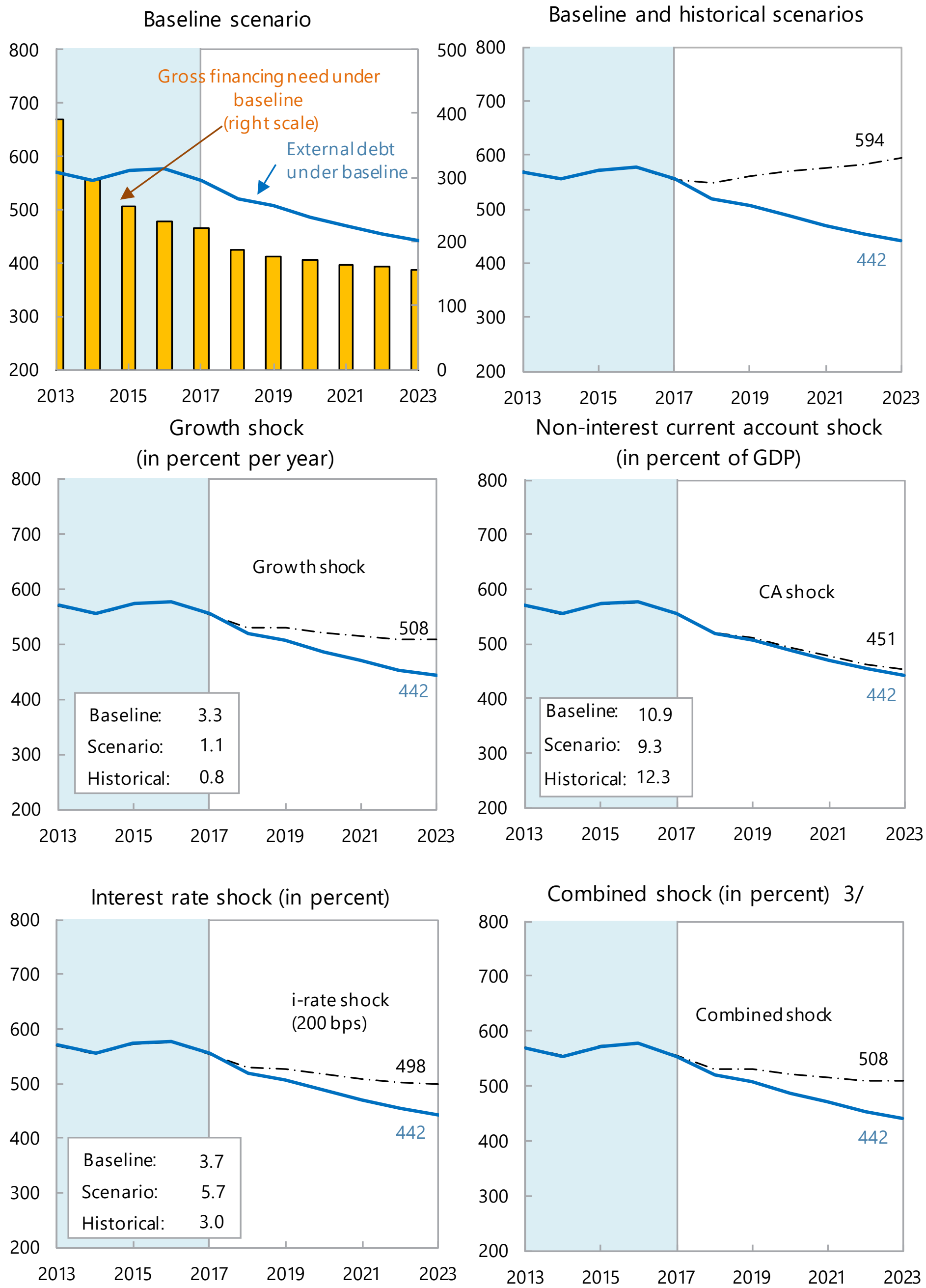
	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	4.2	4.1	3.6	3.0	2.7	2.4
Inflation	1.4	1.8	3.2	2.9	3.2	3.1
Primary balance	5.1	3.3	3.4	5.0	4.9	4.8
Effective interest rate	2.6	2.5	2.6	2.7	2.9	2.9
Real Interest Rate Shock						
Real GDP growth	4.2	4.1	3.6	3.0	2.7	2.4
Inflation	1.4	1.8	3.2	2.9	3.2	3.1
Primary balance	5.1	5.0	5.0	5.0	4.9	4.8
Effective interest rate	2.6	2.5	3.1	3.6	4.2	4.7
Combined Shock						
Real GDP growth	4.2	0.7	0.2	3.0	2.7	2.4
Inflation	1.4	0.9	2.3	2.9	3.2	3.1
Primary balance	5.1	2.2	0.8	5.0	4.9	4.8
Effective interest rate	2.6	2.5	3.2	4.0	4.6	5.2

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	4.2	0.7	0.2	3.0	2.7	2.4
Inflation	1.4	0.9	2.3	2.9	3.2	3.1
Primary balance	5.1	3.5	2.1	5.0	4.9	4.8
Effective interest rate	2.6	2.5	2.6	2.8	2.9	3.0
Real Exchange Rate Shock						
Real GDP growth	4.2	4.1	3.6	3.0	2.7	2.4
Inflation	1.4	2.2	3.2	2.9	3.2	3.1
Primary balance	5.1	5.0	5.0	5.0	4.9	4.8
Effective interest rate	2.6	2.5	2.6	2.6	2.8	2.8
Contingent Liability Shock						
Real GDP growth	4.2	0.7	0.2	3.0	2.7	2.4
Inflation	1.4	0.9	2.3	2.9	3.2	3.1
Primary balance	5.1	-20.0	5.0	5.0	4.9	4.8
Effective interest rate	2.6	2.6	4.2	4.3	4.4	4.5

Source: IMF staff.

Cyprus: External Debt Sustainability—Bound Tests 1/ 2/

(In percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks to growth and non-interest current account 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.

2/ 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.

3/ Permanent 1/4 standard deviation shocks applied to growth rate and current account balance and one-percentage-point increase in average interest rate.

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

(in percent of GDP, unless otherwise indicated)

	Actual							Projection						Debt-stabilizing non-interest current account 5/
	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022	2023	
Baseline: External debt	569	554	573	576	554			**519**	**507**	**487**	**470**	**453**	**442**	**1.7**
Change in external debt	-48.1	-14.8	18.3	3.9	-22.0			-35.5	-12.0	-20.2	-16.5	-16.8	-11.4	
Identified external debt-creating flows (4+9+14)	-30.6	-40.5	-12.8	21.9	-16.8			-34.9	-11.5	-19.8	-16.2	-16.5	-11.1	
Current account deficit, excluding interest payments	-11.4	-12.7	-17.5	-11.0	-8.9			-12.3	-8.4	-9.4	-10.6	-11.9	-12.8	
Deficit in balance of goods and services	-1.8	-2.0	-0.8	0.6	3.5			0.2	3.8	3.3	3.0	2.4	2.0	
Exports	58.6	62.0	64.5	64.5	65.0			64.8	61.0	60.0	59.5	59.1	58.9	
Imports	56.8	60.0	63.7	65.1	68.6			65.0	64.7	63.3	62.5	61.5	60.9	
Interest receipts (negative)	-12.7	-10.9	-12.3	-11.0	-10.0			-9.6	-10.0	-10.9	-12.0	-13.1	-14.2	
Net non-debt creating capital inflows (negative)	-81.4	-61.9	-10.0	39.9	6.7			-9.5	9.9	5.5	4.7	3.5	6.8	
Net foreign direct investment, equity	-4.1	-15.1	38.5	3.2	-21.5			-13.5	-2.6	-3.4	-3.1	-2.9	-3.2	
Net portfolio investment, equity	-65.6	-14.9	-9.5	6.1	21.4			4.1	4.4	5.0	4.5	1.9	1.7	
Net sales of assets under other investment	-11.5	-33.5	-34.0	28.8	5.8			-1.1	7.2	3.1	2.6	3.7	7.6	
Financial derivatives, net	-0.3	1.6	-4.9	1.9	1.0			1.0	0.9	0.8	0.8	0.7	0.7	
Automatic debt dynamics 1/	62.2	34.1	14.7	-7.0	-14.5			-13.1	-13.0	-15.9	-10.3	-8.1	-5.2	
Contribution from nominal interest rate	16.3	17.0	19.0	16.1	17.3			16.4	16.2	16.8	17.6	18.4	19.0	
Contribution from real GDP growth	38.4	7.7	-10.8	-26.4	-23.1			-21.8	-20.0	-17.0	-14.0	-11.8	-10.3	
Contribution from price and exchange rate changes 2/	7.5	9.5	6.5	3.4	-8.8			-7.7	-9.2	-15.7	-13.9	-14.7	-13.8	
Residual (2-3 or 19+20+21+22)	-17.5	25.7	31.1	-18.0	-5.3			-0.6	-0.5	-0.4	-0.3	-0.3	-0.4	
Net accumulation of official reserve assets	-0.2	0.0	0.0	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Captial account flows, net (negative)	-1.4	-0.8	-0.3	-0.2	-0.5			-0.5	-0.5	-0.4	-0.3	-0.3	-0.4	
Errors and omissions, net (negative)	-1.6	3.6	0.4	-0.2	-2.3			0.0	0.0	0.0	0.0	0.0	0.0	
Changes in debt stock without flow transactions, incl. valuation changes, write-offs, and reclassifications	-14.2	22.8	31.0	-17.5	-2.5			-0.1	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	970	893	888	893	853			801	831	811	790	767	751	
Gross external financing need (in billions of euros) 3/	71	52	45	43	43			39	38	40	41	42	43	
in percent of GDP	391	296	254	232	221			186	176	170	164	160	155	
Scenario with key variables at their historical averages 4/						5-Year	5-Year	**548**	**560**	**569**	**576**	**583**	**594**	
						Historical	Standard							Projected
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							Average
Nominal GDP (in billions of euros)	18.1	17.6	17.7	18.5	19.6			20.7	21.9	23.4	24.8	26.3	27.8	
Real GDP growth (in percent)	-5.8	-1.3	2.0	4.8	4.2	0.8	4.4	4.2	4.1	3.6	3.0	2.7	2.4	3.3
GDP deflator in euros (change in percent)	-1.2	-1.6	-1.2	-0.6	1.5	-0.6	1.3	1.4	1.8	3.2	2.9	3.2	3.1	2.6
Nominal external interest rate (in percent)	2.5	2.9	3.5	2.9	3.2	3.0	0.4	3.1	3.3	3.5	3.8	4.1	4.4	3.7
Growth of exports (euro terms, in percent)	2.1	2.7	4.8	4.2	6.7	4.1	1.8	5.3	-0.3	5.2	5.2	5.2	5.2	4.3
Growth of imports (euro terms, in percent)	-3.7	2.5	7.0	6.5	11.4	4.7	5.7	0.1	5.5	4.6	4.6	4.3	4.5	4.0
Current account balance, excluding interest payments	11.4	12.7	17.5	11.0	8.9	12.3	3.2	12.3	8.4	9.4	10.6	11.9	12.8	10.9
Net non-debt creating capital inflows	81.4	61.9	10.0	-39.9	-6.7	21.3	49.8	9.5	-9.9	-5.5	-4.7	-3.5	-6.8	-3.5

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 euro 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.

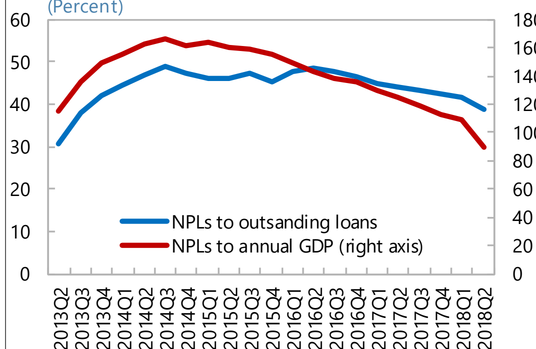
Annex V. Evolution of NPLs[1]

NPLs remain very large at 39 percent of total loans or 85 percent of GDP as of 2018Q2. The decreasing trend of NPLs continued, with the NPL-to-GDP ratio reduced by almost 35 ppts in a year. This reflects increased write-offs and sales of NPLs, as well as strong GDP growth. However, the outflow from NPLs by cash repayments or migration into performing category does not seem to have accelerated substantially despite the recovery from the crisis, implying that the payment discipline continues to be weak. There is a sign that restructuring activities have slowed, and two thirds of the restructuring flow is on the loans already restructured at least once.

Overview of NPL Trends

1. **NPLs decreased from 44 percent of total loans (€22.8 billion) in 2017:Q2 to 39 percent (€16.9 billion) in 2018:Q2.**[2] The NPL ratio to the annual GDP is 85 percent in 2018:Q2, which is the highest in euro area, although down from 125 percent a year earlier. Small borrowers (households and SMEs) owe almost 95 percent of the NPLs, which is among the highest in euro area. Over the past year, NPLs owed by households decreased from 55 percent of loans (€11.8 billion) to 51 percent (€10.2 billion). A faster decrease in NPLs was made by SMEs whose NPLs decreased from 58 percent of loans (€8.9 billion) to 45 percent (€5.3 billion). On the other hand, NPLs owed by large enterprises are smaller at 20 percent of loans (€1.1 billion) as of 2018:Q2, after a decrease by €0.6 billion in a year. NFC NPLs are mostly owed in construction (€1.8 billion), real estate (€0.9 billion), and tourism and trade (€2.3 billion) sectors.

Cyprus: Non-Performing Loans
(Percent)



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

Non-Performing Loans
(Billions of euro)

	2014Q4	2015	2016	2017	2018H1	2018H1
			Change			
Total	28.4	-1.1	-3.0	-3.4	-4.0	16.9
HHs	12.8	-0.1	-0.7	-1.1	-0.8	10.2
NFCs	14.4	-0.5	-2.2	-2.2	-3.1	6.4
Large enterprises	5.3	-0.7	-3.1	-0.5	0.0	1.1
SMEs	9.0	0.1	0.9	-1.7	-3.1	5.3
NFCs						
Tourism and trade	4.0	-0.1	-0.3	-0.6	-0.6	2.3
Construction	5.1	-0.2	-1.1	-0.7	-1.4	1.8
Real estate	2.4	0.0	-0.3	-0.5	-0.6	0.9
Others	2.9	-0.2	-0.4	-0.4	-0.5	1.4
Other financial corporates and government	1.2	-0.5	-0.2	-0.1	-0.2	0.3

Source: Central Bank of Cyprus and IMF staff calculations.

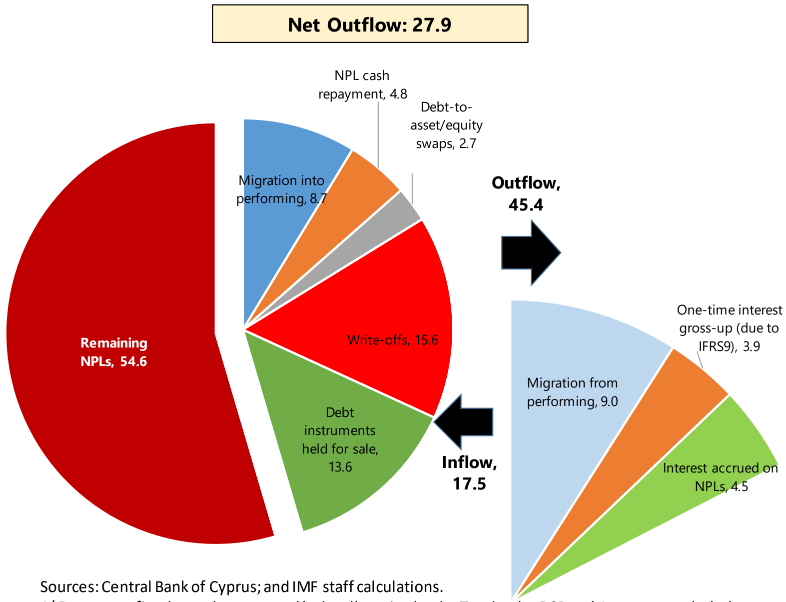
[1] See accompanying SIP, "*Cyprus: Challenges in Reducing NPL Overhang and Restoring Credit Financing*"

[2] Throughout this annex, all data are consolidated accounts of all banks unless otherwise specified. At end-2014, the CBC changed its definition of NPLs to be consistent with the European Banking Authority's definition. From 2018, a shift to IFRS9 accounting standards required recognition of accrued interest on NPLs as part of NPLs.

2. Gross outflows from NPLs were nearly three times the gross inflows to NPLs during one year up to 2018:Q2. The outflows from NPLs consisted of write-offs (about one-third), sale of loans (one-third), migration to performing category (20 percent), NPL cash repayment (10 percent), and debt-to-asset or equity swaps (6 percent).[3] The large contributions from write-offs and sale of loans partly reflect the limited use of foreclosure and insolvency tools.

Cyprus: Flows of Non-Performing Loans 1/

(Q3:2017-Q2:2018. Stock at the beginning of the period normalized to 100.)

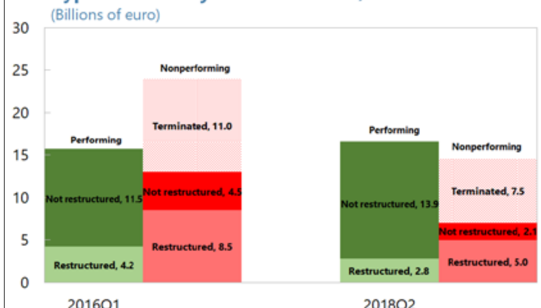


Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Data cover fixed-term loans owned by locally active banks. Two banks, RCB and Astro, are excluded.

3. Viable restructuring of NPLs has been challenging. Almost two-thirds of the restructuring flow is on the loans already restructured at least once, and the default rate on restructured loans has increased. More than a half of NPLs are terminated accounts (whose outstanding balance has been called in), whose amount in euro has decreased moderately (compared to the rest of NPLs) up to 2018:Q2. The relative non-viability of restructuring activities likely reflects still-low repayment capacity particularly for a group of debtors whose loans are being evergreened or weak repayment discipline underscoring the lack of a credible foreclosure framework.

Cyprus: Loans by Classification 1/

(Billions of euro)



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

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[3] Some write-offs were in response to one-time interest gross-up due to the adoption of IFRS9. The majority of the sale of loans reflect a transaction made by one bank in June 2018 (currently subject to the supervisory approval).

4. Financial hardship is likely one of the main contributors to a large stock of NPLs and difficulties in improving repayments by households. The question of the repayment capacity is highly pertinent since despite their high indebtedness, households have net financial assets exceeding 100 percent of GDP. A substantial decrease in net wealth and gross income coincided with an increase in NPLs owed by households during the crisis. The Household Finance and Consumption Survey suggests that median net wealth in a Cypriot household decreased by 36 percent in euro terms between "Wave 1" (2009–10) and "Wave 2" (2014).[4] This rate of decrease in net wealth is large, compared to the euro-area level of 4 percent. Real and financial assets decreased by 30 percent and 29 percent, respectively, while liabilities increased by 26 percent. Gross income also decreased by 30 percent. Indeed, indicators of debt burden—debt-to-asset ratio, debt-to-income ratio, debt-service-to-income ratio, and loan-to-value ratio of primary residence—all deteriorated during the crisis. Particularly, the debt-to-income ratio increased substantially from 1.57 to 2.51, compared to the euro-area average of 0.72. Debt burdens are especially heavy for the households in the bottom-20-percent income or wealth level. The debt burden to income indicators are particularly worse compared to the euro area, underscoring the weak lending standards of banks that focused mainly on collateral values rather than repayment capacity.

Net Wealth of Households, Medians
(Thousand euros)

	Wave 1 (2009-10)	Wave 2 (2014)	Change in percent
Cyprus	267	170	-36
Euro area	108	104	-4
Germany	51	61	18
Belgium	206	218	6
Greece	102	65	-36
Spain	183	160	-13
Italy	173	146	-16
Luxembourg	398	438	10
Malta	201	210	4
Portugal	79	71	-10

Sources: ECB HFCS.

Financial Burden Indicators, Medians

	Cyprus		Euro area	
	Wave 1 (2009-10)	Wave 2 (2014)	Wave 1 (2009-10)	Wave 2 (2014)
Debt-to-income ratio	1.57	2.51	0.63	0.72
Debt-service-to-income ratio	0.23	0.36	0.14	0.14
Mortgage-debt-service-to-income ratio	0.25	0.34	0.16	0.16
Debt-to-asset ratio	0.17	0.23	0.22	0.26
Loan-to-value ratio of main residence	0.32	0.42	0.38	0.44

Sources: ECB HFCS.

[4] The Household Finance Survey provides household-level data related to household balance sheets in participating countries in euro area. In Cyprus, 1,237 and 1,289 households participated in "Wave 1" (2009–10) and "Wave 2" (2014), respectively, while 930 households participated in both. The coverage of the survey is limited, so the result should be interpreted carefully with other evidence.

5. NPLs could also be partly linked to strategic behavior by debtors. Net wealth (financial and real assets net of liabilities) for a median household is about €170,000 in Cyprus as of 2014, higher than the euro-area level of €104,000. The outstanding loans by a median Cypriot household, which are 23 percent as a ratio to total assets, are lower than the euro-area level of 26 percent. The net wealth for the bottom 20-percent group is similar between Cyprus and euro area. The fraction of households whose net wealth is negative was 6.9 percent in Cyprus, only moderately higher than the euro-area level of 5.2 percent. A sizable share of NPLs, particularly among the wealthier debtors, could therefore likely be serviced through disposal of assets.

Annex VI. Regulatory Framework for the Sales of Non-Performing Loans in Cyprus

1. Sales of non-performing loans to qualified third parties is an important element of a successful NPL resolution strategy. While banks often attempt to work-out NPLs in-house, for example, by setting up special units and developing the know-how, evidence suggests that post-crisis clean-up of banks' balance sheets may take time. In the meantime, NPLs continue to weigh on banks' ability to comply with regulatory requirements and their profitability. Shifting NPLs from banks' balance sheets allows to resolve them without the pressure to increase provisions and capital requirements within a limited amount of time. In addition, third parties may bring operational expertise, processes, and tools necessary to manage portfolios with a large number of loans and could be better positioned than banks to deal with NPLs in an arms-length manner.

2. Investor interest in sales of non-performing loans is growing in Cyprus. Several transactions by banks to sell NPL portfolio to third party "credit acquiring companies" (CACs) were concluded recently (text box) and additional sales of NPLs are expected in the horizon owing to the more favorable legal environment for dealing with NPLs and the strong interest from foreign funds to enter this market. In addition to privately owned CACs, the recent CCB transaction has resulted in the creation of a government-owned asset management company, the Cyprus Asset Management Company (CAMC). The transaction included a transfer of NPLs from the CCB (Box 1) to CAMC, a wholly-owned subsidiary of the CCB residual entity.

Date	**Bank**	**Credit Acquiring Company**	**Amount**	**Comments**
August 2018 1/	Bank of Cyprus	Apollo Global Management	€2.7bn	predominantly corporate and small and medium size enterprises (SMEs) secured by real estate; financed the deal through a securitization structure—senior and junior tranches,
June 2018	Hellenic Bank	B2Kapital Cyprus Ltd	€144m	mainly non-retail secured and unsecured exposures
September 2018	Cyprus Cooperative Bank	Cyprus Asset Management Company (CAMC)	€7bn	mainly secured household loans

1/ Date of agreement. Transaction pending supervisory approval.

3. The legal framework for the sales of non-performing loans is established by the 2015 Law on the Sales of Loans. For loans exceeding €1 million where the borrower is an individual or an SME, banks must comply with certain notification requirements.[1] CACs must be corporate entities registered in Cyprus that meet the criteria specified in the law (e.g., the minimum share capital requirement) and are subject to licensing and supervision by the Central Bank of Cyprus (CBC). CACs are also subject to other CBC Directives, including the Directive on Arrears Management and the Code of Conduct for banks in handling arrears. The law empowers the CBC to establish and implement the regulatory and supervision regimes for CACs while taking financial stability and national interest concerns into consideration. For example, the law gives the power to the CBC to interfere in the pace of foreclosure in case of financial stability concerns.

4. The entry of CACs in the Cyprus NPL market underscores the importance of a well-developed legal framework for CACs, including the regulatory and supervision regimes to be established by the CBC. While some of the licensing requirements are set forth in the Sales of Loans law, better guidance is needed on how these rules, including the "fit-and-proper" criteria for CAC shareholders and directors, or change-of-control rules, are to be implemented. The supervisory regime for CACs, yet to be developed by the CBC, should create a level playing field for CACs and facilitate market-based resolution of NPLs. CBC's ability to block certain actions and appointments by CACs in the national interest and for financial stability raises potential conflicts. CBC should develop the framework of using such powers. It is also important to develop a solid governance framework for the government-owned CAMC. Such a framework should include clear and transparent governance arrangements and accountability mechanisms that would facilitate effective operation of CAMC, limit moral hazard, and maximize recovery for the government while safeguarding financial stability.

See Box 4 in Cyprus—Ninth Review Under the Extended Arrangement Under the Extended Fund Facility and Request for Waiver of Applicability of Performance Criteria (IMF Country Report No. 16/26).

Annex VII. Potential Fiscal Impact of the Rollout of the National Health System

1. **A major reform of the health system is underway to address several important deficiencies.** The majority of the Cypriot population is entitled to access free public health care, but service is severely rationed because of capacity constraints. Given the generally better quality of care in the private health sector and rationing in the public sector, patients, including those entitled to free public health care, choose to use private providers, leading to high out-of-pocket private spending. The reform aims at introducing a universal system to allow efficient risk pooling and equitable access to health services, including to the most vulnerable part of the population that cannot afford large out-of-pocket spending.

2. **Public health expenditure in Cyprus is low,** reflecting the lack of a national health insurance system. The level of public health expenditure in Cyprus is only about half the EU average. On the other hand, private health spending is much higher than the EU average, as the rationing in public health care drives parts of the demand to private health care.

3. **The authorities plan to launch National Health System (NHS), a national health insurance with global-budget, in June 2019.** The reform aims to provide universal access to quality healthcare service to the population. The NHS is a system with global-budget, under which the government determines the financial envelope of the system that will be available to participating—both public and private—healthcare providers. The current NHS envelope was determined based on data on actual total health spending in the country. The NHS has also been designed to be financed by two sources of revenue: (i) contributions on payroll—with the burden split between employees and employers—, income of the self-employed, pension and passive income (rent, interest, dividend), and (ii) general taxation (government contribution as a third party). Contribution rates for beneficiaries and government contribution as a third party have been calibrated to balance the budget of the system. Contributions will be collected beginning March 2019 for the first phase of the NHS. Rates are planned to be adjusted upward in March 2020 ahead of the full implementation of the NHS in June 2020.

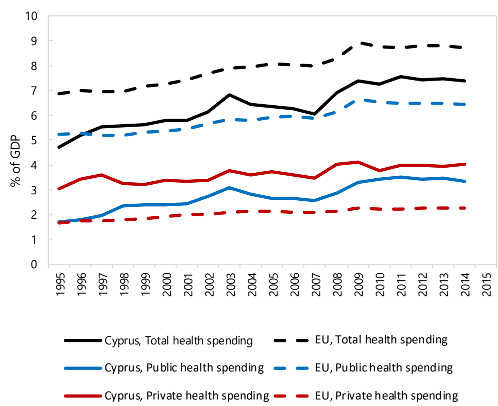
Cyprus: NHS Contribution Rates

	From March 1, 2019	From March 1, 2020
Employees (public and private sector)	1.70 percent of salary	2.65 percent of salary
Employers (including the state as an employer)	1.85 percent of salary	2.90 percent of salary
Self-employed	2.55 percent of income	4.00 percent of income
Pensioners/other income earners (e.g., rent, interest, dividends)	1.70 percent of pensions/income	2.65 percent of pensions/income
State contribution as a third party	1.65 percent of salaries, pensions and self-employed income and officials' remuneration	4.70 percent of salaries, pensions and self-employed income and officials' remuneration

Cyprus: Health Care Expenditure and Efficiency Indicators

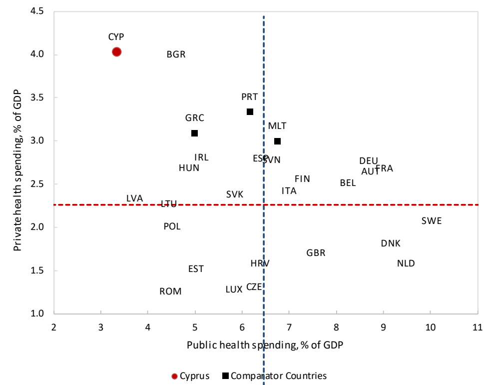
Total health expenditure in Cyprus is below EU level but has been growing in line with the trends in Europe.

Health Expenditure Trend



Public health expenditure is currently about half the EU average

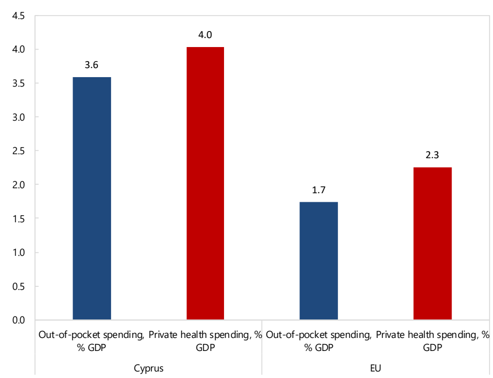
Health Expenditure: Public and Private 1/



LVA: Latest value avaliable
1/ Dashlines are mean of EU.

Private health spending is much higher reflecting very high out-of-pocket health spending.

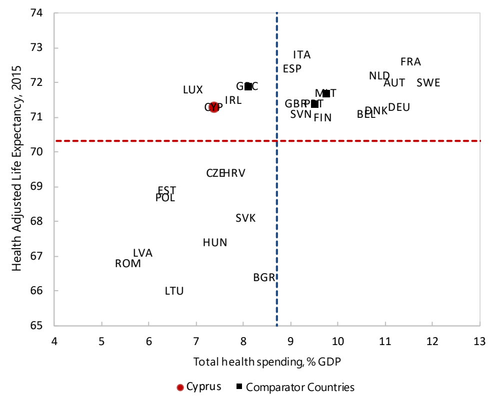
Out-of-pocket health spending vs Private health spending



LVA: Latest value avaliable.

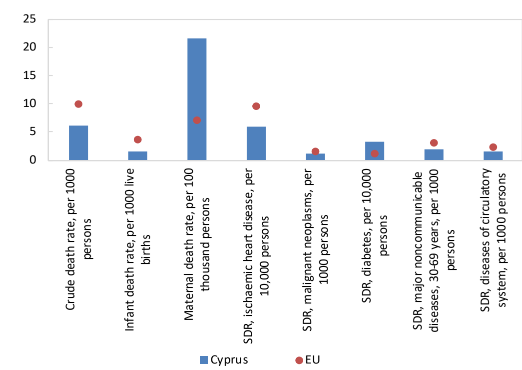
Health care in Cyprus is fairly efficient...

HALE vs Total health spending



...with health outcomes better in most areas despite the low overall spending.

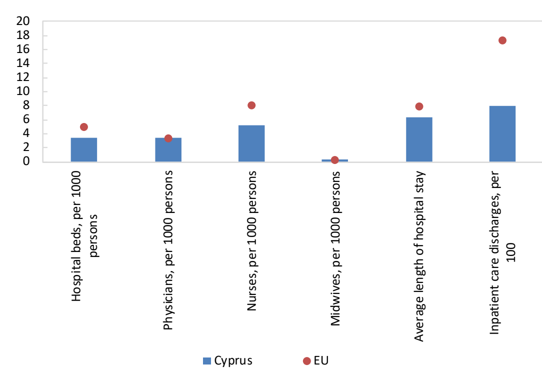
Outcome Indicators



LVA: Latest value available. Benchmark options are the three benchmarks selected on sheet "Select Country & Benchmark".

Costs have been contained which could also reflect the rationing of access in the existing system.

Structural Indicators



LVA: Latest value available. Benchmark options are the three benchmarks selected on sheet "Select Country & Benchmark".

Sources: Eurostat; OECD; and Fund staff estimates.

4. Public healthcare providers (public hospitals, primary care centers etc.) are being transformed with a goal of becoming more autonomous, both financially and operationally. Public healthcare providers currently are a part of the Ministry of Health. The costs, including compensation of employees (doctors and nurses), are on the government budget while these providers have little revenue streams. Furthermore, the remuneration framework and labor contracts for public sector employees differ from those used by the private sector counterpart, leaving limited room for labor adjustment. The law that was adopted in June 2017 together with the NHS law aims to change this situation by establishing and operationalizing a new entity, State Health Service Organization (SHSO), that will be responsible for the administrative and financial autonomy of public healthcare providers. The SHSO is currently being established. It is envisaged that the SHSO adjusts the labor and cost structure to raise productivity gradually, including through the introduction of a new more cost-effective category of jobs as well as through voluntary conversion of healthcare professionals from government employees to workers with private contracts. The goal is to cover eventually the costs of public healthcare providers by the revenue stream that they will generate under the NHS over the long run.

5. The overall fiscal impact of the NHS introduction is expected to be neutral *in the long run*. Once the NHS is introduced, public healthcare providers will operate under SHSO and the spending by the Ministry of Health is expected to shrink substantially (from more than 3 percent of GDP this year to less than ½ percent of GDP). At the same time, the government will make contributions to the NHS, both as an employer on the remuneration of government employees as well as a third party, which are expected to amount to 2½ percent of GDP. Therefore, once public healthcare providers become efficient over the long run and collect enough revenue from NHS to cover their own expenses, the fiscal impact of the NHS introduction would be neutral.

6. However, the introduction of the NHS might lead to a temporary increase in the fiscal outlay. It is expected that it will take time for the SHSO to successfully raise productivity of public healthcare providers, as adjusting the labor structure will need to take place gradually. As a result, the government will likely need to fill the deficit of public healthcare providers in the short run. Indeed, the law on SHSO provides that the central government fill any financial shortfalls in the first five years following public healthcare providers becoming autonomous. The SHSO also needs to ensure that public healthcare providers maintain a certain degree of market share. There is currently excess demand for public health care because it is provided free and more than 80 percent of the population is entitled to it while capacity is limited. With the NHS introduction, patients will be able to choose any healthcare providers participating in the NHS at the same price, which is expected to lead to a shift in demand from public to private healthcare providers. While the shift is not predicted to lead to a sudden shortfall of demand for public healthcare service given the capacity constraints in the private sector, financial sustainability of public healthcare providers depends in part on maintaining a certain amount of demand.

7. **The NHS includes several mechanisms to keep health expenditure in check:**

- Payment to primary care doctors and pediatricians is based on capitation and therefore creates right incentives for service providers to not over-supply.

- Primary care doctors and pediatricians function as gate keepers as patients are required to obtain referrals first to see specialists. The new IT system will also provide a safeguard against unnecessary referrals as it is designed to flag any unusual referral activities based on the system-wide data. Furthermore, the total cost of system-wide special service is pre-determined by the global budget, with frequent and periodic changes in unit prices slated to absorb the potential cost impact emanating from volatility of demand.

- Economy-wide savings could be envisaged from pharmaceuticals. Once the NHS is introduced, pharmaceuticals used in the system will be centrally procured and priced, whereas the current practice is markups are added for the part prescribed in the private sector. Over-subscription is also suspected under the current system, but the new IT system will provide additional checks and balances.

8. **While NHS's global budget might mitigate budgetary pressure, vigilance is needed to ensure the sustainability of the NHS and government health expenditure at the same time.** Increased spending pressures could lead to an accumulation of arrears. The NHS law provides that a periodic actuarial review be undertaken every three years. In the event an increase in the global budget is warranted, contributions, including those by the government, might need to increase. Indeed, demand pressures on public health spending will likely increase as the rationing is eliminated through the rollout of universal service provision and as an increasing share of elderly population leads to a rapid rise in old age dependency ratio. Staff calculation based on population projections under the UN's medium-fertility scenario indicates that, with *no policy changes*, health expenditure-to-GDP ratio increases 1.5 percentage points (ppts) of GDP from 2015 to 2035.[1] The pace of increase is faster by additional 0.1-0.2 ppts if fertility rate or mortality rate is lower.[2] Any increase in the fiscal outlay on health service needs to be carefully reviewed to safeguard fiscal sustainability. It is also critical to ensure that SHSO has adequate tools to make public health providers self-financed.

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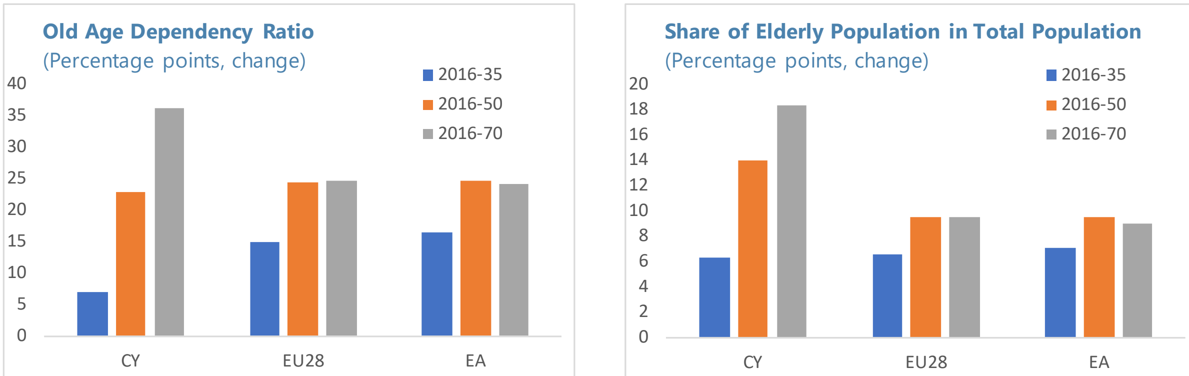
[1] For details of the methodology, see *The Fiscal Consequence of Shrinking Populations*, IMF Staff Discussion Note SDN/15/21.

[2] For methodology, see *Fiscal Policy, How to Assess Fiscal Implications of Demographic Shifts: A Granular Approach*, How to Note No.2, Fiscal Affairs Department, IMF.

Cyprus: Demographic Developments

Old age dependency ratio will rise rapidly… *…driven by an increasing share of elderly population.*



INTERNATIONAL MONETARY FUND

CYPRUS

November 8, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of September 30, 2018)

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	50.02	37.67

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 2018)

	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	11.40	11.40
2019	0.00	12.20	12.20
2020	31.31	12.21	43.52
2021	138.19	10.81	148.99
2022	125.81	8.17	133.99

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, and maintains an exchange 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). External payment restrictions introduced in 2013 in the wake of the banking crisis were fully eliminated, effective April 6, 2015.

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 December 13, 2017 (IMF Country Report No. 17/375).

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 Second Post-Program Monitoring (PPM) discussions was held on June 4, 2018 (IMF Country Report No. 18/153). 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 and subsequently, for another year, on June 4, 2018.

Safeguards. A safeguards assessment was finalized in August 2013 in the context of an EFF arrangement approved in May 2013. The assessment found a weak governance framework at the CBC and a strained balance sheet given the large ELA exposure. The CBC addressed most of the recommendations made in the areas of audit and control oversight, financial reporting transparency, and internal audit. The CBC continues to publish its audited financial statements in a timely manner. Legislative efforts currently underway are expected to address the remaining safeguards recommendations to strengthen the central bank's governance and financial autonomy.

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
MCM	Financial stability	December 2017
FAD	Revenue administration	December 2017
FAD	Spending review	February 2018
LEG	Legal framework for NPL resolution	March 2018
FAD	Spending review and public financial management	September 2019

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).

STATISTICAL ISSUES

(As of October 22, 2018)

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 position 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 roughly a one-quarter lag (e.g., 2018: Q2 data were released in September 2018). 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 have been published since November 2017. Cyprus participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).
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 structural 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 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 22, 2018)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2018	Oct. 2018	M	M	M
Reserve/Base Money	Aug. 2018	Sep. 2018	M	M	M
Broad Money	Aug. 2018	Sep. 2018	M	M	M
Central Bank Balance Sheet	Aug. 2018	Sep. 2018	M	M	M
Consolidated Balance Sheet of the Banking System	Aug. 2018	Sep. 2018	M	M	M
Interest Rates[2]	Current	Current	D	D	D
Consumer Price Index	Sep. 2018	Oct. 2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Aug. 2018	Sep. 2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug. 2018	Sep. 2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug. 2018	Sep. 2018	M	M	M
External Current Account Balance	2018:Q2	Sep. 2018	Q	Q	Q
Exports and Imports of Goods and Services	2018:Q2	Sep. 2018	Q	Q	Q
GDP/GNP	2018:Q2	Sep. 2018	Q	Q	Q
Gross External Debt	2018:Q2	Sep. 2018	Q	Q	Q
International investment position[6]	2018:Q2	Sep. 2018	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] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

Statement by Anthony De Lannoy, Executive Director for Cyprus,
and Dries Cools, Alternate Executive Director
November 28, 2018

The Cyprus authorities thank staff for the in-depth discussions they have had during the September-October Article IV mission in Nicosia. In addition to the ongoing post-program monitoring, the Article IV mission provides the opportunity to take a broader and more long-term perspective at the Cypriot economy. The authorities broadly agree with staff's analysis and would like to make the following remarks.

Since this summer, S&P and Fitch have upgraded Cyprus to investment grade. The authorities take this as an encouragement to remain on the path of prudent fiscal policies and to continue reducing the overhang of non-performing loans ('NPLs') in the banking sector. They also interpret this encouragement as an invitation to deepen the many structural reforms that Cyprus has embarked upon.

Fiscal

Cyprus is expected to close 2018 with a healthy primary surplus of 5.4% of GDP and is projected to continue to record substantial primary surpluses, which under the baseline scenario will bring down the country's public debt from 104% of GDP in 2018 to below 85% by 2021. To safeguard further debt reduction, the authorities are firmly committed to keeping expenditure growth below the medium-term GDP growth rate. This also applies for the gradual reversal of the crisis-era wage cuts.

Cyprus' fiscal consolidation is supported by broad-based economic growth and a strong pick-up in employment. Taking into account growth rates in cumulative terms, Cyprus has recovered to its pre-crisis GDP levels in 2017. Looking ahead, growth is expected to total 15% for the four-year horizon 2018-2021. The authorities underline that growth is broad-based, spanning across all sectors, except the financial sector, with tourism at 1.3 p.p., construction at 1.0 p.p., professional services at 0.7 p.p., and manufacturing at 0.3 p.p. In addition, other sectors such as the investment fund industry and education are contributing to growth, the latter reflecting the various international educational institutions taking roots and expanding in Cyprus. Finally, the tourism industry is becoming more diverse, with an increasingly wider offering and a broader spread of tourists throughout the year.

Most of the investment in Cyprus is foreign-financed, reflecting strong investor appetite among international investors. The pick-up in construction had not led to a sizeable increase in real estate prices, with a notable exception for construction of prime residential real estate for a foreign clientele, mostly concentrated along the Limassol coastline. The authorities underline that foreign residential real estate investments related to the Citizenship by Investment (CbI) scheme are subjected to a recently strengthened 4-layer due diligence procedure, to continue to ensure compatibility with AML/CFT standards. More importantly, risks to the investment outlook are on the upside, despite any possible slowdown in CbI financed projects.

External Sector

Despite the overall global uncertainty, it is the authorities' view that the external sector developments in Cyprus are in line with the fundamentals of the Cyprus economy. Specifically, the projected current account deficit is considered to be at a sustainable level, in line with the overall domestic economic growth momentum.

Financial Sector

Whereas the high level of NPLs has not weighed on strong investor sentiment, the authorities do agree with staff that the high NPL levels pose a risk to debt sustainability. That said, the authorities have made great strides in reducing NPL levels. From a total of €28.4 billion at the end of 2014, NPLs have come down to €16.9 billion in the first half of 2018, with NPL reduction steadfastly continuing in 2018. The decrease in the first half of 2018 is mostly related to the sale of NPLs by Bank of Cyprus to Apollo Fund (Helix) in the order of €2,7 billion, although the sale is still subject to supervisory approval.

The reduction of NPLs is expected to continue at an increased pace in the second half of 2018, following the sale of CCB's good assets to Hellenic Bank. The CCB's NPLs amounting to €5.7 billion have remained outside the banking system, in a residual entity named the Cyprus Asset Management Company ('CAMC'). The CCB operation has come at a major public cost but was necessary to stem the sudden deposit outflows that CCB witnessed mainly in the first half of 2018. Additionally, other transactions to reduce the level of NPLs are in the pipeline, with international investors indeed taking a keen interest in buying blocks of Cypriot NPLs. The approval by the Cypriot parliament in July 2018 of a major legislative package to strengthen the NPL resolution, has strongly underpinned investor interest. The legislative package includes amendments to the sale of loans law, foreclosure law, bankruptcy law, company law, personal insolvency laws, and the regulation on insolvency practitioners. The sale of NPLs to professional investors also allays concerns that NPLs will be simply warehoused.

The authorities of course agree with staff that work is not complete. The supervisory and regulatory framework for credit-acquiring firms needs to be finalized (including for CAMC), and a major reform of Cyprus' judicial system should speed up effective contract enforcement.

The authorities understand that concerns have been raised about the eligibility criteria of Estia ('house'), the burden-sharing scheme intended to strengthen the resolution of a sensitive segment of the NPL portfolio. At the time of writing, the eligibility criteria of the Estia scheme are being finalized. The authorities would like to underline, however, that at €20 million, the net total maximum annual fiscal cost of Estia is manageable. Moreover, Estia is expected to facilitate NPL resolution, and has helped fostering political and societal buy-in for the NPL resolution legislative package approved in July 2018.

Structural Reforms

While Cyprus is sticking to a prudent fiscal policy and reducing its financial sector contingent liabilities, it has at the same time engaged in an impressive array of structural reforms. In 2019, the long awaited National Health Service will be rolled out. The judicial system will be strengthened, with the expected creation of a Commercial Court, and with additional judges being hired to address a backlog in legacy cases, including NPL cases. A local government reform is on the drawing board, and a legislative proposal to enhance the governance of the Central Bank of Cyprus has been submitted. The concomitance of these reforms demonstrates the willingness of the authorities to modernize further the Cypriot state and economy. At the same time, the authorities are dealing with the fallout of regional conflicts, with Cyprus facing one of highest levels of asylum applications in the EU.

As Cyprus is engaged on many fronts, it is inevitable that some reforms take more time than expected to move from the drawing board to the implementation stage. Thus, it is important to take a long-term perspective when analyzing the country's reform efforts. The authorities in particular agree that the problems of issuance and transfer of title deeds needs to be addressed and that judicial reform needs to be further pursued, as well as measures to ease doing business in Cyprus.