INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/151

CYPRUS

June 2019

THIRD POST-PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE AND STAFF REPORT

In the context of the Third Post-Program Monitoring Discussions with Cyprus, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on March 27, 2019, 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 May 16, 2019.

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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June 4, 2019

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IMF Executive Board Concludes Third Post-Program Monitoring Discussions with Cyprus

On June 3, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Third Post-Program Monitoring discussions[1] with Cyprus.

Cyprus's post-crisis economic recovery is gradually decelerating but remains strong. Real GDP grew by 3.9 percent in 2018, buoyed by the services and construction sectors, partly financed with foreign direct investment. The unemployment rate continued to decline, reaching 7.1 percent in February, compared to 9.4 percent a year earlier, while wage pressures and inflation remain low. A large fiscal surplus is helping to lower public debt following a sizable one-off increase related to the sale of Cyprus Cooperative Bank (CCB) last year. The removal of CCB's non-performing loans (NPLs) and securitization of a large NPL portfolio have led to a sharp reduction in NPLs. Nevertheless, NPLs are still among the highest in the EU, public and private debt levels remain elevated and efforts to clean up bank balance sheets and build capital buffers are ongoing.

Executive Board Assessment[2]

Cyprus's rapid recovery is expected to slow gradually, but the outlook remains favorable. Real GDP is projected to grow at a still-robust 3–3½ percent in 2019–20, supported by foreign-financed investment and private consumption. Over the medium term, growth is expected to ease to potential, as the investment boom dissipates and households step up debt servicing.

Capacity to repay the Fund is adequate under the staff's baseline scenario. While risks remain, these have declined and their impact on repayment capacity should be manageable. Repayment capacity is underpinned by projected robust economic growth and sizable primary

[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

fiscal surpluses that anchor a durable decline in the gross public debt-to-GDP ratio and support continued favorable market borrowing terms. However, repayment capacity could be weakened if risks materialize from banks' still weak asset quality, direct fiscal guarantees, and fiscal spending including the reversal of crisis-era measures. The growth outlook could be adversely affected in the event of a disorderly hard Brexit, tightening of foreign financing for investment, or realization of AML/CFT risks. Safeguarding the adequate repayment capacity therefore warrants ambitious financial and fiscal policies as well as structural reforms.

Durable declines in NPLs remain a priority to reduce sovereign-bank linkages further. A package of legislative amendments in 2018 have enhanced the toolkit to address NPLs. While banks have made significant progress in offloading NPLs, their successful workout outside of the banking system is still needed in order to reduce the high debt burden in the economy. The implementation of the foreclosure framework should be complemented by the planned introduction of e-auctions, ongoing reform of the court system and measures to eliminate uncertainties regarding title deeds. Banks should be encouraged to maintain adequate provisioning coverage and capital, including by diversifying revenue sources and rationalizing operational costs. Ensuring ongoing compliance with the eligibility requirements for the *Estia* scheme is crucial to minimize its fiscal cost. An appropriate governance structure for the state-owned AMC should be put in place expeditiously to avoid warehousing of assets and maximize recovery.

Strict fiscal discipline should be maintained. A neutral medium-term fiscal stance should be ensured. Spending growth should continue to be firmly maintained at a pace below that of medium-term GDP and cyclical and windfall revenues, including from state-owned AMC, should be saved to help safeguard the firmly downward path of public debt. In this regard, it is important to keep growth of the wage bill, including increases arising from the reversal of crisis-era public wage and pension cuts, below nominal GDP. Fiscal risks from the introduction of a public health insurance system should be mitigated by reforms aimed at making the public health sector more competitive and managing incentives for providers and patients.

A window of opportunity for structural reforms is opening and should be vigorously pursued. With CCB now resolved and the next Parliamentary elections scheduled only in 2021, the authorities are pursuing some long-delayed structural reforms, including judiciary and local government reforms, and the introduction of a national health insurance system. However, there has been little progress on some important reforms, such as the SOE law, privatizations, and broader civil service reforms. Reforms of civil procedures and the process to issue title deeds, and introduction of the e-justice system, would help resolve crisis legacies and improve access to financing and investment. Further efforts to mitigate AML/CFT risks and strengthen governance of commercial SOEs and the Central Bank of Cyprus will help reduce risks to growth and fiscal risks.

Continued monitoring of Cyprus's repayment capacity under PPM is warranted during the next 12 months. Progress toward external viability is subject to risks, as realization of contingent liabilities arising from banks' still high NPLs could adversely affect the sovereign's market access. The Cypriot authorities have indicated their willingness to continue to engage with the Fund under PPM until 2020.

Cyprus: Selected Economic Indicators, 2015–2019

	2015	2016	2017	Projections 2018	Projections 2019
Output/Demand					
Real GDP	2.0	4.8	4.5	3.9	3.5
Domestic demand	3.9	6.1	8.5	3.0	4.5
Consumption	1.9	3.5	3.9	3.8	2.9
Private consumption	2.4	4.5	4.1	3.7	3.0
Public consumption	-0.5	-0.8	3.1	4.3	3.9
Gross capital formation	18.1	21.9	31.8	-0.3	10.9
Foreign balance 1/	-1.8	-1.2	-3.9	0.7	-1.0
Exports of goods and services	5.2	4.6	6.0	3.3	-1.3
Imports of goods and services	8.4	6.6	12.2	2.0	0.2
Potential GDP growth	1.2	1.6	2.0	2.3	2.6
Output gap (percent of potential GDP)	-7.0	-4.1	-1.8	-0.3	0.6
Prices					
HICP (period average, percent)	-1.5	-1.2	0.7	0.8	0.5
HICP (end of period, percent)	-0.5	0.1	-0.3	1.1	1.2
Employment					
Unemployment rate (EU standard, percent)	14.9	13.0	11.1	8.4	7.0
Employment growth (percent)	-1.3	1.4	4.6	5.6	2.5
Public Finance					
General government balance	-0.3	0.3	1.8	-4.8	3.3
Revenue	39.0	38.0	38.9	39.7	40.8
Expenditure	39.3	37.7	37.1	44.5	37.5
Primary Fiscal Balance	2.7	3.0	4.3	-2.3	5.7
General government debt	108.0	105.5	95.8	102.5	95.2
Balance of Payments					
Current account balance	-1.5	-5.1	-8.4	-7.0	-7.3
Trade Balance (goods and services)	0.8	-0.6	-3.5	-2.2	-3.2
Nominal GDP (billions of euros)	17.7	18.5	19.6	20.7	21.8

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

THIRD POST-PROGRAM MONITORING DISCUSSIONS

May 16, 2019

EXECUTIVE SUMMARY

Background: Economic growth is gradually decelerating but remains strong, buoyed by the services and construction sectors, partly financed with foreign direct investment. While employment is picking up, wage pressures and inflation remain low. A large fiscal surplus is helping to lower public debt after a sizable one-off increase related to the sale of Cyprus Cooperative Bank (CCB) last year. The removal of CCB's non-performing loans (NPLs) and securitization of a large NPL portfolio has led to a sharp reduction in NPLs, earning Cyprus a sovereign rating upgrade back to investment grade status. Nevertheless, NPLs are still among the highest in the EU, public and private debt levels remain elevated and efforts to clean up bank balance sheets and build capital buffers are ongoing.

Capacity to repay the Fund: Repayment capacity is adequate under the baseline scenario given the expected decline of gross public debt, a stable debt servicing profile, and continued favorable market conditions.

Risks: Risks to repayment capacity are declining and expected to be manageable. They mainly stem from contingent liabilities from the still-weak banking sector and increased fiscal spending pressures which could undermine investor confidence, raising interest costs and dragging down medium-term economic growth. Spillovers from adverse external shocks could weaken growth momentum, adversely affecting public debt dynamics and increasing financing pressures. Large external liabilities and financing needs exacerbate these risks.

Policy lines: To mitigate these risks, key policy priorities are to (i) steadfastly implement the recently amended legal tools to lower NPLs and the debt overhang; (ii) encourage greater bank efficiency to improve profitability and build capital buffers to strengthen the banking system; (iii) safeguard fiscal space and reduce risks to debt sustainability by maintaining strict spending discipline; and (iv) pursue structural reforms, especially in the judiciary, anti-money laundering (AML) and public administration, to enhance productivity and strengthen investment. These policies are critical to reduce vulnerabilities, make the economy more resilient to shocks and raise medium-term growth potential.

Approved By

Mr. Philip Gerson (EUR) and Mr. Nathan Porter (SPR)

Discussions took place in Nicosia during March 18–27, 2019. The staff team comprised Ms. Anita Tuladhar (head), Mr. Hajime Takizawa, Ms. Estelle Liu (all EUR), Mmes. Amira Rasekh (LEG), Greta Mitchell Casselle (MCM), Dora Douglass Kochman (SPR), and Maria Heracleous (IMF Office in Cyprus). Mmes. Jenny Lee and Dilcia Noren (both EUR) supported the mission team from headquarters. Mr. Dries Cools (office of the Executive Director) joined the meetings.

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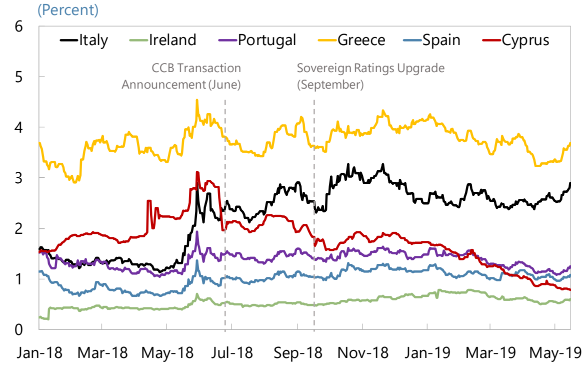
ANNEXES

BACKGROUND[1]

1. **A strong post-crisis economic recovery has supported Cyprus's capacity to repay and helped deal with crisis legacies.** Strong GDP growth has supported employment and contributed to a sizable primary fiscal surplus, helping to lower public debt. The sale of Cyprus Cooperative Bank (CCB) last year marked a critical turning point, boosting confidence and earning Cyprus a sovereign rating upgrade back to investment grade status, despite a significant increase in public debt associated with the deal. Nevertheless, private debt continues to be elevated and banks' asset quality poor, leaving the economy vulnerable to adverse shocks. With non-performing loans (NPLs) among the highest in the European Union, efforts to clean up bank balance sheets are ongoing. In March 2016, the IMF's Executive Board initiated post-program monitoring (PPM) in view of the need for continued close monitoring of the capacity to repay and progress toward external viability. PPM has been extended through July 2019.

10-Year Government Bond Spreads
(Percent)



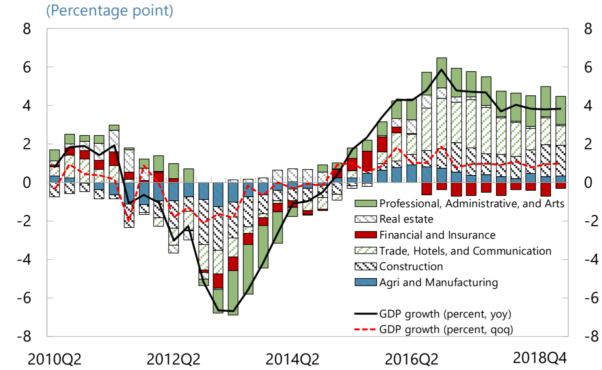
Source: Bloomberg Finance L.P.

RECENT DEVELOPMENTS AND OUTLOOK

A. Recent Developments

2. **Real GDP growth remains strong, albeit slowing (Figure 1).** Real output grew by 3.9 percent in 2018, about half a percentage point slower than a year earlier. Growth is increasingly driven by construction and professional services, partly supported by foreign direct investment (FDI) financing and the Cyprus Investment Program (CIP) scheme while tourism is slowing from record high levels owing to weaker external demand. Domestic demand has been robust, supported by strong employment gains, continued weak loan servicing and FDI inflows. Recent indicators suggest some softening of consumption demand while investment remains solid.

Contributions to GDP Growth
(Percentage point)

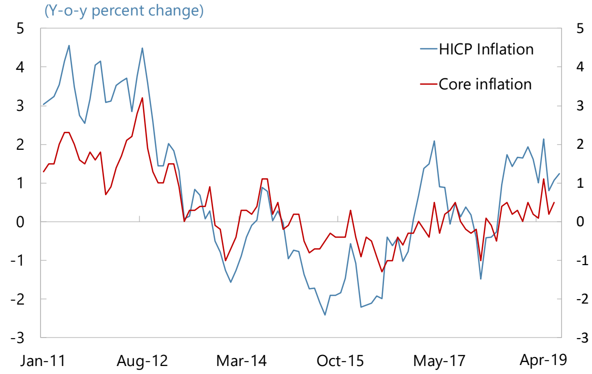


Sources: Cystat; and IMF staff estimates.

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

3. Inflationary pressure remains low, reflecting continued labor market slack (Figure 2). Headline inflation was subdued, at 1.2 percent in April, while core inflation is only slightly above zero, consistent with a gradually closing output gap. The unemployment rate continued to decline, reaching 7.1 percent (seasonally adjusted) in March, compared to 9 percent a year earlier, but remains well above its pre-crisis level of around 4 percent reflecting a persistent skills mismatch. Wages rose modestly, mainly driven by reversal of public sector wage cuts undertaken during the crisis.

Inflation
(Y-o-y percent change)

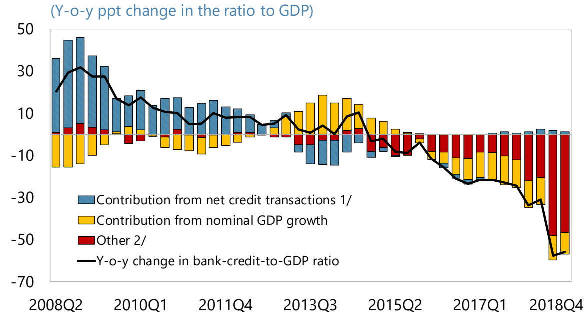


Sources: Haver Analytics; and IMF staff calculations.

4. The underlying current account deficit has widened, financed in part by continued FDI inflows (Figure 3). Adjusted for the effects of special purpose entities (SPEs), the deficit was 4.5 percent of GDP in 2018, up from 3.1 percent in 2017, driven by a decline in financial services exports associated with a new European Securities and Markets Authority regulation and an increase in import-intensive investment. Exports of transport services and tourism also decelerated, the latter reflecting a weaker ruble and a slowdown of arrivals from Russia—a key export market. External financing remained comfortable with continued FDI inflows and the paring back of lending abroad more than offsetting reductions in non-resident bank deposits.

5. The pace of deleveraging picked up, as efforts to clean up bank balance sheets gained momentum (Figures 4 and 5). Growth of net credit transactions, defined as pure new loans and accrued interest net of repayments (before write-offs) was subdued at 1.7 percent (yoy) for non-financial corporates (NFCs) and flat for households in December 2018. Outstanding bank credit to the resident non-financial private sector (NFPS) declined by 56 percentage points of GDP over 12-months to 142 percent of GDP at end-2018. This decline was largely driven by one-off loan sales/transfers outside of the banking system,[2] and to a lesser extent by loan repayments, including through debt to asset swaps, cash repayment, and write-offs. GDP denominator effects also played a role. Consequently, household and NFC deleveraging has proceeded more slowly than the decline in bank credit, underscoring difficulties in debt workouts and repayments (Annex V).

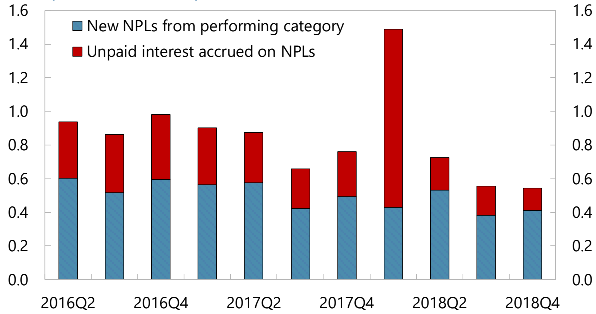
Bank Credit to Resident Non-Financial Private Sector
(Y-o-y ppt change in the ratio to GDP)



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, sales and transfer of loans.

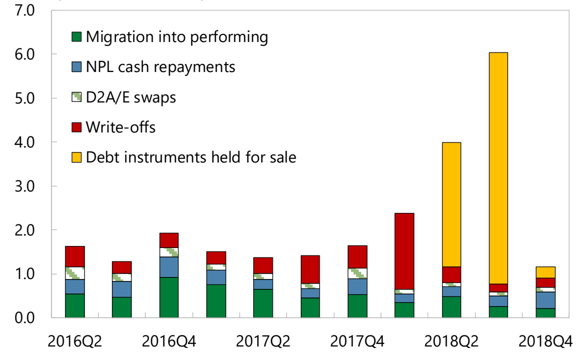
[2] Loan sales included two large transactions transferring loans outside the banking system: first, the transfer of CCB loans to the Cyprus Asset Management Company (34 percent of GDP) following the resolution of CCB in 2018:Q3; and second, the sale of NPL portfolio (HELIX transaction) by Bank of Cyprus (13 percent of GDP) which was approved by the supervisor in 2019:Q1.

Cyprus: Inflows Into NPLs
(Billions of euro)



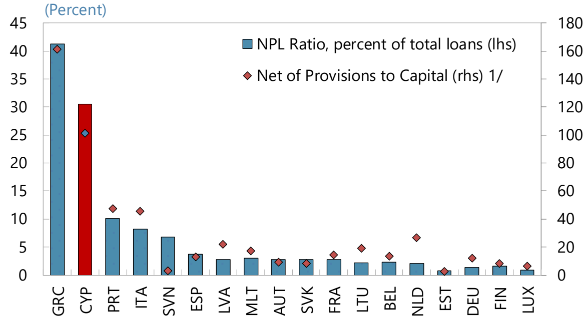
Sources: Central Bank of Cyprus; and IMF staff calculations.
Note: The large one-time increase in *unpaid interest accrued on NPLs* in 2018Q1 was due to IFRS9 conversion.

Cyprus: Outflows from NPLs
(Billions of euro)



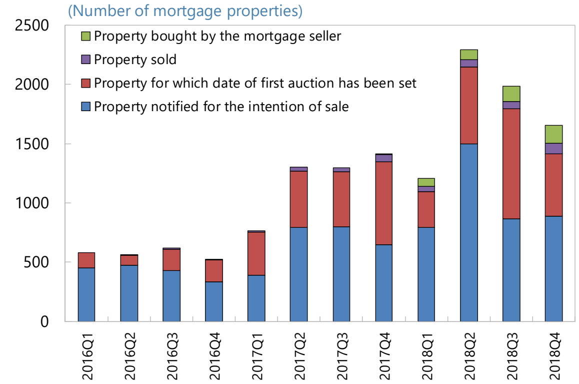
Sources: Central Bank of Cyprus; and IMF staff calculations.

Non-Performing Loans, 2018 or the latest
(Percent)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.
1/ Latest data for Austria, Belgium, Czech Republic, Estonia, Greece, Poland, Portugal, and Slovakia is 2018Q3.
Latest data for France and Italy is 2018Q2.

Processing of Foreclosures
(Number of mortgage properties)



Sources: Central Bank of Cyprus; and IMF staff calculations

6. **Loan sales and transfers led to a sharp reduction of NPLs (Annex III).** NPLs declined to 30½ percent of loans (50 percent of GDP) at end-2018 from 43 percent of loans (106 percent of GDP) at end-2017. Nevertheless, the NPL ratio remains high. Given recent success and continued investor interest, further sales of NPLs are planned. Since the strengthening of the foreclosure framework in July 2018, foreclosure notices and planned auctions have picked up and anecdotal evidence suggests it has encouraged some non-performing borrowers to engage in restructuring negotiations. Repayments through acquisition of property have risen slightly. However, recovery through collateral execution remains limited, in part because of the lagged effect on final property sales. Borrower repayment discipline remains weak and redefault rates remain very high.[3] With foreclosures having a limited impact on property sales, property prices are picking up, albeit mostly concentrated in the CIP-linked luxury segment (Figure 6).

7. **Efforts to strengthen bank balance sheets continue (Figure 5).** The banking system remains highly liquid and the NPL provisioning ratio has increased to 51 percent, above the EU average; but profitability pressures remain amid a low interest rate environment and potentially

[3] The redefault rate, defined as the share of re-restructured loans in restructured loans (only fixed-term loans), increased to 35.3 percent at end-2018 from 26 percent at end-2018:Q2.

higher provisioning needs as banks seek to further offload NPLs. The banking sector reported the first net profit in eight years in 2018. However, operating profits declined due to falling net interest income and an inefficient cost structure, as reflected in the relatively low number of customers per branch and per employee in Cyprus. Ongoing banking sector consolidation and restructuring, including the recent sale of CCB's good assets and deposits to Hellenic Bank, is helping to improve cost-income ratios. The recent approval of the bill allowing conversion of Deferred Tax Assets to Deferred Tax Credits has also helped boost regulatory capital.

Euro Area Banking Sector Capacity Indicators in 2017 1/

	Population per credit institutions	Population per branch	Population per ATM	Population per bank employee	Assets per bank employee (000' euros)
Cyprus	267	20	19	0.9	82
Euro area average	604	28	10	1.3	95

1/ All indicators in this table, except 'assets per bank employee,' are controlled by population density, with each indicator divided by the numbers of inhabitants per square kilometers.
Source: ECB.

8. **Underlying fiscal performance is strong (Figure 7).** Increases in indirect tax revenues and social security contributions, owing to strong domestic demand, along with higher capital revenues drove revenues higher last year, while continued spending restraint contributed to a further decline in the primary expenditure-to-GDP ratio despite the initiation of a gradual reversal of crisis-era public sector wage cuts. As a result, the primary fiscal surplus, excluding the impact of the sale of CCB and the operation of the state-owned AMC, reached 5.7 percent of GDP last year. In March 2019, the Administrative Court ruled that the freeze of civil service wage increase and the reduction in civil service pay implemented during the crisis, estimated to have generated a fiscal saving of more than 1 percent of GDP per year, as unconstitutional. The authorities have appealed the ruling and requested an expedited review. There is an emerging political agreement to enact mitigating measures, including amending the Constitution to allow for pay cuts in the event the original ruling is upheld.[4]

B. Economic Outlook

9. **The near-term growth outlook is favorable under the baseline scenario, with risks predominantly on the downside (see Annex II).** ***Real GDP growth*** is expected to ease moderately to 3¼–3½ percent by 2019–20, supported by continued strength of largely foreign-financed construction investment and robust private consumption due to rising disposable income. The slowdown in the euro area and uncertainties related to a potential hard-Brexit and AML/sanctions, however, weigh on the economy. ***Headline CPI inflation*** is expected to pick up in

[4] The court ruling would imply an immediate wage adjustment to fully undo the wage cuts and freeze in wage increase while restoring back-pay to litigants. In contrast, the authorities' medium-term plan would only undo the wage cuts gradually over 2018–23 while saving the foregone wages. With the mitigating measures, the fiscal impact could be significantly minimized.

line with an emerging positive output gap and gradually rising wages, while strong investment will lead to increased imports and a widening of the ***current account deficit*** in the near term.

10. Over the medium term, growth is projected to ease to its long-run potential rate of around 2½ percent, as the pipeline of investment gradually declines (including from a tightening of the CIP scheme) and increasing loan repayments lead to lower disposable income and private consumption growth. Resulting slower imports will gradually shrink the current account deficit.

Authorities' Views

11. Despite increasing headwinds, economic growth is projected to moderate only gradually, supporting a further decline in unemployment. Notwithstanding the growth slowdown in the euro area and uncertainties related to Brexit, growth is projected to decelerate modestly to 3¼–3½ percent during 2019–20, in line with staff projections, as strengthening confidence in the Cypriot economy and a pipeline of projects continue to drive broad-based foreign investment and rising disposal income supports private consumption. Construction and professional services will remain the main drivers of growth while shipping is expected to pick up further, although the tourism sector might decelerate mostly due to somewhat weak external demand.

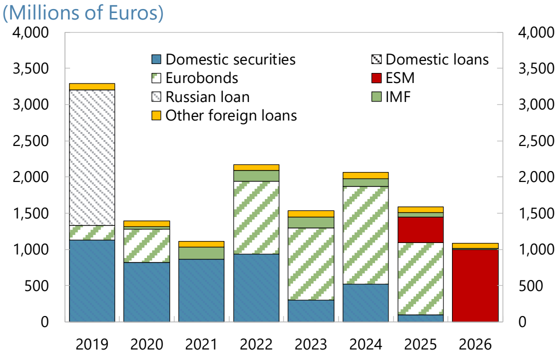
CAPACITY TO REPAY

12. Cyprus's capacity to repay the Fund is expected to be adequate under the baseline. Repayment of the outstanding Fund credit is scheduled to start in October 2020 and is expected to peak in 2021 at €168 million, representing a modest 9 percent of projected total debt service in that year. Repayment prospects remain favorable given expectations of a durable decline of gross public debt, a stable debt servicing profile, and continued favorable market conditions:

- **Robust economic growth and a sizeable primary fiscal surplus are expected to support a downward path of gross public debt.** The issuance of €3.2 billion (15½ percent of GDP) in domestic government bonds, which was aimed at strengthening the balance sheet of the CCB for its sale, contributed to an increase in gross public debt of more than 6 percentage points last year, to 102½ percent of GDP despite an early repayment of domestic loans at end-2018. However, annual nominal GDP growth of 5¼–6 percent and continuing large primary surpluses of 4¼–5¾ percent of GDP are projected to lower the debt-to-GDP ratio to close to 60 percent by 2024 under the baseline scenario (Annex I).

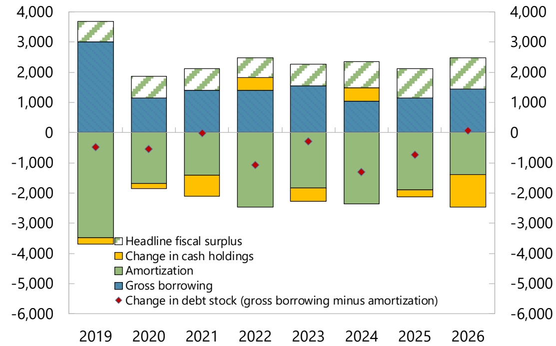
- **Despite the increase triggered by the CCB intervention, gross public financing needs (GPFN) should remain broadly stable over the projection horizon.** The bulk of the domestic bonds placed at the CCB in 2018 is scheduled to be repaid in the next four years, reducing the average maturity of marketable debt to 4.3 years in December 2018, down from 4.9 years at end-2017. Nevertheless, following the early repayment of the loan to Russia this year, the scheduled amortization of medium- and long-term debt (€0.9–2.2 billion), planned cash buffer of 9-months of GPFN, and projected large primary fiscal balance mean GPFNs should remain within moderate levels of €0.7–1.8 billion per year through 2024.

Amortization of Existing MLT Debt
(Millions of Euros)



Source: Public Debt Management Office; and IMF staff projections.

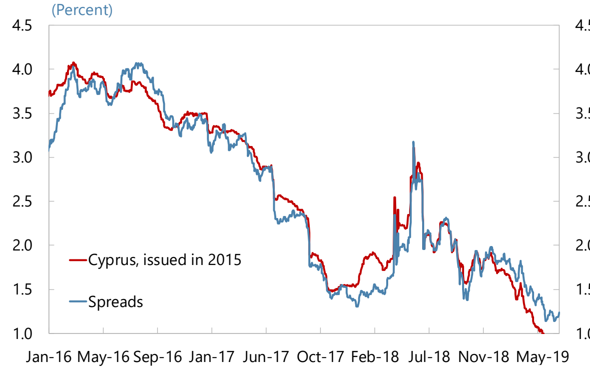
Sources and Uses of Funds
(Millions of euros)



Source: IMF staff projections.

13. **Strong fiscal performance and robust economic growth should be conducive to favorable borrowing terms.** Cyprus's sovereign credit rating upgrade to investment grade in September 2018 makes Cyprus's sovereign bonds eligible for the ECB's Public Sector Purchase Programme. Yield spreads over German sovereign bonds have dropped to historically low levels, helping the government to recently issue a €1 billion 15-year Eurobond and €750 million 30-year Eurobond, the longest maturity Eurobonds to date, at an average yield of 2.75 and 2.88 percent, respectively.

7-Year Government Bond Yields and Spreads
(Percent)



Sources: Bloomberg Finance L.P. and IMF staff calculations.

Authorities' Views

14. **Cyprus's capacity to repay remains strong, underpinned by robust economic growth and strengthened fiscal performance,** as reflected in the 15-year Eurobond issuance which was eight-times over-subscribed. Taking advantage of these favorable conditions, the authorities are undertaking a liability management operation with the Russian loan which will lower the debt servicing burden further. Projected large primary fiscal surpluses and robust economic growth will drive the gross public debt-to-GDP ratio lower on a durable basis, which in turn will support favorable market borrowing terms. The current cash balance is sufficient to cover the debt service through the remainder of 2019 and going forward, cash buffers will be maintained to meet the target of at least nine months of financing needs.

RISKS TO REPAYMENT CAPACITY

15. Risks to Cyprus's capacity to repay the Fund should be manageable. While banks and the NFPS have undertaken significant deleveraging, risks emanate primarily from still sizable NPLs and debt overhang and fiscal contingent liabilities that could potentially undermine financial stability and debt sustainability (Annex I).

- **Risks from the financial sector:** *weak payment discipline and banks' asset quality*. Delays in implementing NPL resolution measures or declines in real estate property prices could weaken bank capital positions by failing to generate improved payment discipline or adversely affecting collateral values, particularly if the NPLs are not sufficiently provisioned. Government guarantees for the Asset Protection Schemes (APS) could also be triggered. An adverse DSA scenario—featuring the realization of a contingent liability of 14 percent of GDP from the banking sector, accompanied by a temporary increase in borrowing costs for the sovereign (of close to 380 basis points), and permanently lower growth and inflation—finds that public debt would remain elevated at 93 percent of GDP in 2024, some 32 percentage points higher than in the baseline. Faster recovery in the government-owned AMC could, however, mitigate these risks.

- **Risks from the fiscal sector:** *increased public expenditures and fiscal contingent liabilities*. Reversal of crisis-era expenditure measures or higher-than-expected fiscal cost of the National Health System (NHS) implementation could reduce the primary surplus and increase borrowing costs. Contingent fiscal liabilities could materialize from government guarantees to public entities, pension deficits of public entities and the recent court ruling against the public wage measures taken during the 2012–13 banking crisis. A scenario of an unforeseen fiscal loosening leading to a lower primary surplus (by ½ standard deviation) and realization of contingent liabilities of 9 percent of GDP would worsen the debt path and push up the government's borrowing costs and financing needs sizably (Annex I). Despite the increased borrowing costs, the risk to repayment capacity is mitigated given that peak annual exposure to the Fund is just 0.7 percent of GDP.

- **Risks to growth:** *external spillovers and policy uncertainties*. The Cypriot economy is subject to a range of downside risks to growth (Annex II). A disorderly hard Brexit would adversely affect Cyprus's economic growth in the near and medium terms, directly through its impact on exports and inward FDI as well as indirectly through its impact on the EU economy and tighter-than-expected global financial conditions (Annex IV). Given the reliance of the booming construction sector on inflows related to the citizenship investment schemes, further tightening of the CIP scheme could also lead to a gradual slowdown of investment over the medium term. Failure to effectively mitigate existing inherent AML/CFT risks or any negative AML/CFT assessment could also adversely affect investment and banks' continued access to correspondent banking. More generally, Cyprus's large current account deficit[5] and external financing needs make it vulnerable to risks arising from tightening of financial conditions in originating countries especially given the highly leveraged firms and households (Annex I, External DSA and Annex V, Balance Sheet Analysis). This risk, however, is mitigated by the improved composition of external liabilities, with greater reliance on FDI and ongoing deleveraging by banks, and large gross external assets held by residents. Progress in exploiting offshore gas deposits also provide an upside for Cyprus's growth outlook.

Authorities' Views

16. The authorities considered risks to repayment to be somewhat smaller than viewed by staff:

- While still high, NPLs on banks' balance sheet have declined considerably. The strengthening of the foreclosure framework in July 2018, which has already led to increased foreclosure initiations and greater willingness of borrowers to engage in NPL restructuring should, along with the *Estia* NPL subsidy scheme (¶19), further allow banks to work out NPLs. Risks from the APS are now estimated to be smaller than initially evaluated. With the completion of the CCB NPL's carve-out, the significant strengthening of the banking system's loss absorption capacity, the potential execution of additional market-based solutions for NPL resolution by banks in near future, and the transposition of the EU Bank Recovery and Resolution Directive to national law, risks to the sovereign are largely contained.

- Despite fiscal pressures from the NHS implementation, the fiscal cost will be held firmly within the budget envelope in the near future. The recent court ruling against the government on the crisis-era pay cuts, even if upheld on appeal, will likely only frontload the ongoing gradual reversal of the crisis-era wage cuts already in place, together with a small cost from retroactive application only to those that appealed (around €40mn). The cost for such an outcome remains significant, but there is now a broad-based political consensus to take all steps, if deemed necessary, including amending the Constitution which would allow for the re-imposition of the same measures addressing the broader public sector wage bill, thus mitigating the fiscal costs going forward. Other government guarantees to the private sector mainly underwrite European Investment Bank loans which have very low risks.

- Some of Brexit-related risks have already materialized through the depreciation of sterling and a reduction in per capita spending of UK tourists. Barring further significant depreciation of the pound, the impact of a hard Brexit should be temporary and manageable. The authorities estimate the macroeconomic impact of CIP to economic growth has been relatively limited. The

[5] A significant share of the deficit is accounted for by Special Purpose Entities (SPEs). However, there is substantial uncertainty about the outlook for SPEs given limited information on the sector's activities and the implications of developments in home countries of beneficial owners.

Authorities will present the progress achieved in AML/CFT risk mitigation during the upcoming MONEYVAL assessment.

REPORT ON POLICY DISCUSSIONS TO MITIGATE RISKS

A. Financial Sector Policies

17. Policies should aim to continue strengthening bank balance sheets while avoiding the commitment of public resources. Facilitating NPL resolution, including durable loan restructuring, collateral execution for NPL recovery, and sales of loans is key. Banks should maintain adequate provisioning coverage and capital buffers to insulate against potential further losses from NPL workouts and sales of loans as well as any regulatory changes, including for building up of O-SII ("Other Systemically Important Institutions") capital buffers. Policies should also seek to raise capital using private solutions and encourage organic capital generation, including by diversifying revenue sources, rationalizing operational costs and ensuring further consolidation. DTC conversion should be used as a one-time, targeted measure.

18. Efforts to facilitate NPL resolution should remain a priority. The 2018 amendments to the foreclosure and insolvency legislation, the sales of loans law, and the adoption of a law on securitization have all enhanced the toolkit to address NPLs on a durable basis. While incentives for engaging in sustainable restructuring solutions are stronger, an increase in concluded restructurings is not yet evident in the data, partly due to delays in implementing the *Estia* scheme. Going forward, the new frameworks should be supported by reforms of the court system in particular and by eliminating uncertainties regarding title deeds (¶27). The framework for electronic auctions should be established in a manner that encourages their use and ensures the integrity of the process. To avoid merely converting credit risk into real estate risk, banks should be cautioned against warehousing properties from debt-to-asset swaps.

19. The *Estia* scheme, aimed at encouraging non-performing borrowers to start servicing their loans, should not be allowed to lead to further risks of moral hazard. The subsidy support, mandated write-offs by banks and enhanced foreclosure threats on re-defaulting restructured loans are expected to strengthen incentives to service restructured loans. However, the scheme is not adequately calibrated to individual borrowers' repayment capacities. Adequate monitoring and efforts to prevent potential abuse should be undertaken by the authorities, including by rigorously verifying eligibility, imposing severe penalties for fraudulent use of the scheme, and regularly reassessing the eligibility of the borrowers.

20. The Central Bank of Cyprus (CBC) should continue to develop and implement a regulatory and supervisory framework for credit acquiring companies (CACs). The CBC has already licensed several credit acquiring companies (CACs) and is putting into place a regulatory and supervisory framework, following guidelines of the proposed EU directive.[6] Focus needs to be given to appropriate supervisory staffing, data collection/reporting requirements, on-site inspections and off-site monitoring. Further, the CBC should issue regulations to govern the limited circumstances where the CBC could intervene in the rate of foreclosures by CACs for financial stability reasons. This should help identify potential conflicts between the CBC's supervisory and financial stability responsibilities over CACs.[7]

21. The state-owned AMC should avoid warehousing of assets. The recruitment of the Board of Directors is at its final stage and an independent advisor has been selected following some delay. The emerging governance structure should have a clear mandate and autonomy of management, accompanied by operational targets, to maximize recovery and solely manage the CCB's residual assets for a limited duration. The legal framework for the Cooperative AMC holding company should be clarified to ensure full public accountability while maintaining independence from the government. Arms-length relationships with servicers should be maintained. A clear dividend policy is needed such that proceeds are used for public debt reduction.

Authorities' Views

22. The authorities agreed that NPL resolution should continue to be a priority. With a more supportive legal environment now in place, the strengthened foreclosure framework is functioning as a credible threat by incentivizing restructuring of loans and execution on collateral where no viable restructuring can be reached. The clarification that old court decisions for the sale of properties can be implemented under the new foreclosure procedures as well as changes in borrower notification procedures have already allowed many stalled foreclosure cases to start moving. The strengthened foreclosure framework has also enabled creditors to acquire the underlying collateral more swiftly. Amendments in the sales of loans legislation is also proving useful. Debt-to-asset swaps remain a useful tool to facilitate NPL resolution as banks have successfully been offloading a large portfolio of onboarded properties.

23. The authorities noted additional measures being considered to facilitate NPL resolution. Efforts will be made to implement e-auctions in a manner that encourages their use. The authorities acknowledge the need to advance efforts on developing a framework for CACs and are taking steps to ensure appropriate staffing. The authorities are also contemplating new support mechanisms such as "rent to buy" for borrowers who cannot successfully restructure their loans under *Estia*. The authorities agreed the state-owned AMC should follow key principles for the governance structure but clarified the duration should be decided as part of AMC's business plan to maximize revenues in a finite timeframe, also taking into account the restructuring horizon under *Estia*.

[6] Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral.

[7] See Annex VI of Cyprus—Staff Report for the 2018 Article IV Consultation, IMF Country Report No. 18/337.

B. Fiscal Policies

24. A procyclical fiscal stance should be avoided. While large primary fiscal surpluses are expected to be maintained, staff projects the fiscal stance to loosen somewhat in 2019. The structural primary balance is expected to decline in 2019 to around 5 percent of GDP. This would imply a slight structural relaxation by ¼ ppts in 2019, mainly due to policy measures that include a cut of excise on fuel, the subsidy scheme to mortgage borrowers, reversal of wage cuts, topping up of low-income pensioners and increased co-financing on EU projects. With the closing output gap, more neutral fiscal stance should be maintained by limiting spending growth and saving revenue surprises.

Cyprus: Fiscal Targets, 2018–24

	2018	2019	2020	2021	2022	2023	2024
		Projections					
		(Percent of GDP, unless otherwise noted)					
2019 Stability and Growth Program							
Total revenue	39.7	40.7	40.9	40.6	40.1	...	...
Total expenditure	44.5	37.7	38.3	38.2	38.0	...	...
Overall balance	-4.8	3.0	2.6	2.4	2.2	...	...
Primary balance	-2.3	5.3	4.8	4.4	4.1	...	...
Gross public debt	102.5	95.8	89.1	83.0	77.6	...	...
Staff projections							
Total revenue	39.7	40.8	41.3	41.0	40.6	40.6	40.9
Total expenditure	44.5	37.5	38.2	38.1	38.2	38.0	37.8
Overall balance	-4.8	3.3	3.1	2.9	2.5	2.7	3.1
Primary balance	-2.3	5.7	5.2	4.9	4.4	4.3	4.6
Gross public debt	102.5	95.2	87.4	82.7	74.0	69.1	61.0
		(Percent of potential GDP)					
Primary balance	5.7	4.1	2.3	1.8	1.4	1.5	1.9
Revenue 1/	39.1	39.4	38.8	38.4	38.1	38.2	38.5
Cyclically-adjusted tax revenue	34.1	33.9	33.6	33.5	33.4	33.6	33.9
Cyclical tax revenue	-0.1	0.2	0.4	0.4	0.4	0.3	0.2
Other revenue 1/	5.1	5.3	4.8	4.5	4.3	4.3	4.3
Primary expenditure 1/	33.4	35.3	36.5	36.6	36.7	36.7	36.5
Cyclically-adjusted primary balance 1/	5.8	5.5	4.9	4.5	4.1	4.1	4.4
Structural primary balance 1/	5.2	5.0	4.6	4.3	4.0	4.0	4.4
Output gap	-0.3	0.6	1.2	1.3	1.2	0.9	0.7

1/ Excludes the fiscal impact of the sale of the Cyprus Cooperative Bank and state-owned AMC.

25. Maintaining strict spending discipline is key to anchoring public debt on a firmly declining path. The baseline scenario presumes that budgeted spending levels are maintained, contributing to the projected decline in gross public debt. However, the debt path is susceptible to fiscal and contingent liabilities shocks ("Risks to Repayment Capacity" ¶13). The focus of fiscal policy therefore should be to limit expenditure growth below medium-term GDP growth rate and contain key risks to the fiscal position in order to keep debt on a durable downward path and support countercyclical policy:

- ***Wage bill:*** The gradual reversal of crisis-era public wage cuts has already pushed the projected nominal wage bill upward. The recent court ruling against the crisis-era wage cuts could further increase the wage bill. Overall wage bill growth should be maintained below nominal GDP growth by containing annual increases in wage rates and staffing levels. At the same time, productivity-enhancing civil service reforms should be enacted.

- ***NHS:*** Risks from the planned introduction of the NHS could be reduced by firmly implementing reforms aimed at making the public health sector more competitive and by ensuring adequate management of incentives for providers and patients.[8]

Authorities' Views

26. The authorities are committed to maintaining a neutral fiscal stance and ensuring a strict spending discipline. The fiscal plans for 2019–22 will safeguard the strong fiscal performance that has underpinned confidence and economic recovery in recent years. Spending growth will be firmly kept below nominal GDP growth and cyclical and windfall revenues, including from the AMC, will be saved. No new tax measures are envisaged. This policy will likely continue to generate sizeable fiscal surpluses on the order of 4½ percent of GDP. While the planned NHS will not likely trigger realization of fiscal risks upon its introduction, such risks will be monitored closely.

C. Structural Reforms

27. Structural reforms should seek to strengthen competitiveness, raise potential growth and reduce risks. Key areas of focus include the following:

- **Judiciary reform and claims enforcement.** Ongoing reforms to increase the efficiency of the courts and accelerate enforcement of commercial claims would help address one legacy of the crisis and improve access to financing and investment. The specialization of some judges in financial litigation and planned recruitment of additional judges is a welcome step, but should be expeditiously complemented by completion of reforms of the rules for civil procedures, clearance of the backlog of cases and introduction of the e-justice system. Speedy implementation of ongoing work to strengthen the institutional framework for the insolvency service and insolvency professionals is also important. Despite some progress with the transfer of title deeds, a substantial backlog remains, especially of cases with no title deeds. Efforts are needed to create a more efficient system of issuing and transferring title deeds, while clearing the outstanding backlog expeditiously.

- **AML Reforms.** Continuing to improve the AML/CFT framework, including through changes to the CIP scheme to effectively address concerns/gaps recently raised by the EC and also in

[8] See Annex VII of Cyprus—Staff Report for the 2018 Article IV Consultation, IMF Country Report No. 18/337.

relation to the ongoing MONEYVAL assessment, and to mitigate inherent AML/CFT risks will be essential.

- **Public sector governance and public administration reforms.** Improving corporate governance of commercial state-owned enterprises (SOEs), including through strengthening financial oversight, implementing a more effective planning and reporting framework, and introducing a code of conduct remains a priority to improve efficiency and help reduce contingent fiscal liabilities. Legislative efforts currently underway would strengthen the governance of the CBC. Local government and civil service reforms could support more efficient and effective service delivery and reduce fiscal risks.

Authorities' Views

28. The authorities noted efforts to move forward structural reforms in several key areas. The recruitment of new judges, as well as the envisaged revision of civil procedure rules and broader court reforms, which would gradually reduce delays in the adjudication of commercial claims and further support the implementation of the insolvency and foreclosures frameworks, are underway. They pointed to progress in the transfer of title deeds but acknowledged that progress has been slower in dealing with the problems related to unissued deeds. The judicial interpretation of the law to facilitate title deeds transfers is currently under review by the Supreme Court. Planned reform of local government should improve the efficiency of service delivery, including the process of issuing building permits and, in turn, title deeds. Efforts are also underway to enhance the governance of the CBC through legislation, while commercial SOEs are encouraged to improve their performance by strengthening corporate governance. Continued efforts are being made to mitigate AML/CFT risks, including through the recent implementation of a CBC regulation to clarify the definition of shell companies. This is also evident in the significant reduction of non-resident deposit accounts.

STAFF APPRAISAL

29. Cyprus's rapid recovery is expected to slow gradually, but the outlook remains favorable. Real GDP is projected to grow at a still-robust 3–3½ percent in 2019–20, supported by foreign-financed investment and private consumption. Over the medium term, growth is expected to ease to potential, as the investment boom dissipates and households step up debt servicing.

30. Capacity to repay the Fund is adequate under the staff's baseline scenario. While risks remain, these have declined and their impact on repayment capacity should be manageable. Repayment capacity is underpinned by projected robust economic growth and sizable primary fiscal surpluses that anchor a durable decline in the gross public debt-to-GDP ratio and support continued favorable market borrowing terms. However, repayment capacity could be weakened if risks materialize from banks' still weak asset quality, direct fiscal guarantees, and fiscal spending including the reversal of crisis-era measures. The growth outlook could be adversely affected in the event of a disorderly hard Brexit, tightening of foreign financing for investment, or realization of

AML/CFT risks. Safeguarding the adequate repayment capacity therefore warrants ambitious financial and fiscal policies as well as structural reforms.

31. Durable declines in NPLs remain a priority to reduce sovereign-bank linkages further. A package of legislative amendments in 2018 have enhanced the toolkit to address NPLs. While banks have made significant progress in offloading NPLs, their successful workout outside of the banking system is still needed in order to reduce the high debt burden in the economy. The implementation of the foreclosure framework should be complemented by the planned introduction of e-auctions, ongoing reform of the court system and measures to eliminate uncertainties regarding title deeds. Banks should be encouraged to maintain adequate provisioning coverage and capital, including by diversifying revenue sources and rationalizing operational costs. Ensuring ongoing compliance with the eligibility requirements for the *Estia* scheme is crucial to minimize its fiscal cost. An appropriate governance structure for the state-owned AMC should be put in place expeditiously to avoid warehousing of assets and maximize recovery.

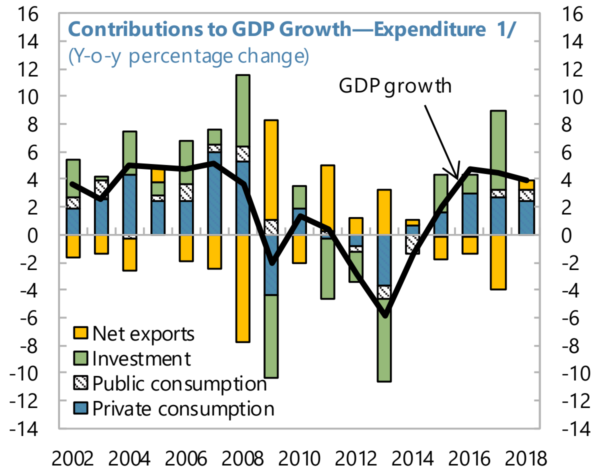
32. Strict fiscal discipline should be maintained. A neutral medium-term fiscal stance should be ensured. Spending growth should continue to be firmly maintained at a pace below that of medium-term GDP and cyclical and windfall revenues, including from state-owned AMC, should be saved to help safeguard the firmly downward path of public debt. In this regard, it is important to keep growth of the wage bill, including increases arising from the reversal of crisis-era public wage cuts, below nominal GDP. Fiscal risks from the introduction of a public health insurance system should be mitigated by reforms aimed at making the public health sector more competitive and managing incentives for providers and patients.

33. A window of opportunity for structural reforms is opening and should be vigorously pursued. With CCB now resolved and the next Parliamentary elections scheduled only in 2021, the authorities are pursuing some long-delayed structural reforms, including judiciary and local government reforms, and the introduction of a national health insurance system. However, there has been little progress on some important reforms, such as the SOE law, privatizations, and broader civil service reforms. Reforms of civil procedures and the process to issue title deeds, and introduction of the e-justice system, would help resolve crisis legacies and improve access to financing and investment. Further efforts to mitigate AML/CFT risks and strengthen governance of commercial SOEs and the Central Bank of Cyprus will help reduce risks to growth and fiscal risks.

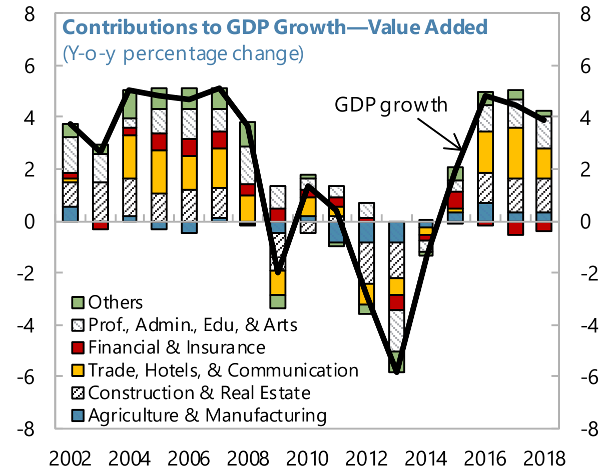
34. Continued monitoring of Cyprus's repayment capacity under PPM is warranted during the next 12 months. Progress toward external viability is subject to risks, as realization of contingent liabilities arising from banks' still high NPLs could adversely affect the sovereign's market access. The Cypriot authorities have indicated their willingness to continue to engage with the Fund under PPM until 2020.

Figure 1. Cyprus: Macroeconomic Performance

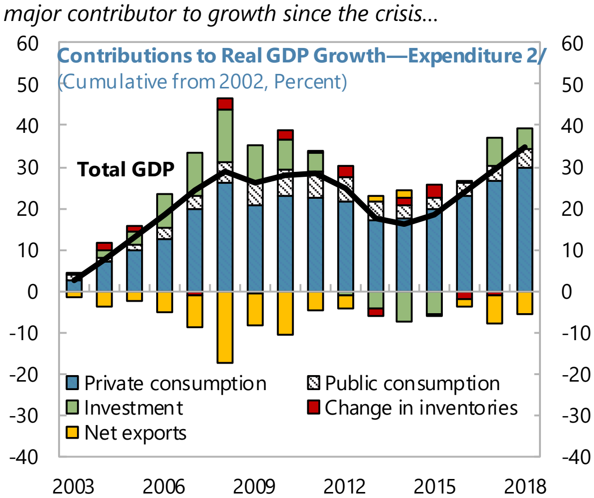
Economic growth has been strong, supported by domestic demand…



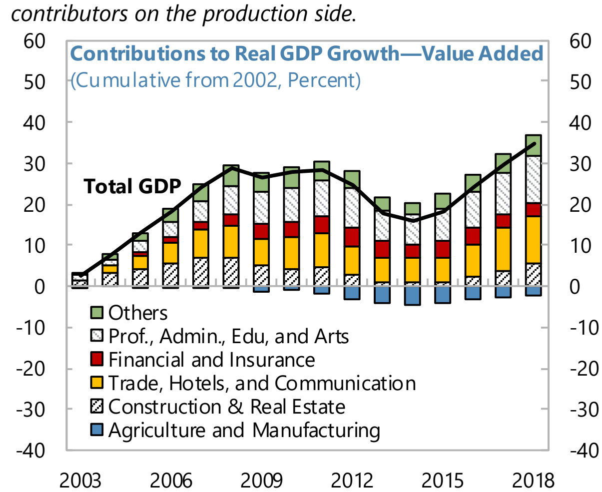
…although there are some signs of moderation in the tourism sector.



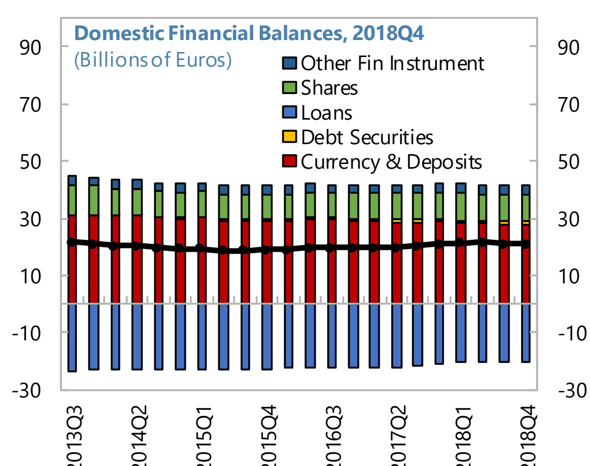
In cumulative terms, private consumption has been the major contributor to growth since the crisis…



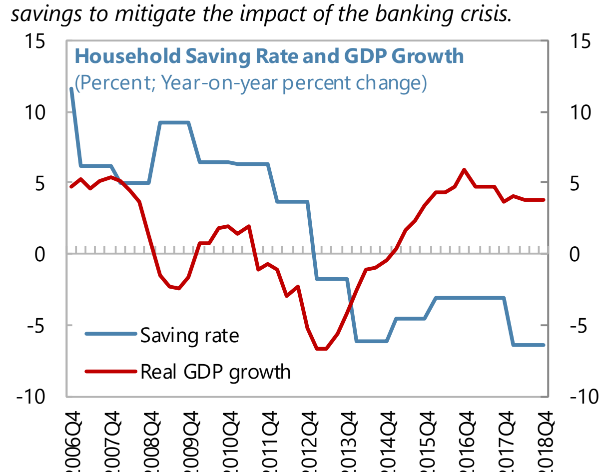
…while professional services and tourism have been main contributors on the production side.



Net financial assets of households remain large…



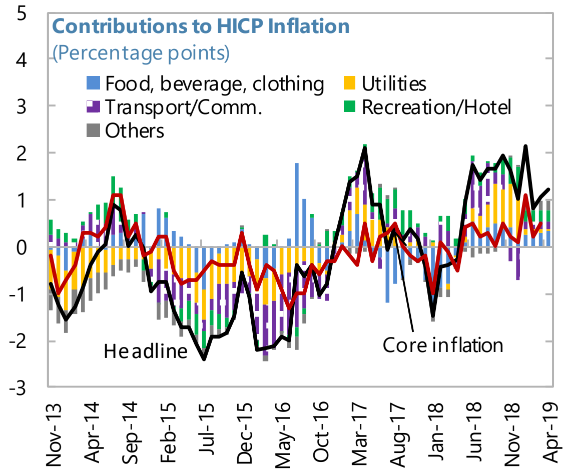
…allowing households to continue drawing down their savings to mitigate the impact of the banking crisis.



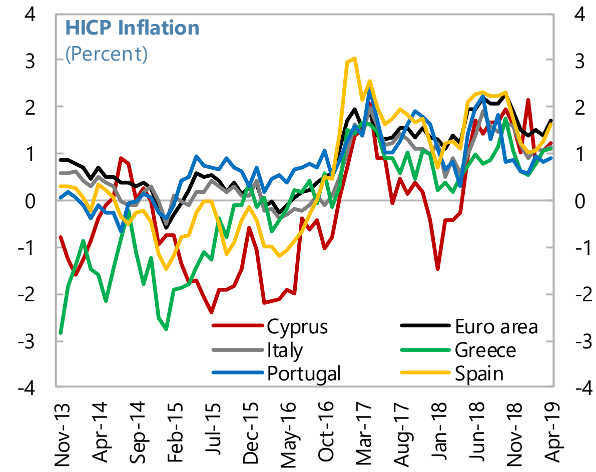
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Investment data for 2018 has not yet been released.
2/ Change in inventories estimated using gross capital formation and gross fixed capital formation (Mil.Chn.2010 Euros).

Figure 2. Cyprus: Inflation and Labor Market

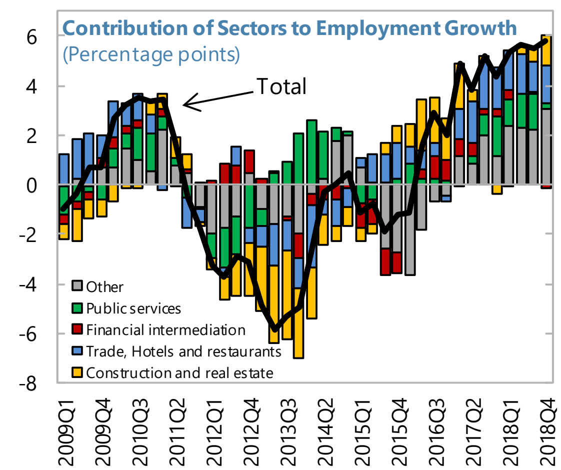
Headline inflation declined recently and core inflation remained subdued…



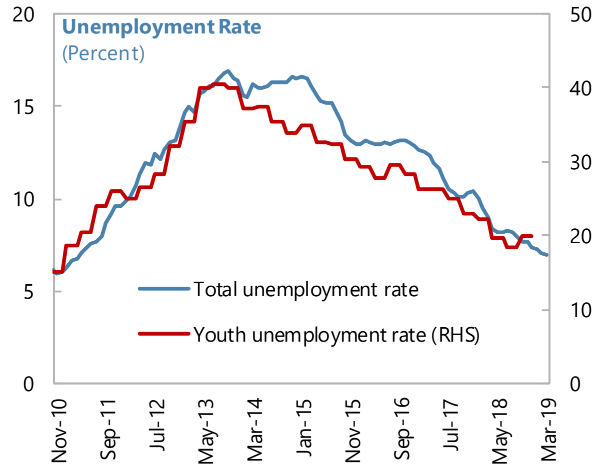
…in line with the trends in other euro area countries.



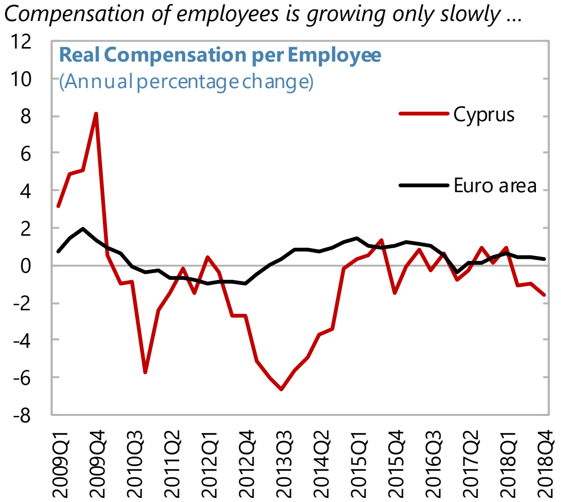
Employment growth remains strong …



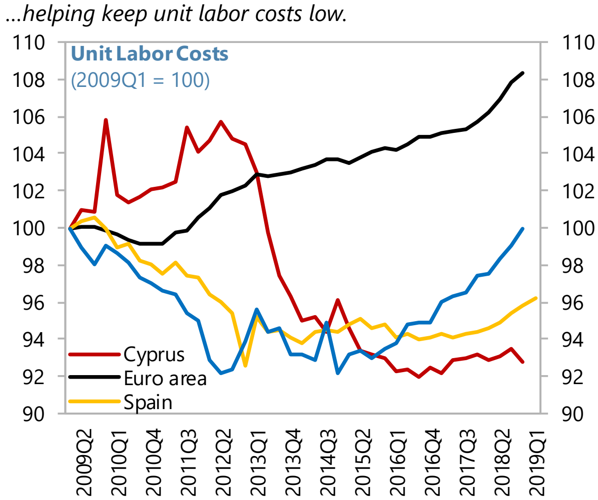
…and unemployment rate is declining.



Compensation of employees is growing only slowly …



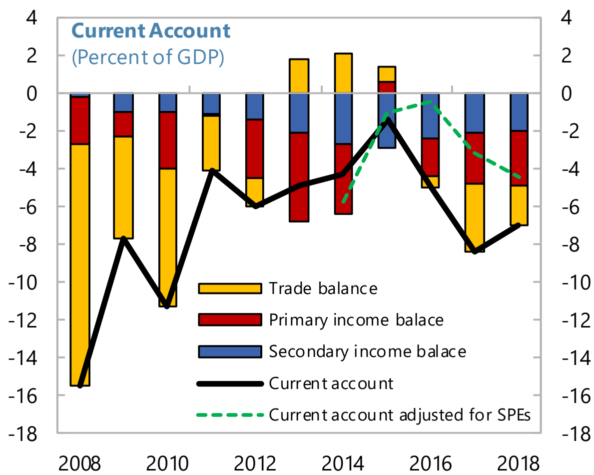
…helping keep unit labor costs low.



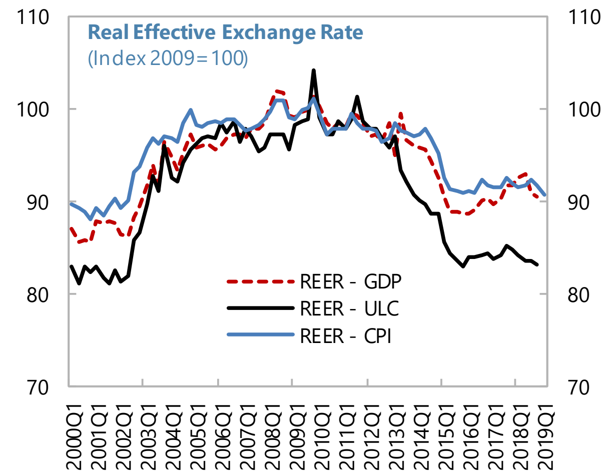
Sources: Cystat; ECB; Eurostat; and IMF staff calculations.

Figure 3. Cyprus: External Indicators

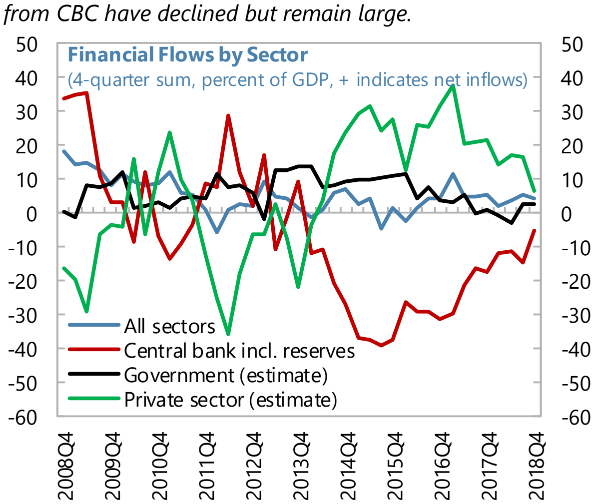
The overall current account deficit narrowed in 2018...



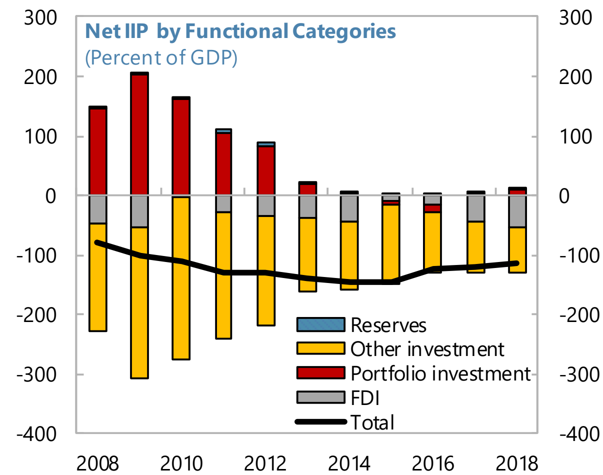
...while the real effective exchange rate stayed at post-crisis low.



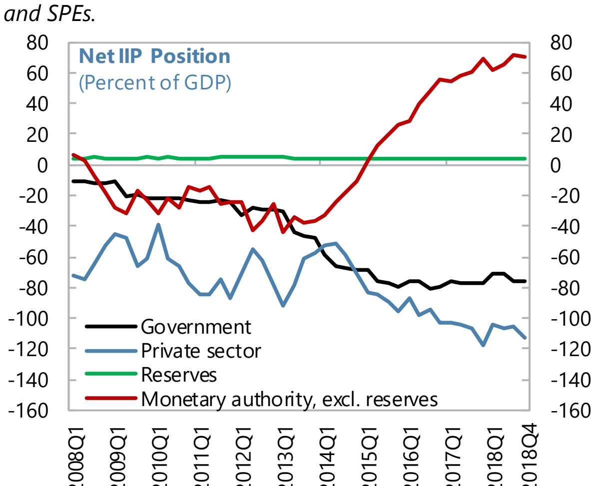
Net capital inflows to the private sector and net outflows from CBC have declined but remain large.



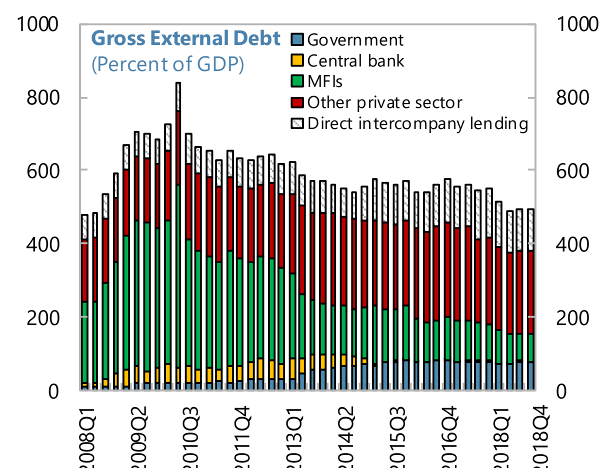
Net IIP remains highly negative...



...reflecting large negative IIP position of the government and SPEs.



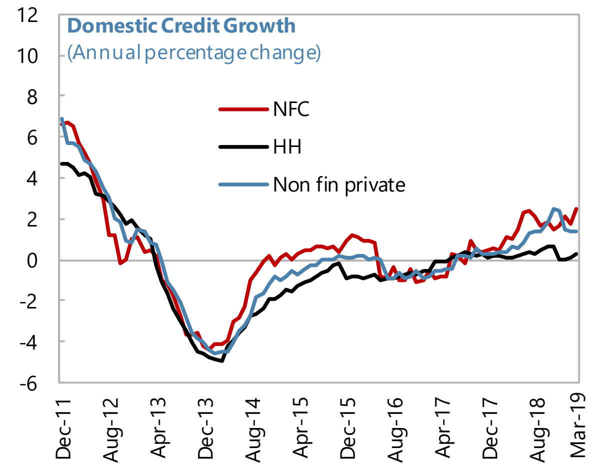
Gross external debt is near post-crisis low.



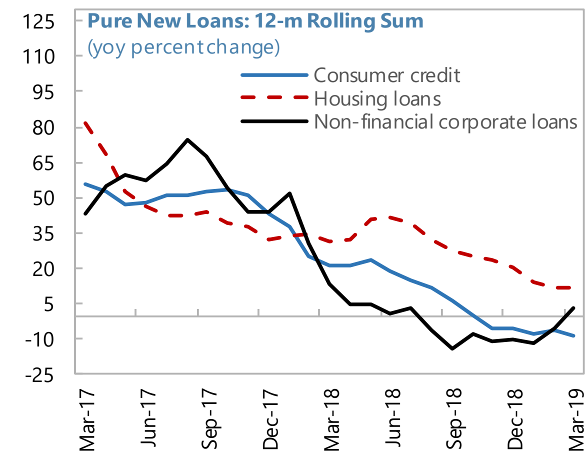
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations

Figure 4. Cyprus: Credit and Balance Sheets

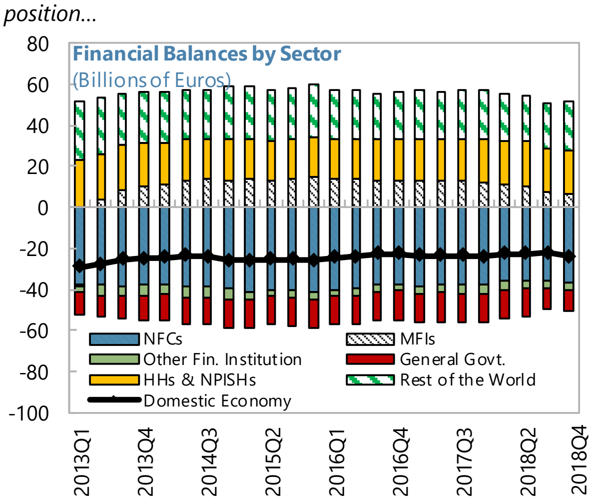
Domestic credit growth remains modest …



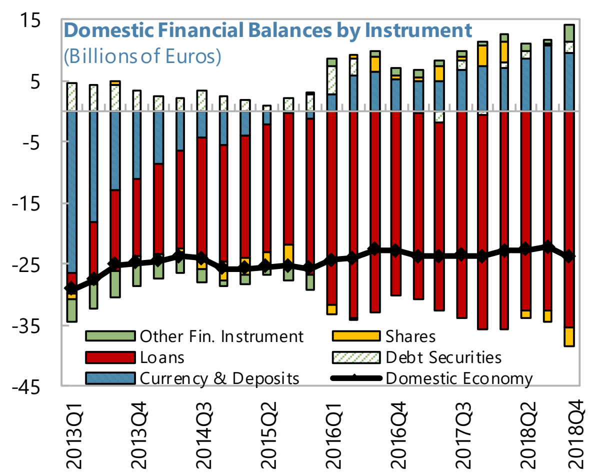
…and growth of pure new loans have continued to decelerate.



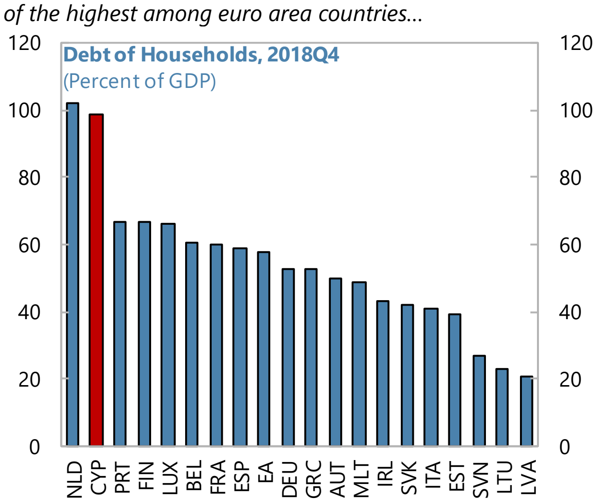
NFCs and the general government remain in large net debt position…



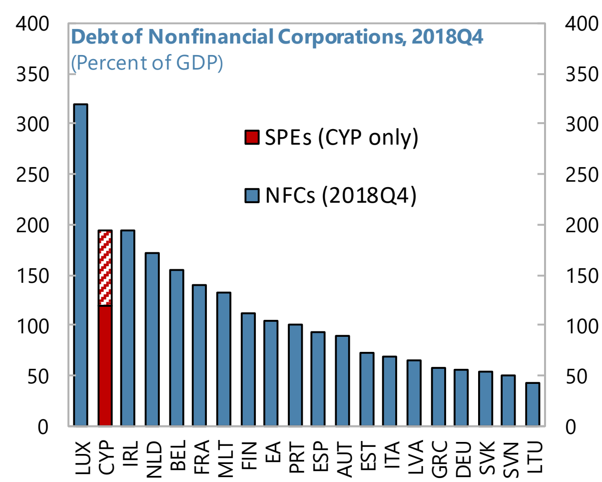
…and loans remain the largest component of net financial liabilities.



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



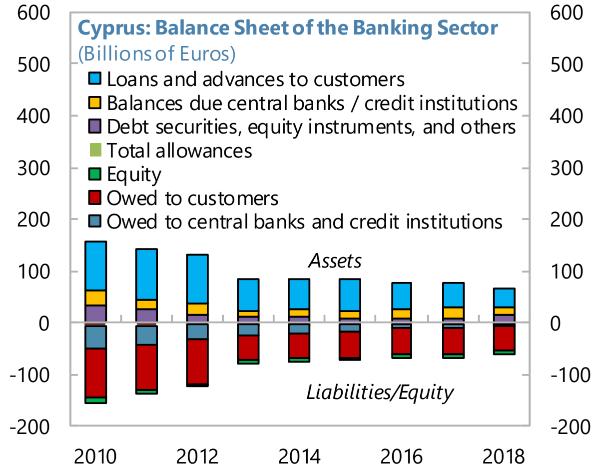
…and so does NFC debt.



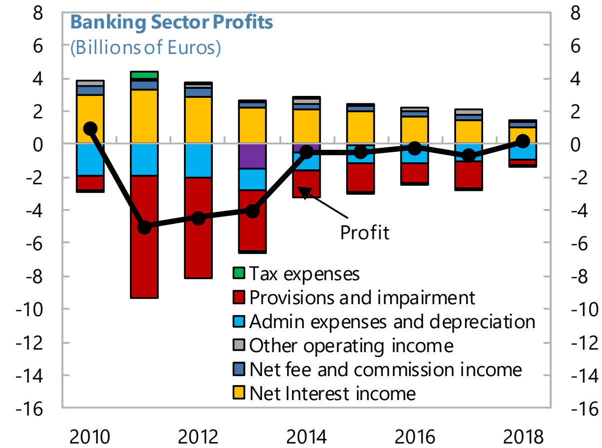
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 5. Cyprus: Banking Sector

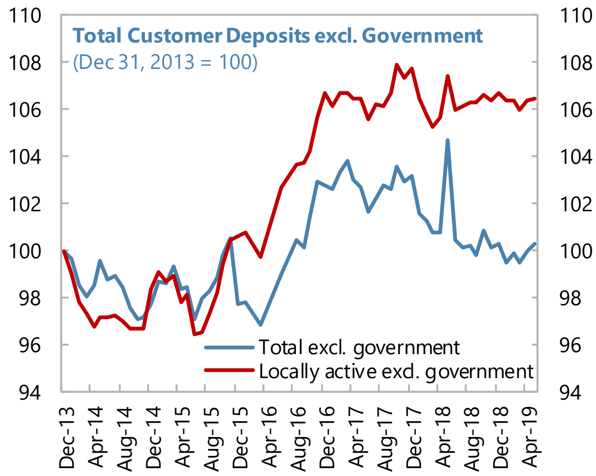
Banks have continued deleveraging…



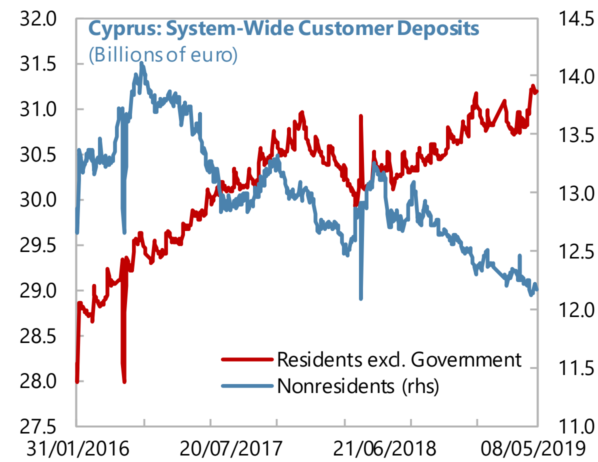
…and total profit of the banking sector turned positive, driven by lower provisioning needs.



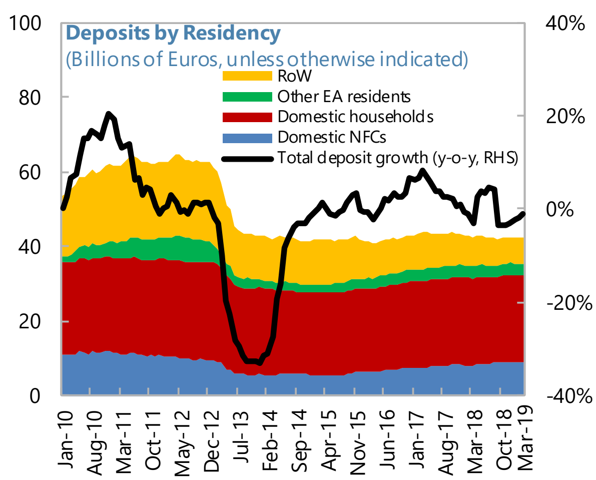
Following temporary heavy outflows triggered by uncertain prospects for the CCB, total customer deposits of locally active banks have stabilized…



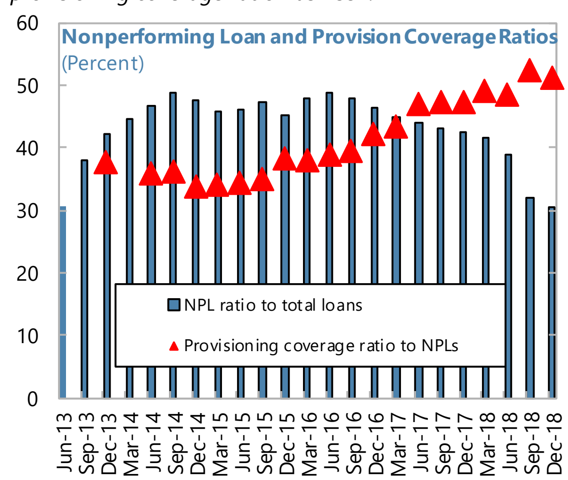
…but non-residents' deposits are declining….



…while deposits of domestic NFCs are increasing steadily.



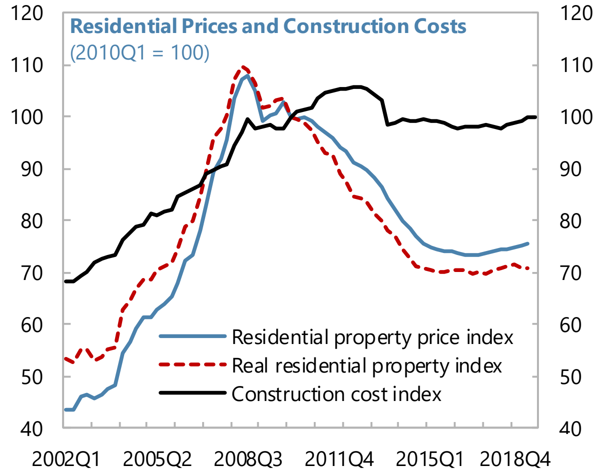
The NPL ratio has recently declined significantly, and provisioning coverage ratio has risen.



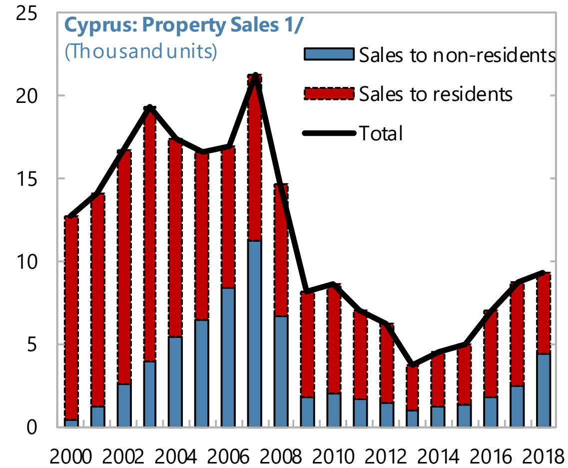
Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff calculations.
Notes: At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Housing Market

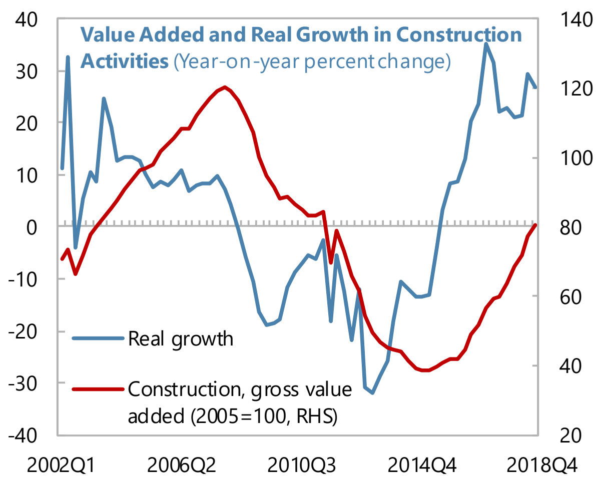
Property prices are rising marginally, and construction cost pressure remains low.



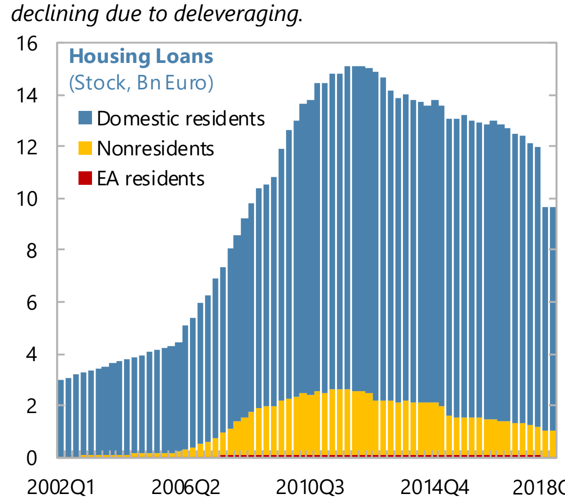
Property sales are recovering, with an increasing share accounted for by sales to non-residents.



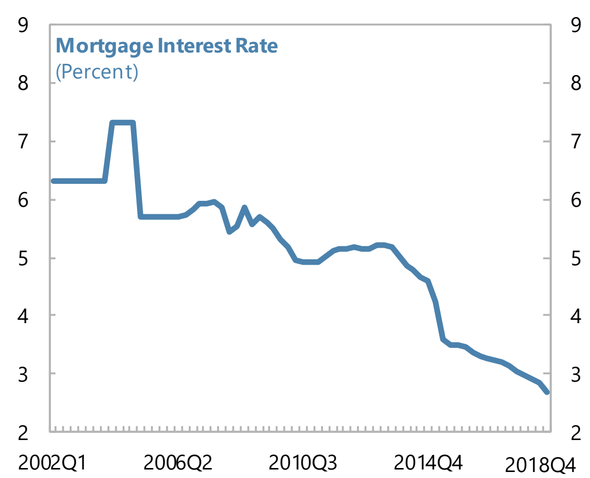
Growth in construction activities continues to be strong...



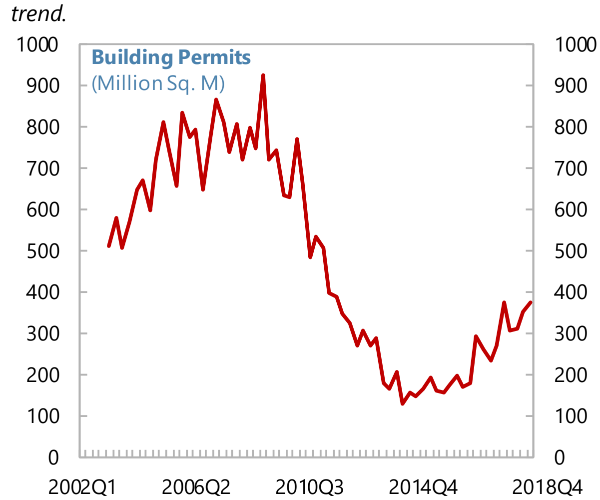
...while at the same time the stock of housing loans is declining due to deleveraging.



Mortgage interest rates are on the downward trend ...



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

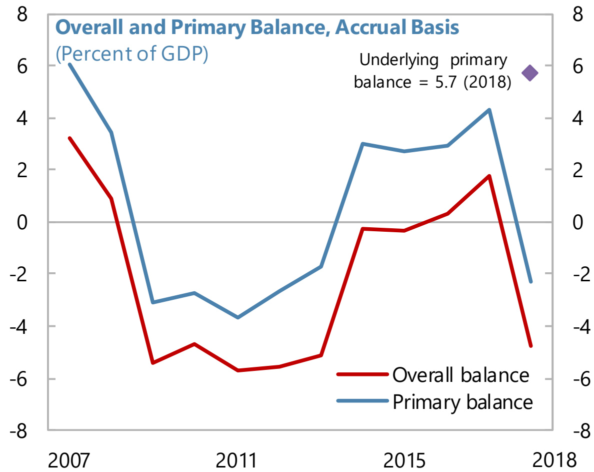


Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.

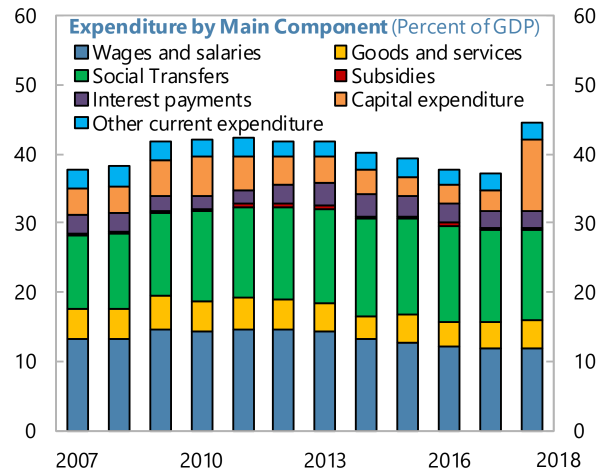
1/ Post-2018 and pre-2018 data on sales to non-residents are not directly comparable as the methodology to compile data has changed.

Figure 7. Cyprus: Fiscal Developments

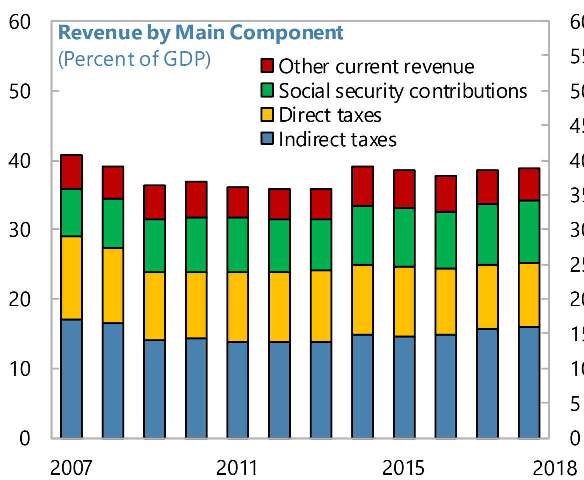
The primary fiscal balance, adjusted for the CCB transaction, has improved...



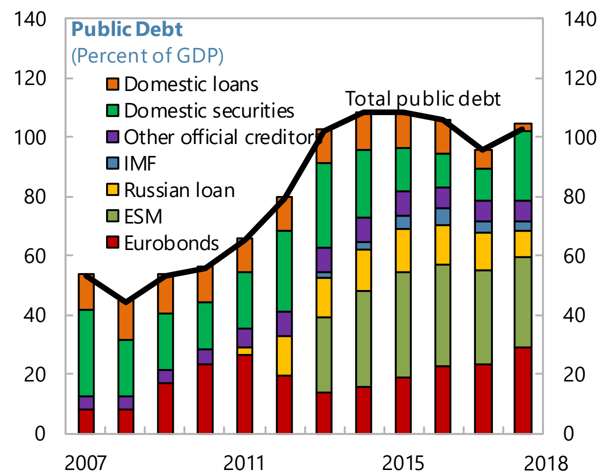
...as expenditure remains contained ...



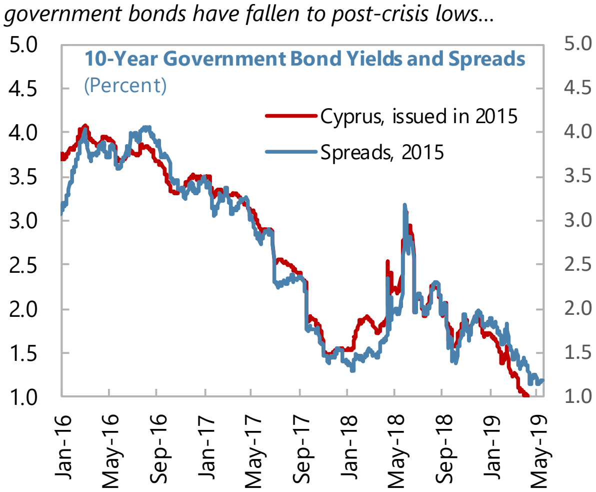
...and revenue collection rises.



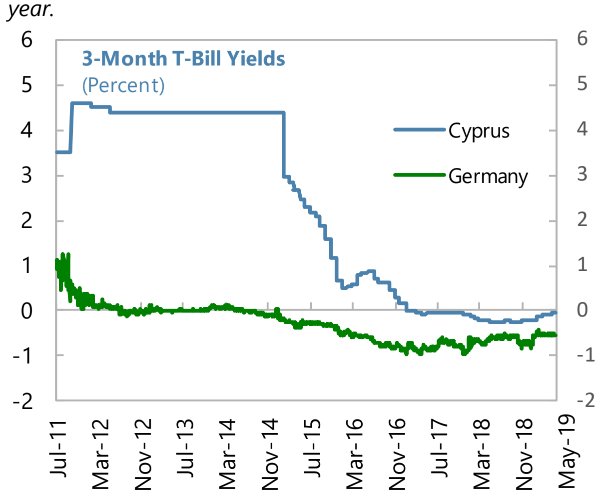
Public debt has risen as domestic bonds were issued to resolve the CCB.



Yields on Cypriot Eurobonds and spreads to German government bonds have fallen to post-crisis lows...



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



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

Table 1. Cyprus: Selected Economic Indicators, 2015–24

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Projections					
Real Economy			(Percent change, unless otherwise indicated)							
Real GDP	2.0	4.8	4.5	3.9	3.5	3.3	2.9	2.6	2.5	2.4
Domestic demand	3.9	6.1	8.5	3.0	4.5	3.3	3.1	2.7	2.4	2.4
Consumption	1.9	3.5	3.9	3.8	2.9	2.4	2.4	2.3	2.3	2.2
Private consumption	2.4	4.5	4.1	3.7	3.0	2.6	2.6	2.5	2.5	2.4
Public consumption	-0.5	-0.8	3.1	4.3	3.9	1.5	1.5	1.5	1.5	1.5
Gross capital formation 1/	18.1	21.9	31.8	-0.3	10.9	6.6	5.7	4.0	3.0	3.0
Foreign balance 2/	-1.8	-1.2	-3.9	0.7	-1.0	-0.1	-0.4	-0.2	-0.1	0.0
Exports of goods and services	5.2	4.6	6.0	3.3	-1.3	4.7	3.5	3.5	3.5	3.5
Imports of goods and services 1/	8.4	6.6	12.2	2.0	0.2	4.6	3.9	3.5	3.4	3.3
Potential GDP growth	1.2	1.6	2.0	2.3	2.6	2.7	2.8	2.8	2.7	2.7
Output gap (percent of potential GDP)	-7.0	-4.1	-1.8	-0.3	0.6	1.2	1.3	1.2	0.9	0.7
HICP (period average)	-1.5	-1.2	0.7	0.8	0.5	1.6	1.7	2.0	2.0	2.0
HICP (end of period)	-0.5	0.1	-0.3	1.1	1.2	1.3	1.8	2.0	2.0	2.0
GDP deflator	-1.2	-0.6	1.7	1.6	1.7	2.7	2.7	3.0	3.0	2.8
Unemployment rate (percent, period average)	14.9	13.0	11.1	8.4	7.0	6.0	5.4	5.2	5.1	5.0
Employment growth (percent, period average)	-1.3	1.4	4.6	5.6	2.5	2.0	1.5	1.2	1.0	1.0
Labor force	-2.6	-0.9	2.3	2.5	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	-4.8	3.3	3.1	2.9	2.5	2.7	3.1
Revenue	39.0	38.0	38.9	39.7	40.8	41.3	41.0	40.6	40.6	40.9
Expenditure	39.3	37.7	37.1	44.5	37.5	38.2	38.1	38.2	38.0	37.8
Primary Fiscal Balance	2.7	3.0	4.3	-2.3	5.7	5.2	4.9	4.4	4.3	4.6
General government debt	108.0	105.5	95.8	102.5	95.2	87.4	82.7	74.0	69.1	61.0
Balance of Payments										
Current account balance	-1.5	-5.1	-8.4	-7.0	-7.3	-6.7	-6.6	-6.2	-5.8	-5.3
Trade Balance (goods and services)	0.8	-0.6	-3.5	-2.2	-3.2	-2.6	-2.4	-1.9	-1.4	-0.9
Exports of goods and services	64.5	64.5	64.8	64.9	60.9	60.9	60.6	60.2	60.0	59.9
Imports of goods and services	63.7	65.1	68.3	67.1	64.2	63.5	63.0	62.2	61.4	60.8
Goods balance	-16.7	-21.0	-24.2	-21.1	-21.6	-20.0	-20.1	-19.9	-19.8	-19.6
Services balance	17.5	20.4	20.7	18.9	18.4	17.4	17.7	18.0	18.3	18.7
Primary income, net	0.6	-2.0	-2.7	-2.8	-2.3	-2.3	-2.3	-2.3	-2.4	-2.4
Secondary income, net	-2.9	-2.4	-2.1	-2.0	-1.8	-1.8	-1.8	-1.9	-1.9	-2.0
Capital account, net	0.3	0.2	0.5	0.7	0.6	0.4	0.4	0.4	0.4	0.4
Financial account, net	-1.6	-4.7	-5.6	-4.2	-6.7	-6.2	-6.2	-5.8	-5.4	-4.9
Direct investment	47.4	-9.8	-23.1	-22.6	-8.9	-8.6	-8.5	-8.2	-8.0	-7.9
Portfolio investment	-11.6	-17.5	0.2	12.2	-7.0	2.8	-0.2	1.4	0.3	3.2
Other investment and financial derivatives	-37.3	22.7	17.4	6.0	9.3	-0.4	2.5	1.1	2.4	-0.2
Reserves (+ accumulation)	0.0	-0.1	0.0	0.2	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	-0.6	-0.4
Errors and omissions	-0.4	0.2	2.2	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance										
National saving	11.5	12.6	13.1	12.4	13.9	14.9	15.4	16.0	16.5	17.1
Government	2.4	3.1	4.8	5.8	5.5	5.3	5.1	4.7	4.8	5.2
Non-government	9.1	9.5	8.4	6.6	8.4	9.6	10.3	11.3	11.7	11.9
Gross capital formation	13.0	17.7	21.5	19.4	21.1	21.6	22.0	22.2	22.3	22.4
Government	2.8	2.8	3.0	10.5	2.2	2.2	2.2	2.2	2.2	2.2
Private	10.2	14.8	18.5	8.9	18.9	19.4	19.8	20.0	20.1	20.2
Foreign saving	-1.5	-5.1	-8.4	-7.0	-7.3	-6.7	-6.6	-6.2	-5.8	-5.25
Memorandum Item:										
Nominal GDP (billions of euros)	17.7	18.5	19.6	20.7	21.8	23.2	24.5	25.9	27.3	28.8
External debt	572.6	576.5	552.3	494.6	477.8	458.5	448.0	434.8	423.6	414.1
Net IIP	-145.0	-123.0	-121.1	-114.7	-115.7	-115.2	-115.3	-114.8	-114.1	-113.2

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

1/ Projected negative growth of gross capital formation and a slowdown of imports of goods and services growth in 2018 reflect the base effect of volatile special purpose entities (SPEs) activity and a large but one-off purchase of airplanes.

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, 2016–24 1/ 2/

(Percent of GDP)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
						Projections			
Revenue	38.0	38.9	39.7	40.8	41.3	41.0	40.6	40.6	40.9
Current revenue	37.8	38.4	38.9	40.3	40.8	40.8	40.5	40.5	40.7
Tax revenue	24.3	24.9	25.2	24.6	24.4	24.4	24.2	24.2	24.2
Indirect taxes	14.8	15.6	15.9	15.3	15.2	15.2	15.1	15.1	15.1
Direct taxes	9.5	9.3	9.3	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	8.7	8.9	10.9	12.1	12.2	12.2	12.2	12.5
Other current revenue	5.2	4.8	4.8	4.8	4.3	4.2	4.1	4.1	4.1
Capital revenue	0.2	0.5	0.8	0.5	0.4	0.2	0.1	0.1	0.1
Expenditure	37.7	37.1	44.5	37.5	38.2	38.1	38.2	38.0	37.8
Current expenditure	34.9	34.1	33.9	35.3	36.0	35.9	36.0	35.8	35.6
Wages and salaries	12.2	12.0	11.8	12.1	12.4	12.6	12.6	12.7	12.7
Goods and services	3.5	3.6	4.0	3.9	3.7	3.7	3.7	3.7	3.7
Social Transfers	13.9	13.3	13.1	14.4	15.4	15.5	15.5	15.5	15.5
Subsidies	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Interest payments	2.6	2.6	2.5	2.4	2.1	2.0	1.9	1.7	1.5
Other current expenditure	2.2	2.4	2.3	2.3	2.2	2.0	2.0	2.0	2.0
Capital expenditure	2.8	3.0	10.5	2.2	2.2	2.2	2.2	2.2	2.2
Capital transfers, payable	0.6	0.5	5.2	0.2	0.2	0.2	0.2	0.2	0.2
Gross capital formation less NFA disposal	2.3	2.5	5.3	2.0	2.0	2.0	2.0	2.0	2.0
Overall balance	0.3	1.8	-4.8	3.3	3.1	2.9	2.5	2.7	3.1
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.4	1.8	-4.8	3.3	3.1	2.9	2.5	2.7	3.1
Net financial transactions	0.4	1.8	-4.4	3.3	3.1	2.9	2.5	2.7	3.1
Net acquisition of financial assets	-5.2	-3.6	9.1	1.1	0.7	2.9	-1.6	1.6	-1.5
Currency and deposits	-5.2	-3.6	9.1	1.1	0.7	2.9	-1.6	1.6	-1.5
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	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	-5.6	-5.4	13.5	-2.2	-2.4	0.0	-4.1	-1.0	-4.6
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	-5.2	0.4	21.0	6.1	-2.5	0.4	-3.8	-0.7	-4.4
Loans	-0.4	-5.8	-7.5	-8.3	0.1	-0.4	-0.3	-0.3	-0.1
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Underlying expenditure 2/	37.7	37.1	36.0	35.6	35.2	35.0	35.2	35.2	35.1
Output Gap	-4.1	-1.8	-0.3	0.6	1.2	1.3	1.2	0.9	0.7
Underlying overall balance 3/	0.3	1.8	3.2	3.3	3.1	2.9	2.5	2.7	3.1
Primary balance (ESA2010)	3.0	4.3	-2.3	5.7	5.2	4.9	4.4	4.3	4.6
Underlying primary balance 3/	3.0	4.3	5.7	5.7	5.2	4.9	4.4	4.3	4.6
Structural overall balance 3/	1.7	1.9	2.8	2.6	2.5	2.3	2.1	2.3	2.8
Structural primary balance 3/	4.3	4.5	5.2	5.0	4.6	4.3	4.0	4.0	4.4
Public debt	105.5	95.8	102.5	95.2	87.4	82.7	74.0	69.1	61.0
Public debt net of cash holding	100.1	92.4	100.1	91.9	83.5	76.2	69.5	63.2	56.9

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

2/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction, state-owned AMC, and NHS contributions as an employer and third party.

3/ Excludes the fiscal impact of the sale of the CCB transaction and state-owned AMC of 8.0 percent of GDP.

Table 3. Cyprus: General Government Gross Financing Requirements and Sources of Financing, 2019–24
(Millions of euros)

	2019	2020	2021	2022	2023	2024
			Projections			
Gross borrowing needs	2,799	983	698	1,828	1,107	1,479
Overall deficit	-722	-712	-713	-645	-727	-881
Primary surplus	-1,239	-1,206	-1,195	-1,140	-1,181	-1,324
Interest payments	516	495	482	495	454	443
Amortization	3,488	1,694	1,411	2,473	1,834	2,360
Medium- and long-term	3,288	1,356	943	2,020	1,381	1,952
Foreign	2,158	536	82	1,082	1,083	1,432
Eurobonds	199	458	0	1,000	1,000	1,350
Russia	1,875	0	0	0	0	0
Other	84	78	82	82	83	82
Domestic	1,131	820	861	938	298	520
Short-term	200	300	300	300	300	300
EU and IMF	0	38	168	153	153	108
Stock-flow adjustment 1/	33	0	0	0	0	0
Gross financing sources	2,799	983	698	1,828	1,107	1,479
Privatization receipts	0	0	0	0	0	0
Market access	3,000	1,150	1,400	1,400	1,550	1,050
Medium- and long-term	2,700	850	1,100	1,100	1,250	750
Foreign	2,400	650	900	900	1,150	650
Domestic	300	200	200	200	100	100
Short-term	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0
Use of deposits 2/	-201	-167	-702	428	-443	429
Net placement	-488	-544	-11	-1,073	-437	-1,418
Medium and Long Term Debt	-588	-506	157	-920	-284	-1,310
Domestic Securities	-831	-620	-661	-738	-198	-420
Eurobonds	2,051	42	750	-250	0	-850
Domestic Loans	0	0	0	0	0	0
Foreign Loans	-1,809	72	68	68	-86	-40
Short term (Net increase)	100	0	0	0	0	0
EU and IMF	0	-38	-168	-153	-153	-108
Memorandum item:						
Cash holding (eop)	714	882	1,584	1,156	1,598	1,170
General government debt (eop)	20,770	20,225	20,215	19,141	18,857	17,547
General government debt (eop, percent of GDP)	95.2	87.4	82.7	74.0	69.1	61.0
General government net debt (eop, percent of GDP) 3/	91.9	83.5	76.2	69.6	63.2	56.9

1/ Adjustments for consistency between estimated cash basis fiscal balance and debt data.
2/ Minus (-) sign represents accumulation of deposits.
3/ General government debt minus cash holding.

Table 4. Cyprus: Balance of Payments, 2015–24

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Projections					
					(Percent of GDP)					
Current Account Balance	-1.5	-5.1	-8.4	-7.0	-7.3	-6.7	-6.6	-6.2	-5.8	-5.3
Trade Balance (Goods and Services)	0.8	-0.6	-3.5	-2.2	-3.2	-2.6	-2.4	-1.9	-1.4	-0.9
Goods Balance	-16.7	-21.0	-24.2	-21.1	-21.6	-20.0	-20.1	-19.9	-19.8	-19.6
Exports	16.2	14.0	13.3	16.9	13.5	14.9	14.6	14.4	14.1	14.0
Imports	33.0	35.1	37.5	38.0	35.1	34.9	34.7	34.3	33.9	33.6
Services Balance	17.5	20.4	20.7	18.9	18.4	17.4	17.7	18.0	18.3	18.7
Exports	48.3	50.5	51.5	48.0	47.5	46.0	46.0	45.9	45.9	46.0
Imports	30.8	30.1	30.8	29.1	29.1	28.6	28.3	27.9	27.5	27.2
Primary Income	0.6	-2.0	-2.7	-2.8	-2.3	-2.3	-2.3	-2.3	-2.4	-2.4
Secondary Income	-2.9	-2.4	-2.1	-2.0	-1.8	-1.8	-1.8	-1.9	-1.9	-2.0
Capital Account	0.3	0.2	0.5	0.7	0.6	0.4	0.4	0.4	0.4	0.4
Financial Account (- financing)	-1.6	-4.7	-5.6	-4.2	-6.7	-6.2	-6.2	-5.8	-5.4	-4.9
Direct Investment	47.4	-9.8	-23.1	-22.6	-8.9	-8.6	-8.5	-8.2	-8.0	-7.9
Portfolio Investment	-11.6	-17.5	0.2	12.2	-7.0	2.8	-0.2	1.4	0.3	3.2
Financial Derivatives	-4.9	1.9	1.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other Investment	-32.4	20.8	16.4	5.9	9.1	-0.5	2.4	1.0	2.3	-0.3
Reserves (+ accumulation)	0.0	-0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	-0.4	0.2	2.2	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Current Account Balance adjusted for SPEs 1/	-1.0	-0.4	-3.1	-4.5	...	...	...	...	...	...
Program Financing 2/	5.7	0.7	-1.4	0.0	0.0	-0.2	-0.7	-0.6	-0.6	-0.4
Private Net Capital Flows 3/	-27.9	-31.5	-21.9	-6.4	...	...	...	...	...	...
o/w Portfolio Investment	-12.8	-20.9	-4.6	17.0	...	...	...	...	...	...
o/w Other Investment	-57.6	-2.8	4.8	-1.0	...	...	...	...	...	...
o/w MFIs	-38.1	7.2	-1.9	14.2	...	...	...	...	...	...
o/w Non-MFIs	-19.5	-10.0	6.7	-15.2	...	...	...	...	...	...
Gross External Debt	572.6	576.5	552.3	494.6	477.8	458.5	448.0	434.8	423.6	414.1
o/w Short-term Debt	197.0	180.3	149.9	126.3	115.7	108.9	106.7	106.0	105.9	108.7

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

1/ Treating Special Purpose Entities (SPEs) as non-residents.

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

3/ Private net capital flows (- inflows, + outflows) are defined to exclude the public-sector flows (the central-bank flows and 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, 2015–24

(Millions of euros)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Projections					
GROSS FINANCING REQUIREMENTS	**45,010**	**42,963**	**43,255**	**39,140**	**37,308**	**34,895**	**34,757**	**36,746**	**38,175**	**40,072**
Current account deficit ("-" = CA surplus)	259	935	1,643	1,461	1,588	1,544	1,607	1,592	1,573	1,510
Medium- and long-term debt amortization	8,065	7,073	8,001	8,223	9,539	8,060	7,759	8,907	9,053	9,548
Public sector	1,392	276	609	697	2,158	536	82	1,082	1,083	1,432
Banks	1,146	887	761	636	530	514	504	499	496	494
Other private	5,527	5,910	6,630	6,890	6,851	7,010	7,173	7,325	7,473	7,622
Short-term debt amortization	36,686	34,956	33,345	29,456	26,180	25,253	25,223	26,095	27,396	28,907
Public sector	2,874	222	293	313	360	400	466	541	630	732
Central Bank	2,874	201	275	296	344	400	466	541	630	732
General government and SOEs	0	20	18	17	16	0	0	0	0	0
Banks	19,593	22,493	17,997	17,174	13,407	11,286	9,950	9,556	9,366	9,272
Other private	14,219	12,241	15,055	11,968	12,413	13,566	14,808	15,997	17,400	18,902
EU and IMF	0	0	267	0	0	38	167	152	152	107
SOURCES OF FINANCING	**44,000**	**42,838**	**43,255**	**39,140**	**37,308**	**34,895**	**34,757**	**36,746**	**38,175**	**40,072**
Capital account (net)	49	37	103	148	123	101	94	101	112	113
Foreign direct investment (net)	-8,415	1,804	4,540	4,678	1,951	1,999	2,078	2,132	2,194	2,263
Cypriot investment abroad	15,752	5,632	5,243	-4,924	5,373	5,698	5,984	6,293	6,621	6,966
Foreign investment in Cyprus	7,337	7,436	9,782	-246	7,324	7,697	8,062	8,425	8,815	9,229
New borrowing and debt rollover	44,572	43,371	38,494	34,589	35,759	34,173	35,413	36,850	38,759	40,853
Medium and long-term borrowing	9,617	10,026	9,038	8,409	10,506	8,950	9,318	9,454	9,852	9,580
General government	2,062	125	850	1,500	2,400	650	900	900	1,150	650
Banks	112	390	257	213	463	473	484	489	486	514
Other private	7,443	9,510	7,931	6,696	7,644	7,827	7,935	8,065	8,216	8,417
Short-term borrowing	34,956	33,345	29,456	26,180	25,253	25,223	26,095	27,396	28,907	31,272
Public sector	222	293	313	360	400	466	541	630	732	852
Central Bank	201	275	296	344	400	466	541	630	732	852
General government and SOEs	20	18	17	16	0	0	0	0	0	0
Banks	22,493	17,997	17,174	13,407	11,286	9,950	9,556	9,366	9,272	9,635
Other private	12,241	15,055	11,968	12,413	13,566	14,808	15,997	17,400	18,902	20,786
Other	7,793	-2,373	118	-275	-526	-1,379	-2,828	-2,338	-2,890	-3,157
Of which: Net errors and omissions	-74	32	441	444	0	0	0	0	0	0
FINANCING GAP	**1,010**	**125**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	600	0	0	0	0	0	0	0	0	0
IMF	410	125	0	0	0	0	0	0	0	0
ROLLOVER RATES										
General government 1/	150%	48%	138%	212%	110%	121%	1094%	83%	106%	45%
Central bank	7%	137%	108%	116%	116%	116%	116%	116%	116%	116%
Private	104%	103%	92%	89%	99%	102%	105%	106%	106%	108%
Banks	109%	79%	93%	76%	84%	88%	96%	98%	99%	104%
Non-financial corporates	100%	135%	92%	101%	110%	110%	109%	109%	109%	110%

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

1/ High rollover rate in 2021 reflects a low level of scheduled amortization of external debt and pre-financing to accumulate deposits.

Table 6. Cyprus: Financial Soundness Indicators, 2012–18Q3 1/
(Percent, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018
Capital Adequacy							
Regulatory capital ratio	7.3	13.5	15.3	16.6	16.8	16.3	17.5
Tier I capital ratio	6.3	12.3	14.6	16.0	16.4	15.4	16.6
Asset Quality							
Non-performing loans (NPLs) to total gross loans 2/	27.1	44.4	47.5	45.3	46.4	42.5	30.5
Non-performing loans (NPLs) to total gross loans (local operations) 3/	22.6	44.4	47.8	45.8	47.2	43.7	30.3
Provisions to NPLs	...	...	33.9	38.3	42.3	47.3	65.4
Restructured loans classified as NPLs to total NPLs	...	28.0	33.9	40.1	40.8	40.9	44.9
Earnings and Profitability							
Return on assets 4/	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.4
Return on equity 4/	-69.5	-69.5	-8.1	-7.4	1.7	-10.9	8.7
Net interest income to gross income ratio	78.9	86.2	78.4	81.2	75.3	70.8	67.2
Net fees and commissions income to gross income ratio	16.0	13.4	11.6	13.8	14.6	16.5	19.5
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	1.9
Liquidity							
Cash, trading and available-for-sale assets to total assets ratio	8.6	7.0	14.4	19.8	22.9	27.9	27.6
Others							
Total loans and advances to total assets ratio	82.9	83.6	73.4	73.6	69.1	64.1	54.6
Total deposits (other than from credit institutions) to total assets ratio	71.7	63.8	63.0	65.1	74.9	75.7	79.2

Sources: Central Bank of Cyprus.

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

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

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

4/ Annual return. The last observation is the year-to-date return.

Table 7. 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	9.8	44.5	149.9	134.7	131.8	92.2	53.4	9.2
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	9.8	13.2	11.7	8.8	6.0	3.5	1.8	1.0
Total debt service, in percent of														
Quota	1.0	2.4	4.8	4.3	77.7	3.8	3.2	14.6	49.3	44.3	43.4	30.4	17.6	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	3.4	3.3	3.2	2.8	2.0	1.3	0.7	0.3	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. 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 or a fiscal shock, including from contingent liabilities. If 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. 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. One-off factors led to an increase in the debt ratio last year after a sharp decline in 2017.[1] The government took advantage of rapidly-rising cash balances arising from the increasing primary surplus and strong growth in 2017 to repay part of its debt to the Fund and the CBC ahead of schedule. 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 to Hellenic Bank, the government placed €3.19 billion domestic bonds (15 percent of projected GDP in 2018) at the CCB in July 2018. Despite an early repayment of the remaining balance of the debt owed to the CBC (€483 million) and the balance of a loan owed to a domestic bank (€324 million) at end-2018, this transaction contributed to an increase in public debt to 102.5 percent of GDP at end-2018.

2. Public debt is projected to resume a rapid decline from 2019. Projected high primary surpluses and robust economic growth will support a durable decline in public debt to 61 percent of GDP by 2024.

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 are being redeemed gradually over a five-year period beginning last year. Nevertheless, following the debt management operation to repay early the loan to Russia this year (€1.56 billion), GPFN will remain well below the benchmark for advanced economies (20 percent of GDP) over the projection horizon. 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. As part of the CCB sale, the government agreed to an Asset Protection Scheme (APS) covering the loan portfolio transferred to

[1] The coverage of the public DSA is the general government. Debt guaranteed by the government is not included in the baseline DSA, but debt of public entities guaranteed by the general government as well as their pension fund deficits of public entities is included in the calculation of the DSA contingent liabilities scenario.

the HB (€2.6 billion), although the eventual loss to which the government is exposed will likely be much smaller.[2] In addition, broader risk from NPLs at other systemic banks could spill over to the government's balance sheet if higher provisioning and recapitalization needs cannot be met through private financing. 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. However, the probability that public debt to GDP could remain high over the medium-term has diminished. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 85 percent until 2024 with a probability of only 10 percent (fan chart in Annex Figure 1).[3]

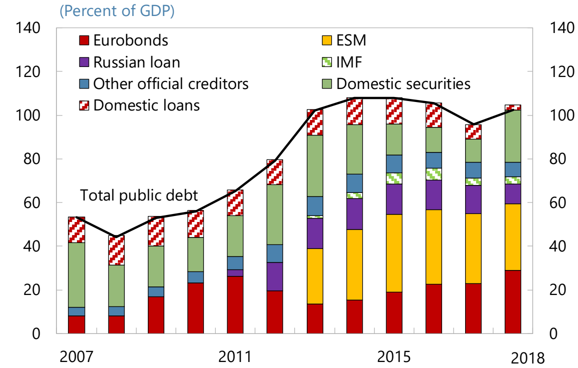
6. **Gross public financing needs are susceptible to a range of shocks.** In the event of short-duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would jump several percentage points of GDP, although it remains well 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, although they are estimated to have declined in 2018 on ongoing reductions in non-resident deposits at Cypriot banks. The private sector GFN may create pressure if liabilities are not rolled over or flows reverse, although gross liabilities are to a considerable extent matched by gross assets of a similar duration.

- About 76 percent of public debt is owed to non-residents. However, about 67 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 the back-loaded repayment schedule on a significant share of debt, mitigates interest rate and financing risks.[4]

Public Debt
(Percent of GDP)



Sources: Ministry of Finance and IMF staff estimates.

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

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

[4] As of end-March 2019, the weighted average maturity of total debt is 6.3 years, while that of marketable debt is 5.0 years. The shares of debt that falls due within 1 year and 5 years are 11.3 percent and 45.4 percent, respectively.

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 10-year sovereign bond spread relative to German bonds—an indicator of market perception of sovereign risk—was around 174 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 (3.5 percentage points) decrease in growth during 2020–21, accompanied by (i) a 39 and 81 basis points (bps) rise in interest rates in 2020 and 2021, 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 106 percent of GDP by 2021, before declining to 73 percent of GDP by 2024.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.6 percent of GDP during 2020–21, accompanied by 40 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 556 bps during 2020–24 would raise public debt by 2 percent of GDP by 2024, respectively.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 99 percent of GDP in 2021 before declining to 79 percent of GDP by 2024. Gross financing needs would peak at 11 percent of GDP in 2022 before falling back.

10. **Under a scenario with a lower fiscal balance and realization of contingent liabilities from government guarantees, the public debt-to-GDP ratio declines somewhat slowly.** The primary fiscal balance is assumed to be permanently lower than in the baseline by ½ standard deviation, which could materialize from the reversal of expenditure measures implemented during

the adjustment program or the higher-than-expected fiscal cost of the forthcoming National Health System (NHS) implementation. Further realization of contingent liabilities from government guarantees to public entities, pension deficits of public entities, and the court case against the public-sector wage cuts implemented during the banking crisis (9 percent of GDP) is also assumed. As risk premiums rise, interest rate is higher than under the baseline by 246 basis points in 2020 and 40–45 basis points thereafter. Under this scenario, public debt would rise to 97 percent of GDP in 2020 and thereafter decline to 77 percent in 2024. Gross financing needs would jump to 14 percent of GDP in 2020 before declining to 8 percent in 2024.

11. Under an alternative adverse scenario of lower economic growth and primary fiscal balances combined with a further realization of 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 the 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 (14 percent of GDP) in 2020, on top of the support already provided to the CCB, is also assumed.[5] Under this adverse scenario, public debt would rise to 105 percent of GDP in 2020 and would decline only slowly to 94 percent of GDP in 2024. Gross financing needs would also spike to 21 percent of GDP in 2020 before declining to 10 percent of GDP over the medium term.

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 478 (94) percent of GDP in 2019 to 414 (27) percent of GDP by 2024.[6] 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 40 percent of GDP, mostly reflecting further declines in nonresident deposits. External debt of private nonbank sectors is also forecast to decline, 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 186 percent of GDP in 2024 from 250 percent of GDP in 2019.

[5] Contingent liabilities from the banking sector comprise two components: (i) 50 percent default rate for loans covered by the APS and 50 percent loss-given-default rate; and (ii) 75 percent loss from gross book value of NPLs minus provisions of the banking system.

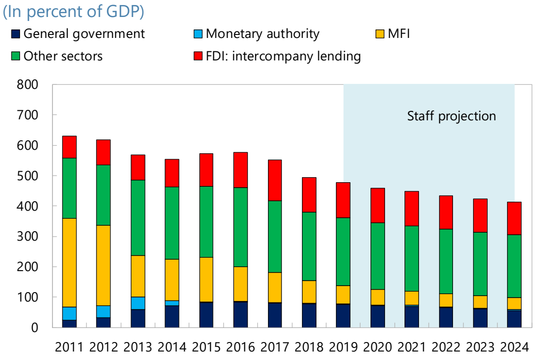
[6] Cyprus is a regional financial center and its external assets and liabilities are very large. The external DSA focuses on gross external debt and associated gross interest payments. However, changes in gross external debt may be accompanied by changes in gross external assets, which—in a financial 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.

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 5.6 percent annually on average, contributing to an annual external debt reduction of 24 percentage points of GDP. At the same time, growth is expected to sustain the trade deficit (2.1 percent of GDP annually, on average), which together with net interest payments (2.9 percent of GDP annually, on average), is forecast to partially offset the denominator effect. The result would be an average annual decline in external debt by 13 percentage points of GDP.

Cyprus: External Debt Developments and Forecast, Including SPEs

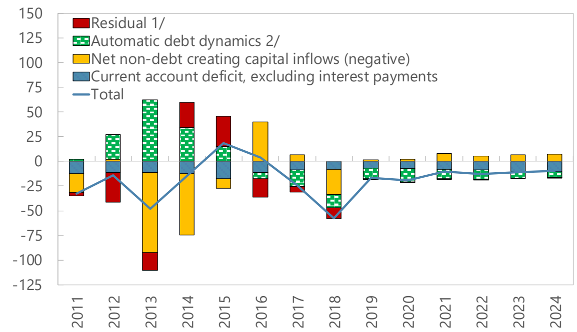
Reduction in debt of MFIs and the general government is expected to drive the fall in external debt.

Gross External Debt by Sector
(In percent of GDP)



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

Contributions to External Debt Dynamics
(Changes in gross external debt in percent of GDP)



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 slow debt reduction, as the large stock of external debt would 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 52 percentage points by 2024, 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 34 percentage points by 2024 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 11 percentage points higher by 2024 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 49 percentage points by 2024 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 47 percent of GDP by 2024 mostly reflecting near-zero inflation.

Gross Financing Needs

15. Gross external financing needs are projected to decline but remain elevated (over 130 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 an estimated 70 percentage points of GDP over the last three years to around 125 percent of GDP. Some 86 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 public sector debt.

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.

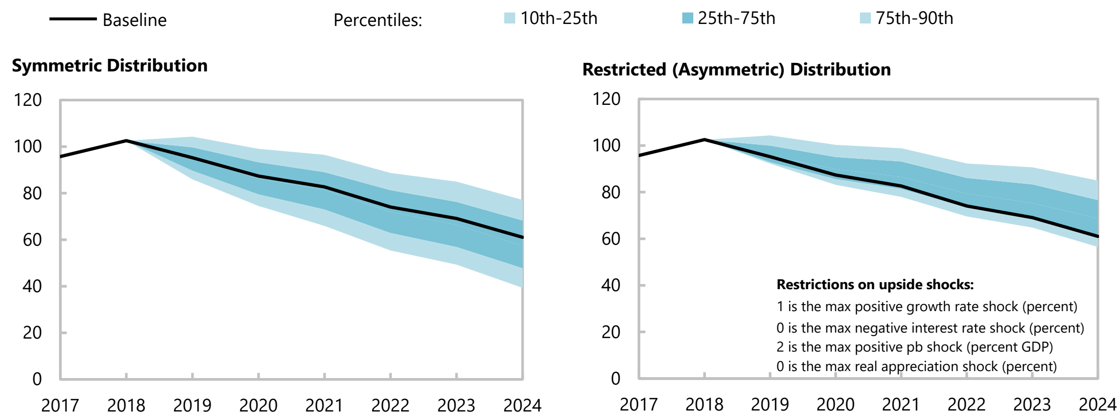
Cyprus: Public DSA Risk Assessment

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

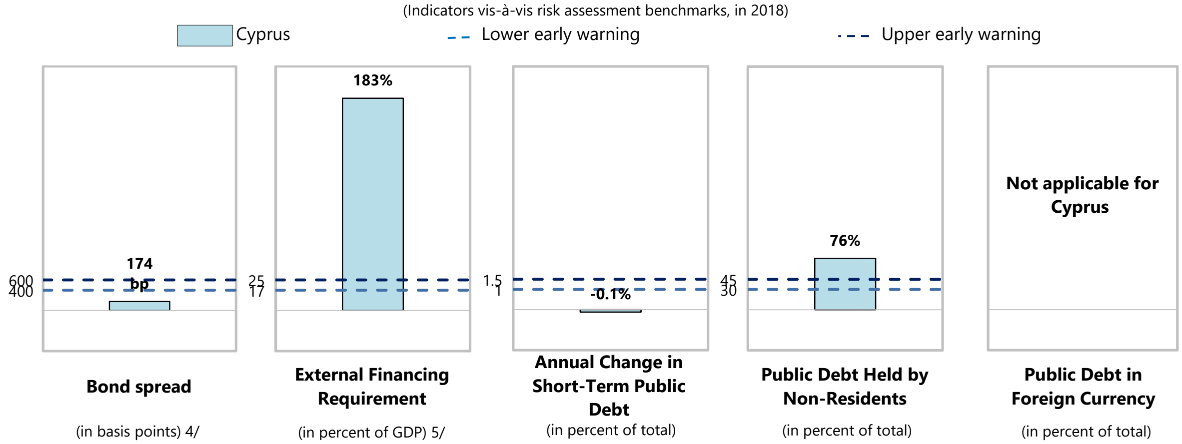
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



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:

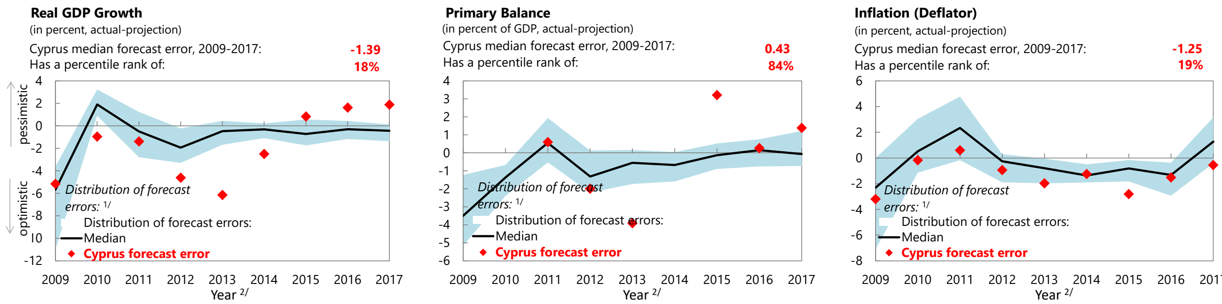
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 22-Jan-19 through 22-Apr-19.

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

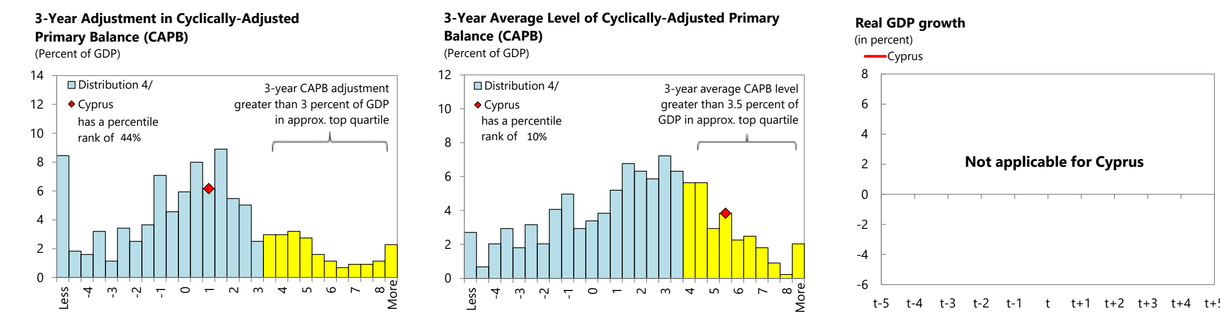
Cyprus: Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment

Boom-Bust Analysis 3/



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 observations 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)

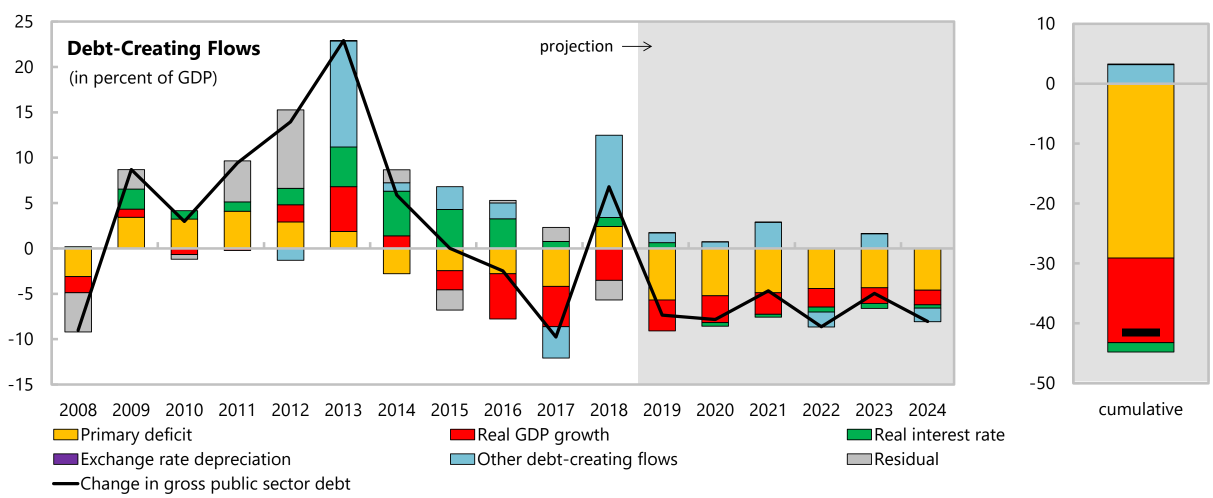
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	80.1	95.8	102.5	95.2	87.4	82.7	74.0	69.1	61.0
Public gross financing needs	13.5	9.8	16.1	12.7	4.2	2.8	7.1	4.0	5.1
Real GDP growth (in percent)	0.0	4.5	3.9	3.5	3.3	2.9	2.6	2.5	2.4
Inflation (GDP deflator, in percent)	0.7	1.7	1.6	1.7	2.7	2.7	3.0	3.0	2.8
Nominal GDP growth (in percent)	0.7	6.3	5.5	5.3	6.1	5.6	5.7	5.6	5.3
Effective interest rate (in percent) [4/]	3.9	2.6	2.7	2.4	2.4	2.4	2.4	2.4	2.3

As of April 22, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		147
5Y CDS (bp)		83
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	5.8	-9.8	6.8	-7.4	-7.8	-4.7	-8.6	-5.0	-8.0	-41.5	
Identified debt-creating flows	4.7	-11.3	9.0	-7.4	-7.8	-4.7	-8.7	-5.0	-8.1	-41.6	
Primary deficit	0.5	-4.2	2.4	-5.7	-5.2	-4.9	-4.4	-4.3	-4.6	-29.1	-3.5
Primary (noninterest) revenue and grant	37.4	38.7	39.6	40.8	41.3	41.0	40.6	40.6	40.9	245.2	
Primary (noninterest) expenditure	37.9	34.6	42.0	35.1	36.1	36.1	36.2	36.3	36.2	216.1	
Automatic debt dynamics [5/]	2.5	-3.7	-2.5	-2.8	-3.4	-2.7	-2.6	-2.3	-2.0	-15.7	
Interest rate/growth differential [6/]	2.5	-3.7	-2.5	-2.8	-3.4	-2.7	-2.6	-2.3	-2.0	-15.7	
Of which: real interest rate	2.6	0.8	1.0	0.6	-0.4	-0.3	-0.5	-0.5	-0.4	-1.5	
Of which: real GDP growth	-0.1	-4.4	-3.5	-3.4	-3.0	-2.4	-2.1	-1.7	-1.6	-14.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.7	-3.5	9.1	1.1	0.7	2.9	-1.6	1.6	-1.5	3.2	
Privatization/Drawdown of Deposits (+	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	1.7	-3.5	9.1	1.1	0.7	2.9	-1.6	1.6	-1.5	3.2	
Residual, including asset changes [8/]	1.1	1.6	-2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.1	

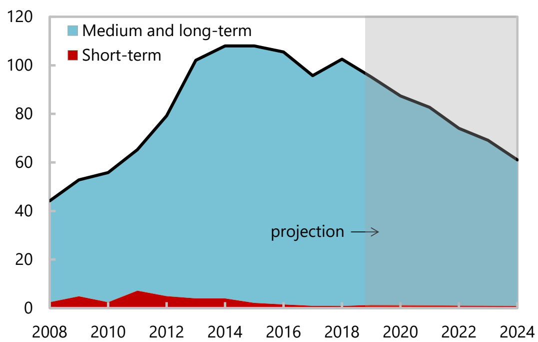


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ))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

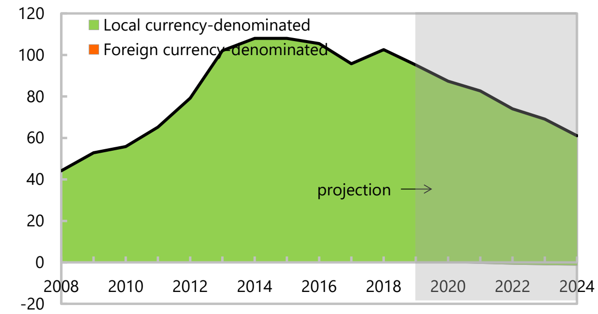
Cyprus: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



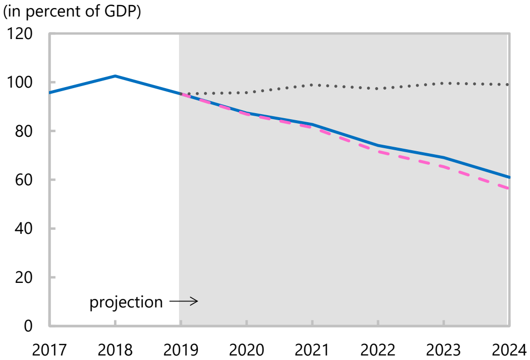
By Currency
(in percent of GDP)



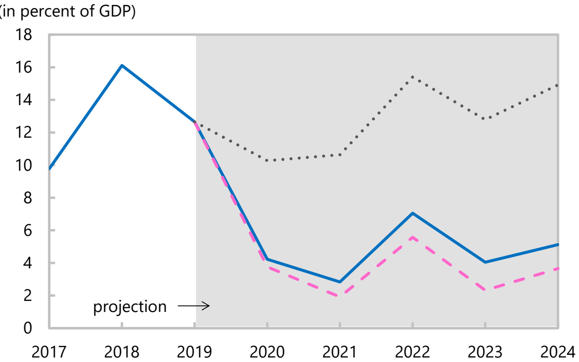
Alternative Scenarios

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)

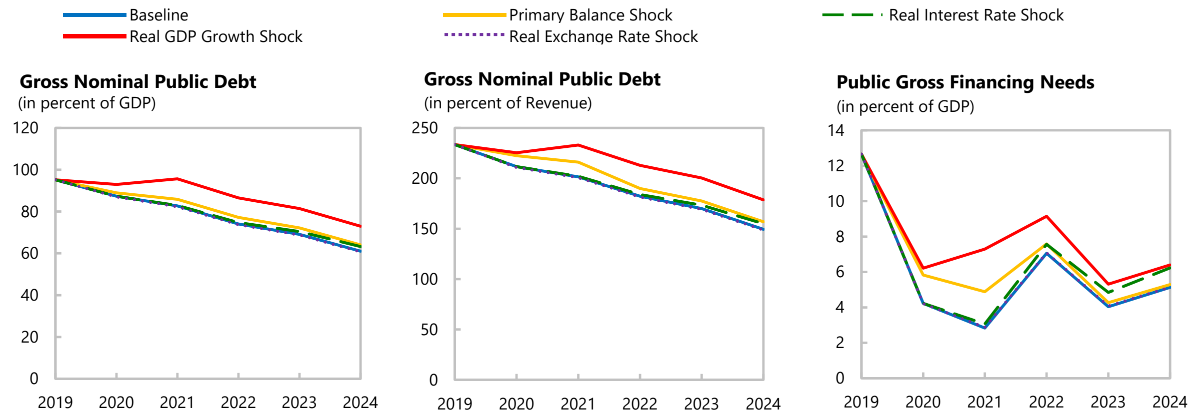
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary Balance	5.7	5.2	4.9	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.4	2.4	2.4	2.3
Constant Primary Balance Scenario						
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary Balance	5.7	5.7	5.7	5.7	5.7	5.7
Effective interest rate	2.4	2.4	2.4	2.4	2.3	2.3

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.5	0.5	0.5	0.5	0.5	0.5
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary Balance	5.7	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	2.4	2.4	2.7	3.1	3.4	3.7

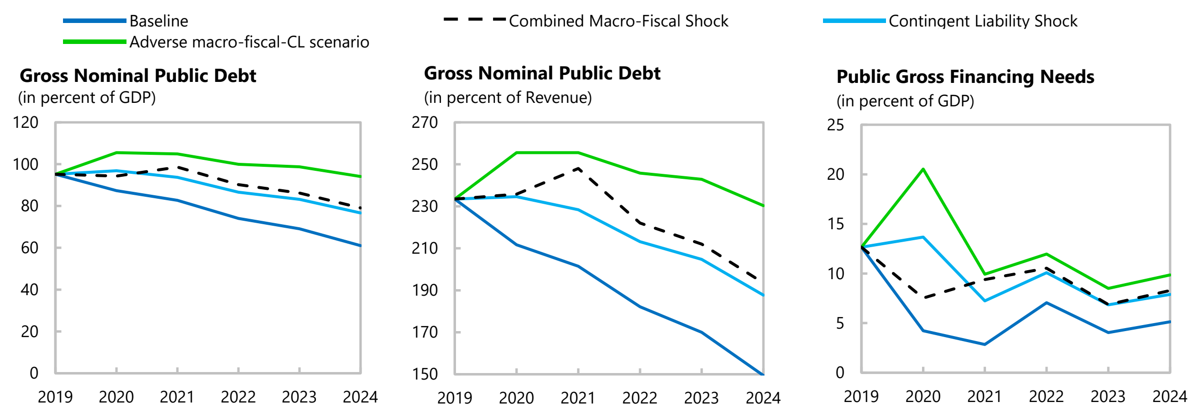
Source: IMF staff.

Cyprus: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



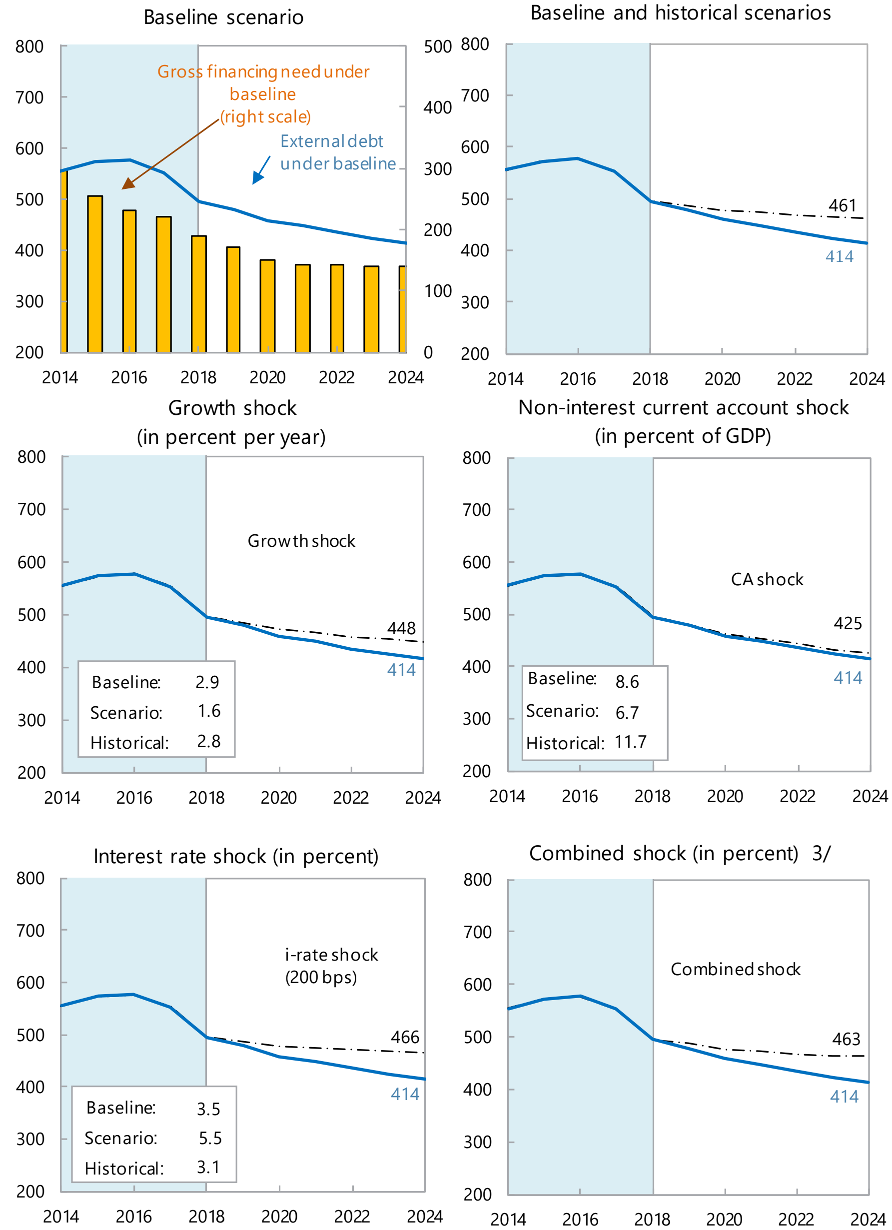
Underlying Assumptions
(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary balance	5.7	3.6	3.3	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.4	2.5	2.4	2.4
Real Interest Rate Shock						
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary balance	5.7	5.2	4.9	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.6	3.0	3.3	3.7
Combined Shock						
Real GDP growth	3.5	-0.2	-0.6	2.6	2.5	2.4
Inflation	1.7	1.8	1.8	3.0	3.0	2.8
Primary balance	5.7	2.3	0.4	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.8	3.4	3.8	4.2

	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	3.5	-0.2	-0.6	2.6	2.5	2.4
Inflation	1.7	1.8	1.8	3.0	3.0	2.8
Primary balance	5.7	3.6	1.6	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.4	2.5	2.5	2.4
Real Exchange Rate Shock						
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	3.1	2.7	3.0	3.0	2.8
Primary balance	5.7	5.2	4.9	4.4	4.3	4.6
Effective interest rate	2.4	2.4	2.4	2.4	2.4	2.3
Contingent Liability Shock						
Real GDP growth	3.5	3.3	2.9	2.6	2.5	2.4
Inflation	1.7	2.7	2.7	3.0	3.0	2.8
Primary balance	5.7	-4.2	3.3	2.8	2.7	3.0
Effective interest rate	2.4	2.4	2.6	2.7	2.7	2.7

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/
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	
Baseline: External debt	554	573	576	552	495			**478**	**458**	**448**	**435**	**424**	**414**	**1.5**
Change in external debt	-14.8	18.3	3.9	-24.2	-57.7			-16.8	-19.4	-10.5	-13.2	-11.2	-9.5	
Identified external debt-creating flows (4+9+14)	-40.4	-12.8	21.9	-19.0	-47.1			-16.1	-18.9	-10.1	-12.8	-10.7	-9.1	
Current account deficit, excluding interest payments	-12.7	-17.5	-11.0	-8.9	-8.2			-7.0	-7.4	-7.8	-8.7	-9.7	-10.6	
Deficit in balance of goods and services	-2.0	-0.8	0.6	3.5	2.2			3.2	2.6	2.4	1.9	1.4	0.9	
Exports	62.0	64.5	64.5	64.8	64.9			60.9	60.9	60.6	60.2	60.0	59.9	
Imports	60.0	63.7	65.1	68.3	67.1			64.2	63.5	63.0	62.2	61.4	60.8	
Interest receipts (negative)	-10.9	-12.3	-11.0	-10.0	-10.6			-10.5	-10.7	-11.3	-12.2	-13.2	-14.1	
Net non-debt creating capital inflows (negative)	-61.9	-10.0	39.9	6.6	-25.3			1.3	1.9	7.7	5.4	6.6	7.1	
Net foreign direct investment, equity	-15.1	38.5	3.2	-21.4	-22.7			-1.2	-4.0	-3.9	-3.7	-4.0	-3.9	
Net portfolio investment, equity	-14.9	-9.5	6.1	21.3	7.8			3.8	4.4	4.1	1.5	1.3	1.1	
Net sales of assets under other investment	-33.5	-34.0	28.8	5.8	-10.5			-1.5	1.4	7.4	7.5	9.2	9.8	
Financial derivatives, net	1.6	-4.9	1.9	1.0	0.1			0.1	0.1	0.1	0.1	0.1	0.1	
Automatic debt dynamics 1/	34.1	14.7	-7.0	-16.7	-13.6			-10.4	-13.4	-10.0	-9.4	-7.6	-5.6	
Contribution from nominal interest rate	17.0	19.0	16.1	17.3	15.2			14.3	14.1	14.4	14.9	15.5	15.9	
Contribution from real GDP growth	7.7	-10.8	-26.4	-24.2	-20.3			-16.4	-14.9	-12.4	-11.1	-10.2	-9.8	
Contribution from price and exchange rate changes 2/	9.5	6.5	3.4	-9.7	-8.5			-8.2	-12.7	-12.0	-13.2	-12.9	-11.6	
Residual (2-3 or 19+20+21+22)	25.7	31.1	-18.0	-5.2	-10.6			-0.6	-0.4	-0.4	-0.4	-0.4	-0.4	
Net accumulation of official reserve assets	0.0	0.0	-0.1	0.0	0.2			0.0	0.0	0.0	0.0	0.0	0.0	
Captial account flows, net (negative)	-0.8	-0.3	-0.2	-0.5	-0.7			-0.6	-0.4	-0.4	-0.4	-0.4	-0.4	
Errors and omissions, net (negative)	3.6	0.4	-0.2	-2.2	-2.1			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	22.8	31.0	-17.5	-2.4	-8.0			-0.1	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	893	888	893	853	762			784	753	740	722	706	691	
Gross external financing need (in billions of euros) 3/	52	45	43	43	39			37	35	35	37	38	40	
in percent of GDP	296	254	232	220	189			171	151	142	142	140	139	
Scenario with key variables at their historical averages 4/						5-Year Historical Average	5-Year Standard Deviation	**485**	**477**	**474**	**468**	**464**	**461**	Projected Average
Key Macroeconomic Assumptions Underlying Baseline														
Nominal GDP (in billions of euros)	17.6	17.7	18.5	19.6	20.7			21.8	23.2	24.5	25.9	27.3	28.8	
Real GDP growth (in percent)	-1.3	2.0	4.8	4.5	3.9	2.8	2.5	3.5	3.3	2.9	2.6	2.5	2.4	2.9
GDP deflator in euros (change in percent)	-1.6	-1.2	-0.6	1.7	1.6	0.0	1.6	1.7	2.7	2.7	3.0	3.0	2.8	2.7
Nominal external interest rate (in percent)	2.9	3.5	2.9	3.2	2.9	3.1	0.2	3.0	3.1	3.3	3.5	3.8	3.9	3.5
Growth of exports (euro terms, in percent)	2.7	4.8	4.2	6.7	5.7	4.8	1.5	-1.2	6.0	5.0	5.2	5.2	5.2	4.2
Growth of imports (euro terms, in percent)	2.5	7.0	6.5	11.4	3.7	6.2	3.5	0.7	5.0	4.7	4.4	4.3	4.3	3.9
Current account balance, excluding interest payments	12.7	17.5	11.0	8.9	8.2	11.7	3.7	7.0	7.4	7.8	8.7	9.7	10.6	8.6
Net non-debt creating capital inflows	61.9	10.0	-39.9	-6.6	25.3	10.1	37.7	-1.3	-1.9	-7.7	-5.4	-6.6	-7.1	-5.0

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 II. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Time Horizon	Expected Impact of Risks	Policy Response
External Risks			
High		Medium/High	
Rising protectionism and retreat from multilateralism: Escalating and sustained trade actions threaten the global trade system, regional integration, and global and regional collaboration.	ST, MT	The Cypriot economy is heavily dependent on foreign demand, including tourism from the U.K. and the EU, and for goods exports to the latter. A slowdown that weighs on inward FDI from the U.K., possibly reflecting SPE activity, also could impact business services. In the short term, escalating trade tensions, including disorderly Brexit, could increase uncertainty about growth and higher financial market volatility. Weaker external demand would adversely affect long-term growth through its impact on the tourism sector.	Seek to broaden sources of foreign demand. Restart structural reforms to make the economy more dynamic and flexible in response to demand shocks. In the event of a sharp slowdown, allow automatic stabilizers to operate.
High			
Weaker than expected growth in Europe: In the near term, weak foreign demand makes euro area businesses delay investment, while faltering confidence reduces private consumption. Adverse financial market reaction to debt sustainability concerns further dampens growth. A disorderly Brexit could cause market disruption with negative spillovers. In the medium term, disregard for the common fiscal rules and rising sovereign yields for high-debt countries test the euro area policy framework, with an adverse impact on confidence and growth.	ST, MT		
Low, Medium		Medium	
Sharp tightening of global financial conditions: Financial conditions tighten as a result of (i) market expectation of tighter U.S. monetary policy, or (ii) sustained rise in the risk premium in reaction to concerns about debt levels in some euro area countries, a disorderly Brexit, or idiosyncratic policy missteps in large emerging markets.	ST	Higher interest rates on private sector debt would raise debt service obligations, decreasing domestic demand and/or resulting in deteriorating loan quality. The impact of higher interest rates on Cypriot government borrowing should be less significant given limited borrowing needs in the near-term.	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.

Source of Risks and Relative Likelihood	Time Horizon	Expected Impact of Risks	Policy Response
Domestic Risks			
High		Medium, High	
Low NPL workouts 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.	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. Encourage strengthening of bank profitability by addressing the system's inefficient cost structure and diversifying income sources.
Low		Medium	
Pressure to increase fiscal expenditure: Political pressure could rise to reverse crisis-era expenditure measures or fiscal cost of the NHS implementation could turn out to be higher than envisaged. Contingent liabilities from public entities could materialize.	MT	The size of primary surplus and the pace of debt reduction decline and the borrowing costs increase.	Strengthen efforts to control fiscal spending, including through stricter wage restraint measures, and acceleration of civil service and SOE reforms.
Medium		Medium	
Renewed boom-bust cycle: Business cycle becomes increasingly dependent on construction activity leading to excess supply of luxury properties until eventually the CIP 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 CIP scheme from real estate in a timely manner.
Medium		High	
Slow progress in effectively implementing the AML/CFT framework: Failure to effectively mitigate existing inherent AML/CFT risks, as well as any negative AML/CFT assessment, lead to lower investment and pressures on banks' ability to access correspondent banks.	MT	Cyprus's attractiveness as a financial and business center is weakened, with adverse effects on foreign investment, economic growth and the external position. Reductions in financial services by correspondent banks would weigh on the professional services sector and long-term growth.	Focus on the effective implementation of the improvements of the AML/CFT framework that have recently been adopted; expeditiously address any assessed areas for concern.

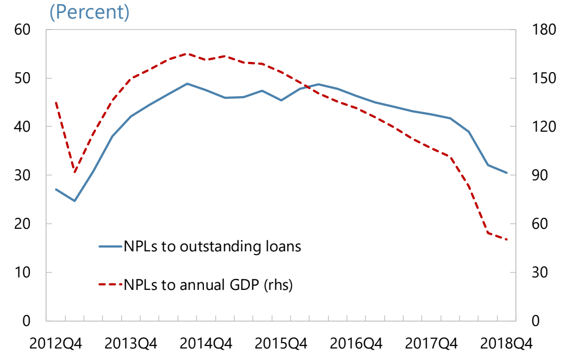
Annex III. Evolution of Non-Performing Loans

NPLs decreased to 30½ percent of total loans or 50 percent of GDP at end-2018. This mainly reflects the resolution of CCB in September as non-performing loans were transferred to an asset management company. However, the momentum of outflow from NPLs by cash repayments or migration into performing category does not seem to have changed significantly, implying that the payment discipline continues to be weak.

Overview of NPL Trends

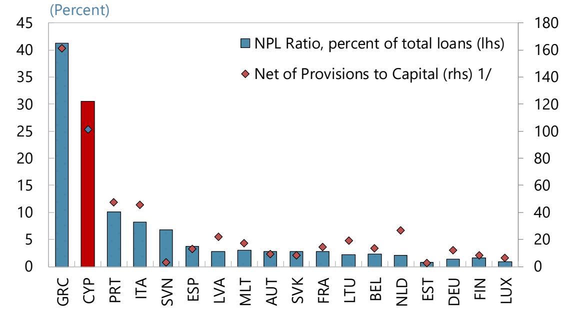
1. **At end-2018, NPLs declined to 30½ percent (€10½ billion) of total loans, from 39 percent (€16.9 billion) at the end of 2018:Q2.**[1] The NPL ratio to annual GDP was down to 50 percent at the end of 2018, a significant decline from the 84 percent recorded in 2018:Q2. The decline in NPLs was mainly due to the resolution of the Cyprus Cooperative Bank (CCB) in September 2018, when €6.9 billion (gross book value) worth of NPLs were transferred to the Cyprus Asset Management company. The fastest decline in NPLs was made by NPLs owed by households, which decreased from 50.7 percent of total loans (€10.2 billion) to 37½ percent (€5.2 billion). In the meantime, NPLs made by SMEs decreased, at a smaller scale, from 45 percent of total loans (€5.3 billion) to 39½ percent (€4.1 billion). The NPL ratio owed by large enterprises declined slightly to 19 percent of loans. In addition, NPLs declined across the board for all non-financial business sectors. Despite the changes, the NPL to GDP ratio and the share of small borrowers (households and SMEs) remain among the highest in the euro area.

Cyprus: Non-Performing Loans
(Percent)



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

Non-Performing Loans, 2018 or the latest
(Percent)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.
1/ Latest data for Austria, Belgium, Czech Republic, Estonia, Greece, Poland, Portugal, and Slovakia is 2018Q3.
Latest data for France and Italy is 2018Q2.

[1] 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 standard required recognition of accrued interest on NPLs as part of NPLs.

Cyprus: Non-Performing Loans
(Billions of Euro)

	2014Q4	2015	2016	2017	2018	2018
		Change				
Total	28.4	-1.1	-3.0	-3.4	-10.5	10.4
HHs	12.8	-0.1	-0.7	-1.1	-5.8	5.2
NFCs	14.4	-0.5	-2.2	-2.2	-4.5	4.9
Large enterprises	5.3	-0.7	-3.1	-0.5	-0.3	0.8
SMEs	9.0	0.1	0.9	-1.7	-4.3	4.1
NFCs						
Tourism and trade	4.0	-0.1	-0.3	-0.6	-0.7	1.5
Construction	5.1	-0.2	-1.1	-0.7	-1.7	0.8
Real estate	2.4	0.0	-0.3	-0.5	-0.7	2.2
Others	2.9	-0.2	-0.4	-0.4	-0.8	1.1
Other financial corporates and government	1.2	-0.5	-0.2	-0.1	-0.1	0.4

Source: Central Bank of Cyprus and IMF staff calculations.

2. **Gross outflows from NPLs were nearly four times the gross inflows to NPLs in 2018.**[2] The outflows from NPLs consisted of write-offs (about 18.2 percent total outflows), debt held for sale (61.6 percent), migration to performing category (9.5 percent), NPL cash repayment (7.7 percent), and debt-to-asset or equity swaps (3.0 percent).[3] The large contributions from debt held for sale reflect the securitization of a large NPL portfolio (project of Helix) by the Bank of Cyprus to NPL investors (€2.6 billion) and transfer of CCB NPLs to KEDIPES, a state-owned asset management company (€6.9 billion). Investor interest in sales of NPLs is growing owing to more favorable legal environment for dealing with NPLs and the strong interest from foreign funds.

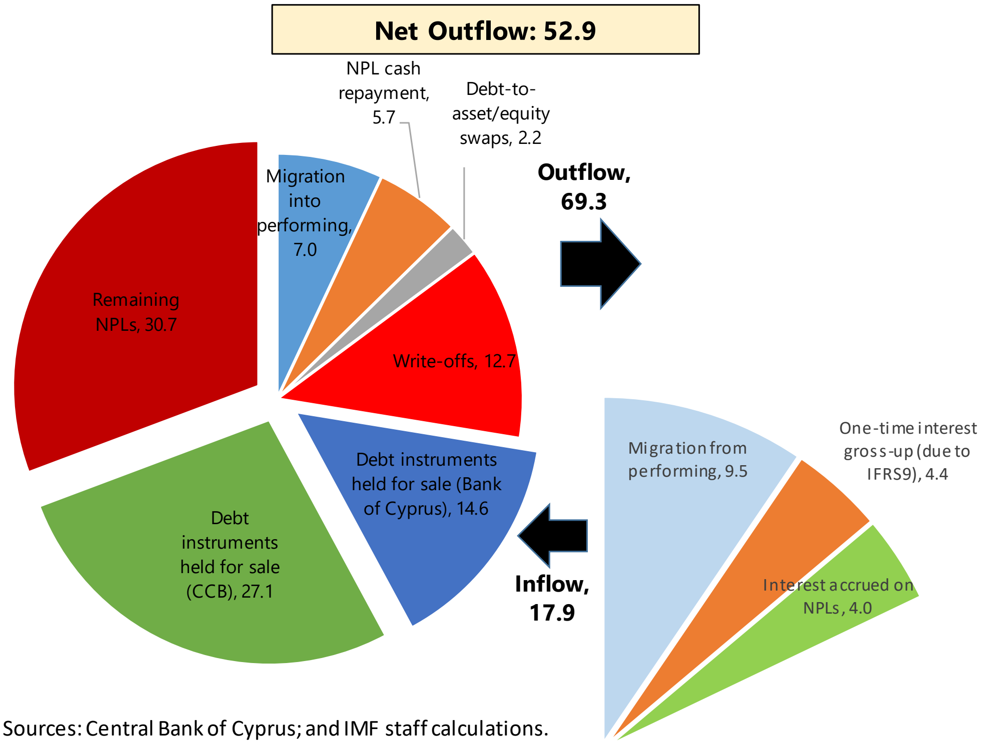
3. **The structure of the NPLs remain broadly unchanged.** Terminated accounts, constituted more than half of total NPLs, though the amount in euro almost halved up to 2018:Q4 compared to 2018:Q1. The share of restructured loans in NPLs increased modestly to 37 percent. Although the strengthened foreclosure framework has reportedly increased incentives for NPL borrowers to negotiate a workout, restructuring of the terminated accounts remained limited thus far, which may also be due to pending rollout of the *Estia* scheme. Re-restructuring remained sizable, likely reflecting evergreening of loans or weak repayment discipline.

[2] Due to data limitation, NPLs in this paragraph and the remaining of the annex refer to only the fixed-term loans owned by locally active banks, which amount to around 83 percent of total NPLs as shown in the published NPL data by CBC.

[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).

Cyprus: Flows of Non-Performing Loans 1/

(Q1:2018-Q4:2018. Stock at the beginning of the period normalized to 100.)



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

Cyprus: Loan by Classification 1/

(Billions of Euro)

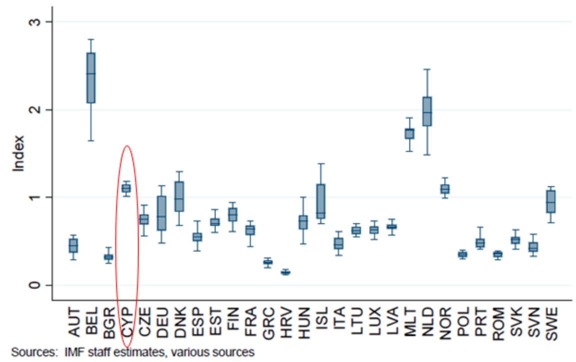
	2016	2017	2018			
	Q1	Q1	Q1	Q2	Q3	Q4
Total loans	**39.7**	**37.6**	**34.4**	**31.3**	**25.3**	**24.4**
Total Performing	**15.4**	**16.3**	**16.5**	**16.6**	**16.0**	**15.8**
of which: not restructured	12.8	n.a.	13.5	13.9	13.6	13.9
of which: restructured	2.6	n.a.	3.0	2.8	2.4	2.0
Total NPL	**23.7**	**21.3**	**17.9**	**14.6**	**9.1**	**8.6**
of which: not restructured	4.2	3.1	2.4	2.1	1.0	1.1
of which: restructured	8.5	7.3	6.4	5.0	3.4	3.2
of which: terminated	10.9	10.9	9.1	7.5	4.8	4.3

Source: Central Bank of Cyprus.
1/ Fixed term loans, local operations only, excluding RCB bank. Information is based on available data shared by authorities during missions. An account is considered terminated if the outstanding balance has been called in.

Annex IV. Cyprus's Linkages with the U.K. and Exposure to Brexit

1. As the U.K. is an important trading partner for Cyprus, the Cypriot economy is vulnerable to Brexit risks. Cyprus's integration with the U.K. is relatively high, particularly through its tourism sector and migration.[1] The U.K. also is among the top six sources of foreign direct investment. Cyprus's relatively high degree of integration with the U.K. as reflected in an index developed by IMF staff, which takes into account trade and financial linkages and migration, suggests Cyprus could be impacted disproportionately by Brexit. At the same time, Cyprus also stands to benefit from some positive spillovers.

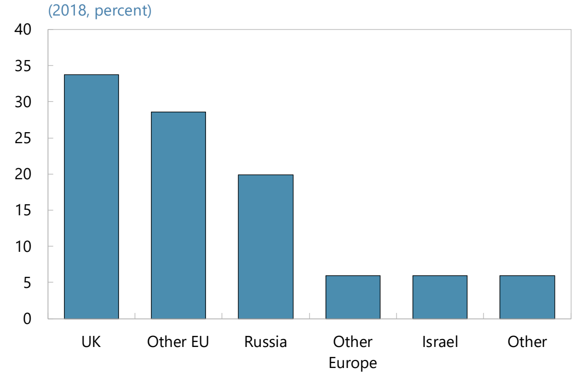
Index of Integration with the U.K.
Excludes Ireland



Sources: IMF staff estimates, various sources

2. Brexit could adversely impact tourism flows in the near- to medium-term, while the direct impact of possible new tariff barriers should be limited. Tourism constitutes more than 20 percent of Cypriot exports, with the U.K. the largest source market. A weaker sterling and reduced output in the U.K. could dampen tourism demand. A disorderly hard Brexit could exacerbate the impact through potential travel complications as well as its adverse impact on the rest of the EU. Mitigating factors may be the proportion of U.K. visitors that stay in their own vacation residences or with family and friends, insulating them to some extent from exchange rate effects, as well as historical links that sustain the appeal of Cyprus for British tourists. Decreased European demand may be partly offset by substitution from other countries, reflecting Cyprus's ongoing efforts to diversify its source markets and tourism offerings. With only 6 percent of goods exports destined to the U.K., the direct impact of any tariffs will likely be limited. Over the long term, the appeal of Cyprus for British tourists is unlikely to dissipate given the historical links.

Cyprus Tourism Arrivals
(2018, percent)

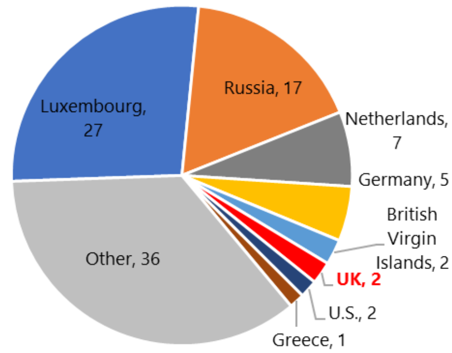


Source: Statistical Service of Cyprus.

[1] A synthetic index of exposure to the UK has been constructed using a principal component analysis to measure the degree of country's integration with the UK economy. The exposure index is scaled so that it ranges between 0 (minimal exposure) and 10 (highest exposure). See Euro Area 2018 Article IV Selected Issues, "Long Term Impact of Brexit on the EU."

3. Among financial exposures, direct investment is most significant but may partly reflect SPE activity.[2] The U.K. is the sixth most significant source of direct investment for Cyprus, with the stock of inward FDI equivalent to 22 percent of Cypriot GDP and outward direct investment in the U.K. amounting to 42 percent of GDP. A slowdown in the U.K. economy could weigh on inward FDI and limit returns on existing outward FDI. To the extent some of these exposures reflect SPE activity, the business services sector may be affected. Cypriots' U.K. portfolio assets, mostly held by other financial companies, amounts to just 3 percent of GDP, which limits room for adverse impacts through a sharp depreciation of the pound or a decline in asset prices. Cypriot borrowing from U.K. banks is also limited, equivalent to 6 percent of GDP on an ultimate risk basis and mostly attributable to NFCs.[3]

Inward Direct Investment
(2017, percent of total)



Source: IMF Coordinated Direct Investment Survey

4. Cyprus could also benefit from Brexit. Cyprus's attractiveness for future FDI could strengthen and economic activities could relocate from the U.K. to Cyprus. Cyprus has already had a ship insurer establish a new subsidiary in the country, as well as new ship registrations. Brexit may also have implications for the location of financial activity within the EU to enjoy passporting rights.

[2] The limited information on the SPE sector's activities and home countries of beneficial owners introduces some uncertainty.

[3] IMF Consolidated Direct Investment Survey; IMF Consolidated Portfolio Investment Survey; BIS Banking Statistics.

Annex V. Balance Sheet Analysis by Economic Sectors

1. A sectoral balance sheet analysis shows that banks have the largest gross liabilities exposure in Cyprus.[1,2] Although sizable (265 percent of GDP), these liabilities are financed mainly by deposits from the non-financial private sectors, a relatively stable source of financing, with limited cross exposure to the rest of the financial sector. Banks also have a significant external exposure (77 percent of GDP) mainly comprising of foreign deposits. MFIs also extend substantial credit to overseas entities, mainly through long-term loans (about 45 percent of GDP) and long-term debts (11 percent of GDP).

Cyprus: Balance Sheet Matrix
(Percent of GDP, 2018:Q3)

Issuer of the Financial Liability (Debtor Sector)	Holder of the Financial Liability (Creditor Sector): GG		Banks		Investment funds		OFIs		Insurance & Pension		NFCs		HHs		CBC		ROW	
	A	L	A	L	A	L	A	L	A	L	A	L	A	L	A	L	A	L
GG 1/	41	41	26	2	0	0	1	18	0	0	1	2	4	2	3	13	78	2
Banks	2	26	1	1	1	1	16	7	8	0	42	81	113	67	4	54	77	86
Investment funds	0	0	1	1	0	0	1	0	0	0	6	0	1	0	n.a.	n.a.	17	8
OFIs	18	1	7	16	0	1	1	1	2	0	4	11	3	25	n.a.	n.a.	218	258
Insurance & Pension	0	0	0	8	0	0	0	2	0	0	0	0	0	1	n.a.	n.a.	0	17
NFCs	2	1	81	42	0	6	11	4	0	0	3	3	0	0	n.a.	n.a.	95	23
HHs	2	4	67	113	0	1	25	3	1	0	0	0	0	0	n.a.	n.a.	1	18
CBC	13	3	54	4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0	67
ROW	2	78	86	77	8	17	258	218	17	0	23	95	18	1	67	0		
Total	**79**	**156**	**323**	**265**	**9**	**27**	**314**	**253**	**30**	**0**	**81**	**193**	**139**	**96**	**74**	**67**	**486**	**477**

Sources: ECB and IMF staff.
1/ GG (general government) includes central, state and local government and social security funds.

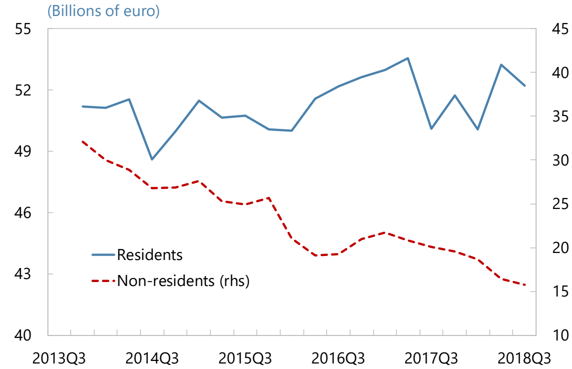
2. While still large, bank balance sheets have been reduced sizably as part of the economic deleveraging. To resolve bad loans and improve the balance sheets of banks, various measures have been taken in the past years, including transfer, sales and restructuring of bad loans, debt write-offs, and debt-to-equity/asset swaps. Consequently, both financial assets and liabilities, have declined by 23 and 13 percent, respectively since end-2013. On the liability side, deposits from abroad have more than halved, in part reflecting efforts to minimize AML/CFT risks by closing a large number of foreign accounts over the period 2014–17. Domestic deposits, on the other hand,

[1] As an offshore financial center, Cyprus has very large financial positions of Other Financial Institutions (OFIs) versus the Rest of the World (RoW). However, the financial positions are largely attributed to offsetting cross-border financial flows related to special purposes entities (SPEs), which have little impact on the domestic economy. Due to limited information on SPEs, we do not discuss OFIs in this annex.

[2] These economic sectors include: (1) General Government (GG); (2) Monetary Financial Institutions (MFIs, or banks); (3) Investment Fund (Ifs); (4) Insurance and Pension; (5) Other Financial Institutions (OFIs); (6) Non-financial Corporations (NFCs); (7) Households (HHs); (8) Central bank of Cyprus (CBC), and (9) Rest of the World (ROW). Financial exposures include various instruments such as debt, loans, deposits, listed shares and positions at investment funds.

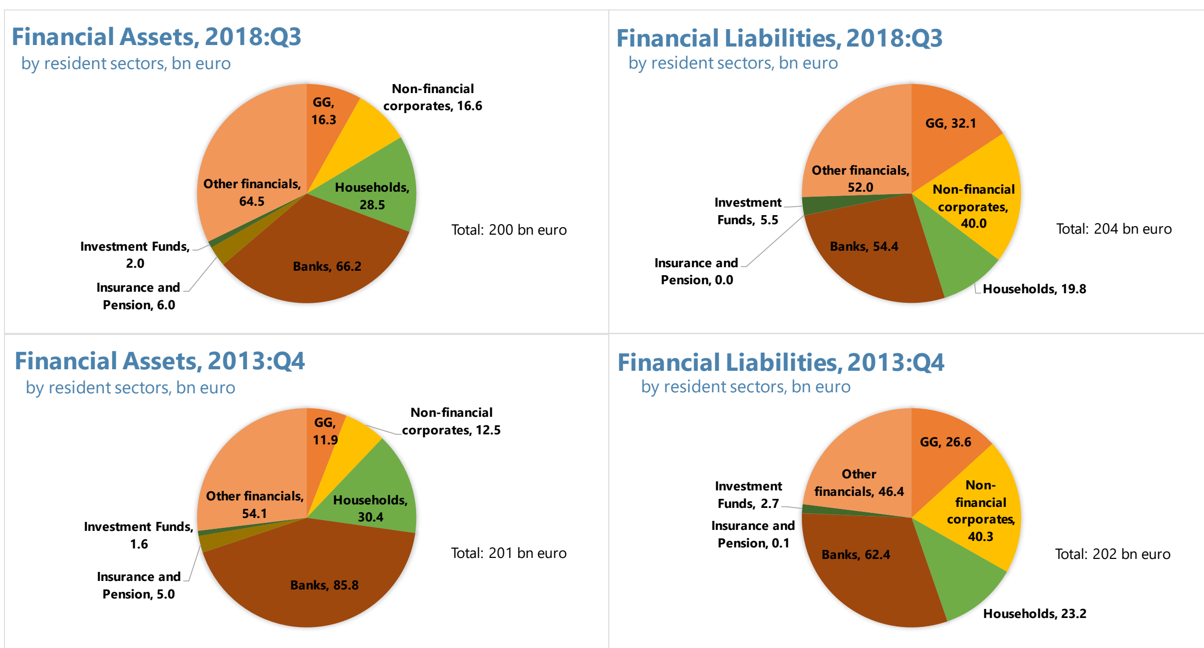
have been broadly stable, except for a few episodes of volatility. On the asset side, loans comprise 70 percent of total assets. Overall loans declined by 36 percent, mainly to HHs. Short-term loans declined even faster, leading to an increase in the duration of MFIs' loan portfolio. Debt portfolios, in contrast, increased as MFIs increased their holdings of bonds issued by Cypriot governments. Nevertheless, risks from the bank-sovereign nexus remain moderate with MFI's sovereign exposure at less than 8 percent of total assets.

Cyprus: Customer Deposits
(Billions of euro)



Sources: ECB and IMF staff.

Cyprus: Financial Assets and Liabilities by Sectors



Sources: ECB, and IMF staff.

Note: Total financial assets and liabilities include intra-sectoral claims. GG (general government) includes central, state and local government, and social security funds. MFIs exclude the Central Bank of Cyprus.

3. In comparison with the banking sector, progress in reducing household indebtedness has been slower. Since 2013, HHs' liabilities (mainly loans from MFIs) declined by about 14½ percent, remaining at a still high level of 96 percent of GDP. Although partially removed from banks' balance sheets, these loans have been transferred to asset management companies (as shown by the large exposures to OFIs), where the loan workout process is still underway.[3] Despite

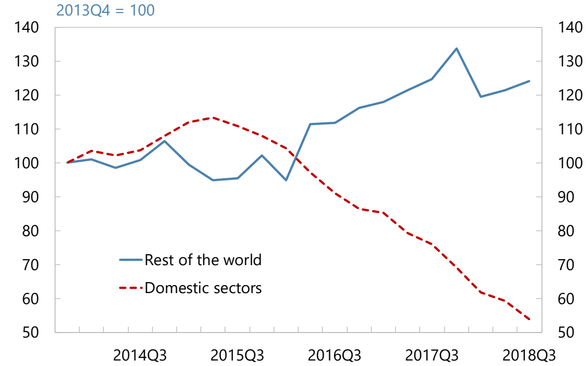
[3] Beginning 2018:Q4, the asset management company has been reclassified as part of GG instead of an OFI.

the large gross liabilities, households have a positive net asset position with a sizable holding of financial assets, primarily as bank deposits (Annex Table), suggesting household capacity to service their debt with a proper claims enforcement regime.[4]

4. Corporate deleveraging has been limited as borrowing is increasingly reliant on external sources. Corporate liabilities remain large at 193 percent of GDP. While domestic credit has declined on the back of accelerating bank deleveraging, NFCs have increasingly borrowed from abroad, mainly in the form of loans. Risks are mitigated to the extent that these loans represent intra-company borrowing or credit channeled to SPEs with limited footprint on the domestic economy; however, detailed information on this breakdown is unavailable.

Net Financial Liabilities: NFCs

2013Q4 = 100



Sources: ECB and IMF staff.

5. Non-bank financial institutions, mainly investment funds, have expanded rapidly, but risks appear to be mostly contained. Since the beginning of 2017, total liabilities of investment funds in Cyprus have increased by 81 percent, by 2018:Q3 but from a low base (16 percent of GDP). Both domestic and external creditors have increased their investment in investment funds. The investment strategy mainly focuses on private equities and real estate. The majority of these investment funds are operated by professional investors who tend to have better-established risk management practices. Pension funds and insurance firms have limited financial liabilities, although data limitation hampers more detailed risk assessment.

[4] For detailed analysis of households' payment behavior and repayment capacity, see "Challenges in Reducing NPL Overhang and Restoring Credit Financing", selected issues, IMF 2018 Article IV Staff Report.