February 2003
IMF Country Report No. 03/30

Cyprus: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Cyprus

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

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 4, 2002,** 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 January 16, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **January 31, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 31, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Cyprus.

The document(s) listed below have been separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Cyprus

Approved by Alessandro Leipold and Shigeo Kashiwagi

January 16, 2003

The Article IV consultation discussions were held in Nicosia during October 23–November 4, 2002. The mission, comprising Mr. Milesi-Ferretti (head), Mr. Eskesen, and Mr. Vamvakidis (all EU1), met with the Finance Minister, Mr. Klerides; the Central Bank Governor, Mr. Christodoulou; the Chairman of the Finance Committee, Mr. Kyprianou; the Chief EU Negotiator, Mr. Vassiliou; officials from government agencies and the Central Bank; and representatives of the private sector, including employers' associations, trade unions, and financial and academic institutions.

At the conclusion of the last Article IV Consultation on August 3, 2000, Executive Directors praised Cyprus's impressive economic performance over recent decades and welcomed the reforms underway to prepare for EU membership, but noted the limited progress in fiscal consolidation and in reducing long-standing structural rigidities. Directors stressed the need to reduce inflation risks and ensure a sustainable reduction in the fiscal deficit and debt-to-GDP ratio, so as to avert balance of payments pressures.

Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current account transactions.

Cyprus's statistics are generally of good quality and adequate for surveillance, and the publication policy is open. Further progress is needed in specific areas—see Appendix II.

On December 13, 2002 the European Council invited Cyprus to join the EU on May 1, 2004. Legislative elections took place in May 2001, and presidential elections are scheduled for February 2003.

The Central Bank of Cyprus hosted a press conference for the mission at the conclusion of the consultation discussions, and the mission's preliminary conclusions were published.

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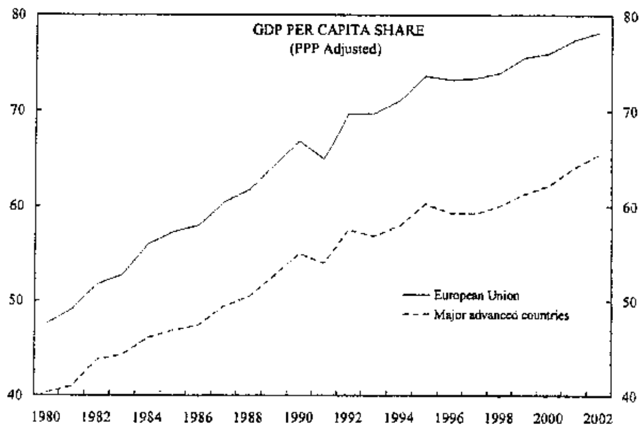
I. Background to the Discussions

1. **Over the last two decades the Cypriot economy has rapidly approached the average level of GDP per capita in EU countries.** Real income per capita more than doubled between 1980 and 2001; adjusted for differences in purchasing power, it is now around 80 percent of the average EU level, and well above the level in other accession countries. Growth has been driven by a fast expanding tourism industry (Figure 1), now accounting for around 20 percent of value added, and in recent years by financial and other services, while agriculture and manufacturing are in decline.



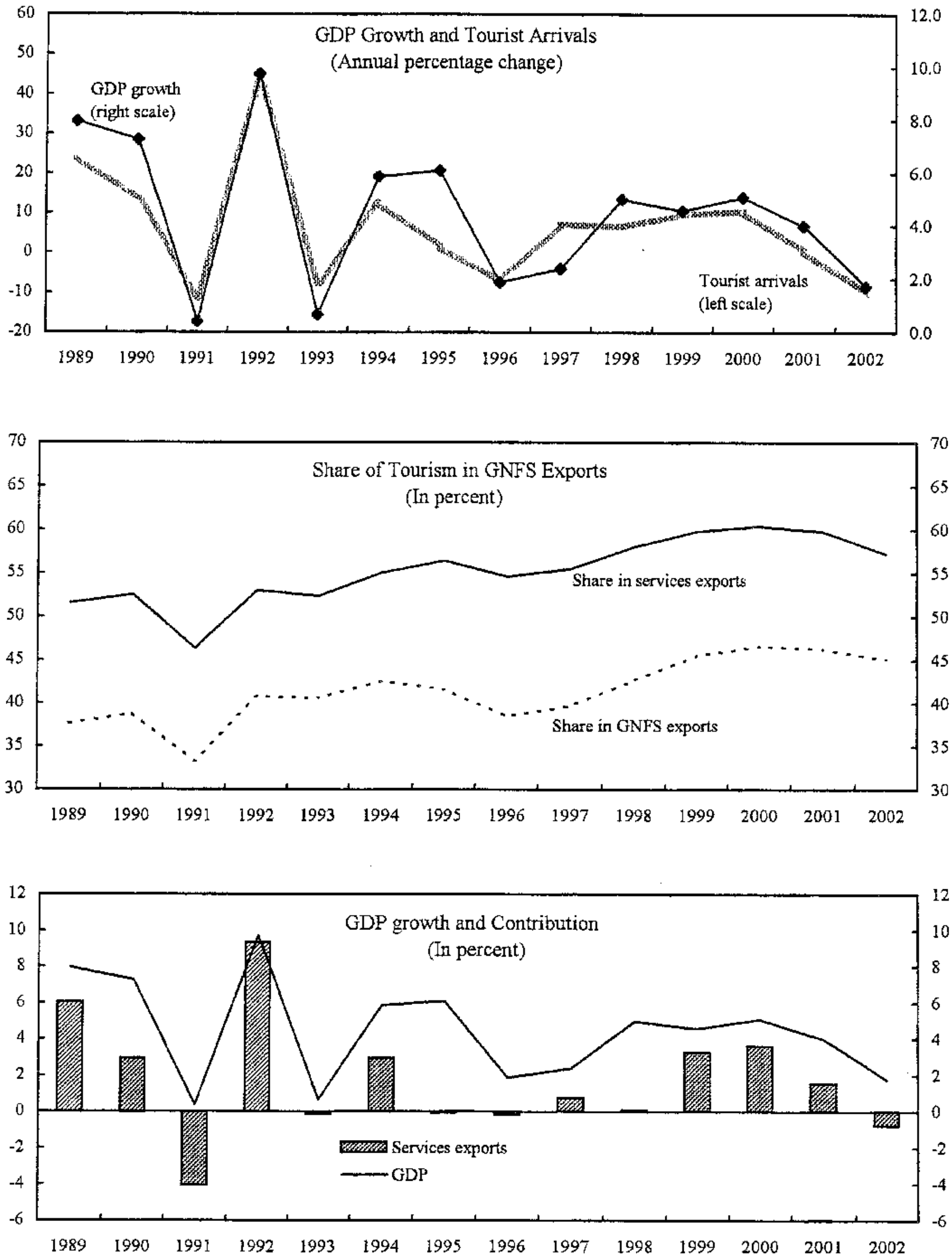
2. **On December 13, Cyprus was invited to join the European Union in 2004, and discussions on a United Nations peace plan are underway.** The invitation to join the EU is a notable achievement for Cyprus, and bears witness to its record of macroeconomic stability and progress in market-oriented reforms, in line also with long-standing IMF recommendations (Box 1). The UN plan, presented on November 11, envisages the creation of a common state and two component states. Differences in income between the two parts of Cyprus are substantial—GDP per capita in the North is estimated to be between ¼ and ⅓ of the level in the South. A political settlement could provide a boost to investment, given the infrastructure needs of the North, while posing policy challenges due to differences in development, openness, and macroeconomic stability.

Box 1. Policy Recommendations and Implementation

The Fund's advice in recent consultations has focused on securing further progress in fiscal consolidation; reducing structural rigidities; strengthening the institutional setting for monetary policy by abolishing the interest rate ceiling, ensuring central bank independence, and reinforcing financial sector legislation; phasing out the preferential tax treatment for offshore companies; and reforming the cost-of-living allowance (COLA) system.

Over the past 4 years, the budget deficit was reduced, although further progress remains needed. Structural rigidities are being gradually removed, in line with the requirements of EU accession. The institutional setting for monetary policy was strengthened, with the abolition of the interest rate ceiling in January 2001, and the law granting central bank independence of July 2002; financial sector legislation is being brought in line with the *acquis communautaire*; and capital account liberalization has proceeded without jeopardizing external stability. The preferential tax treatment for offshore companies is being phased out. The price effects of excise tax changes were excluded from the COLA system, but the effects of changes in VAT are still included.

Figure 1. Cyprus: Growth and Tourism, 1989–2002



Sources: Central Bank of Cyprus; IMF, *International Financial Statistics*; and Fund staff calculations.

II. Recent Economic Developments and Outlook

3. **After four years of strong growth, economic activity has tailed off since late 2001, affected by the global economic slowdown**. While domestic demand sustained the 2001 output expansion, external demand—particularly for tourism—was hit by the global slowdown and the decline in air travel following the events of September 11. The slowdown continued into 2002, with weakening consumer and business confidence, increasing (albeit still low) unemployment, and falling tourist arrivals, and staff projects growth for the year to fall below 2 percent (Table 1). Consumer price inflation rose to 2.9 percent year-on-year in December, primarily on account of the July VAT rate increase.

4. **After notable progress in 1999 and 2000, fiscal consolidation stalled in 2001 and 2002** (Figure 2). Despite a favorable cyclical position, the 2001 general government deficit remained virtually unchanged from the previous year as increased spending, particularly on current transfers and defense, more than offset the cyclical gains (text table). In 2002 a tax reform further aligned indirect taxation with EU standards, while lowering direct taxation and harmonizing the corporate tax rates of domestic and foreign companies (Box 2). The economic slowdown, compensatory social spending measures accompanying the tax reform, and significant slippages on the spending side—especially on current transfers—imply that the general government budget deficit is likely to exceed 3½ percent of GDP in 2002, one percentage point above its target. The general government debt ratio will increase, after several years of decline, also on account of net accumulation of government financial assets (close to 2 percent of GDP).

General Government Budget Balance: Program Targets and Outcomes

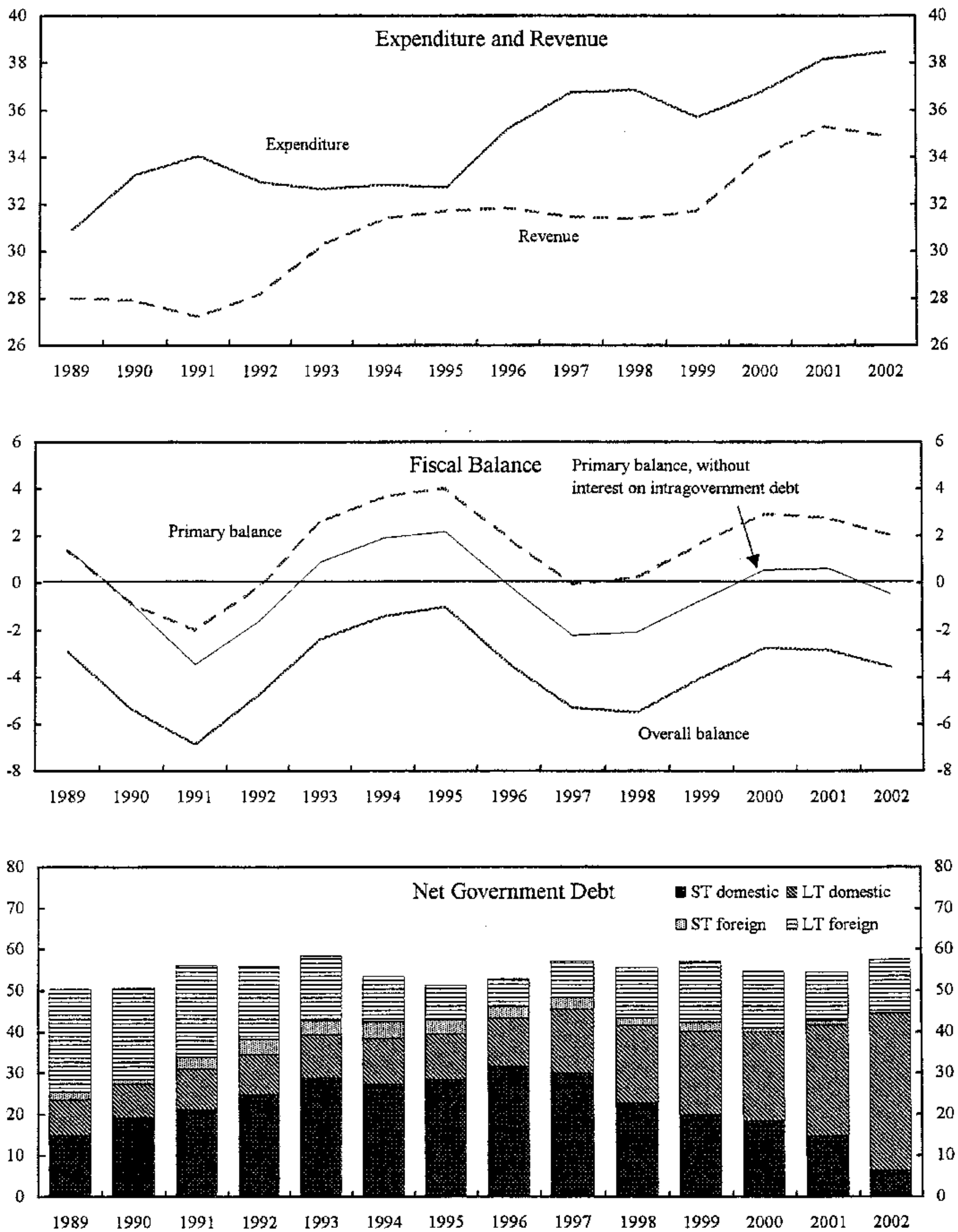
(In percent of GDP)

	1999	2000	2001	2002
1999 program targets	-5.9	-4.0	-3.0	-2.0
2001 program targets	n.a.	n.a.	-2.2	-1.9
2002 program targets	n.a.	n.a.	n.a.	-2.6
Actual budget outcome	-4.5	-3.1	-3.0	-3.6 1/

Source: Ministry of Finance.

1/ Staff projections.

Figure 2. Cyprus: Central Government Finances, 1989–2002
(In percent of GDP)



Source: Ministry of Finance.

Box 2. 2002 Tax Reform

- **Indirect Taxes**: The VAT rate was raised from 10 to 13 percent in July 2002, and to 15 percent on January 1, 2003, bringing it closer to EU levels (average rate close to 20 percent). Excise duties on cigarettes and fuels were raised in June/July. Foodstuffs remain exempt from VAT.

- **Direct Income Taxes**: The top income tax rate was lowered from 40 to 30 percent at the beginning of 2003, and the threshold for tax-free income is being gradually raised.

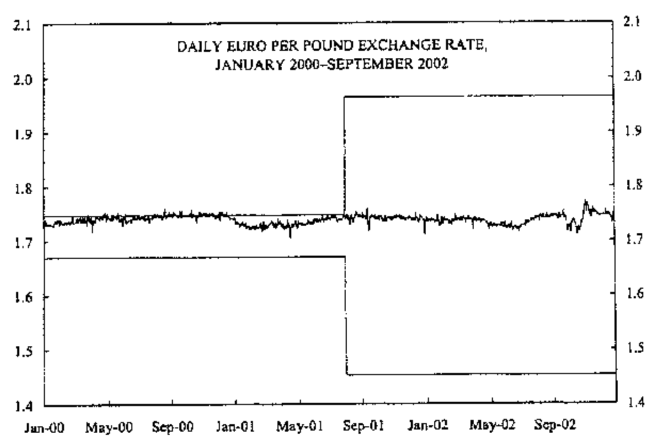
- **Defense Levy**: The defense levy on salaries and pensions (2 percent), and profits (3 percent) was abolished in January 2003, while the 3 percent levy on interest income was replaced in July 2002 by a 10 percent tax levied at source.

- **Corporate Taxes**: From 2003, domestic and offshore companies face a uniform corporate tax rate of 10 percent (the EU average is around 30 percent). This constitutes a significant tax reduction for domestic companies, which were previously paying 20–23 percent, and an increase for offshore companies, previously paying 4.25 percent. Offshore companies registered before end-2001 will continue to pay 4.25 percent until 2005.

5. **The institutional setting for the conduct of monetary and exchange rate policy has undergone substantial changes, to align legislation to EU requirements.**

- In January 2001, the 9 percent ceiling on interest rates—existing since the 1940s—was abolished, allowing banks to compete more effectively and price risks more appropriately.

- In August 2001, the exchange rate band around the central euro parity was widened to ±15 percent from ±2.25 percent, in response to substantial capital inflows; nevertheless, exchange rate fluctuations remain close to the previous margins.



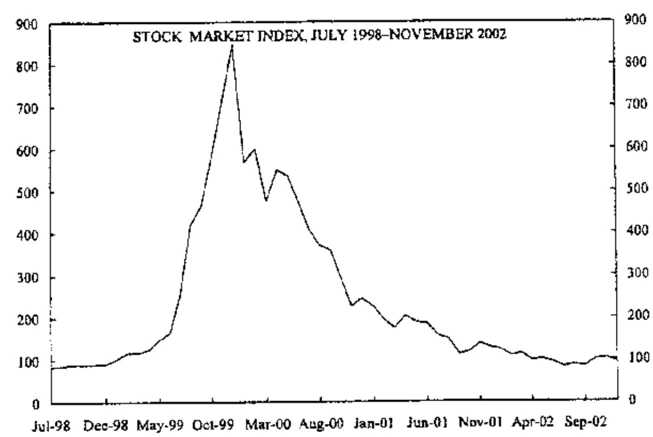
- Legislation to make the Central Bank of Cyprus (CBC) fully independent was approved by parliament in July 2002. The new law, designed to comply with the provisions of the Treaty and Statute of the European System of Central Banks, prohibits public sector borrowing from the central bank, providing for the conversion of outstanding central bank advances into long-term bonds.

- Monetary policy decisions are now taken by a six-member Monetary Policy Committee, chaired by the Central Bank Governor, which includes three experts external to the CBC.

6. **After easing in 2001, monetary policy remained unchanged until December 2002, when the CBC followed the 50 basis points' interest rate reduction of the European Central Bank**. The CBC reduced rates in August, September, and November 2001 by 50 basis points each time, bringing the interest rate of the marginal lending facility (Lombard rate) to 5.5 percent, 125 basis points above the ECB's marginal refinancing rate, in response to strong capital inflows in the first half of the year and the global slowdown in the last quarter. During 2002, the CBC intervened in the money market to absorb excess liquidity generated by capital inflows and the government's reliance on central bank advances before their prohibition. Given subdued core inflation pressures and weak private credit growth (Figure 3), interest rates were reduced in December, following the ECB rate cut.

7. **The external current account deficit is estimated to have widened to some 5½ percent of GDP in 2002, on account of falling tourism receipts and a host of temporary factors** (Table 2; Figure 4). Tourist arrivals are estimated to have fallen by 10 percent in 2002, and aircraft purchases by Cyprus Airways (accounting for 0.7 percent of GDP), higher oil prices, and high defense spending widened external imbalances, despite a deceleration of imports. The Cyprus pound's appreciation vis-à-vis sterling partly reversed previous gains in price competitiveness (Figure 5).[1]

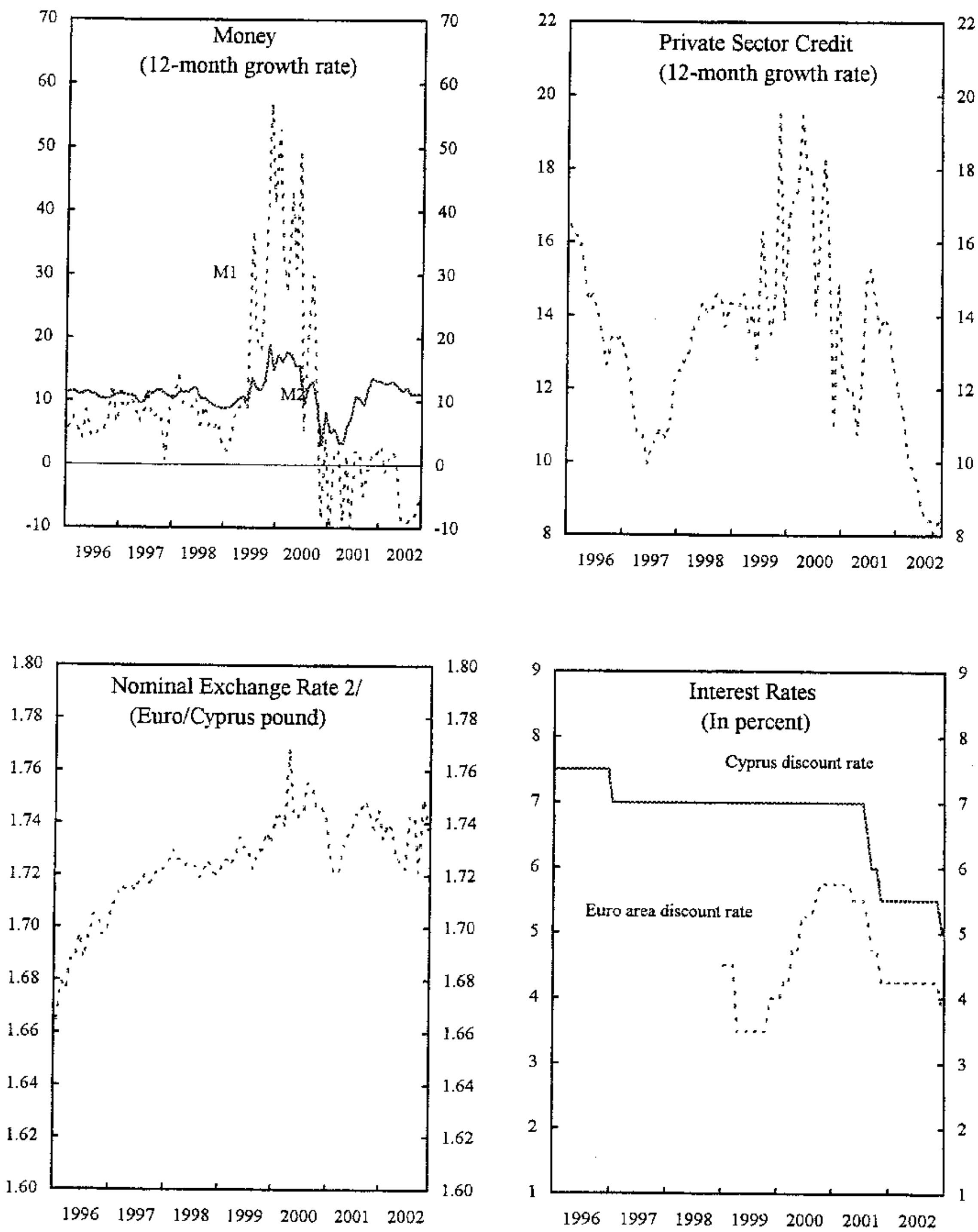
8. **Restrictions on medium- and long-term capital movements have been lifted and liberalization of short-term flows should be completed by EU accession**. The liberalization of foreign-currency borrowing for maturities over 2 years was followed by high capital inflows in the first half of 2001—foreign exchange reserves increased by 8.5 percent of GDP—but lower interest rates and the widening of the exchange rate band slowed net inflows in late 2001 and during 2002.



9. **The financial system has been weakened by the economic slowdown and the bursting of the stock market bubble, but banks remain well capitalized.** Stock market valuations rose more than eight-fold during 1999 and 2000, with tax incentives spurring a wave of initial public listings, and subsequently collapsed back to their pre-bubble level (text chart). Banks are well capitalized,

[1] The United Kingdom is the country of origin of over 50 percent of Cyprus's tourists.

Figure 3. Cyprus: Monetary Conditions, 1996–2002 1/

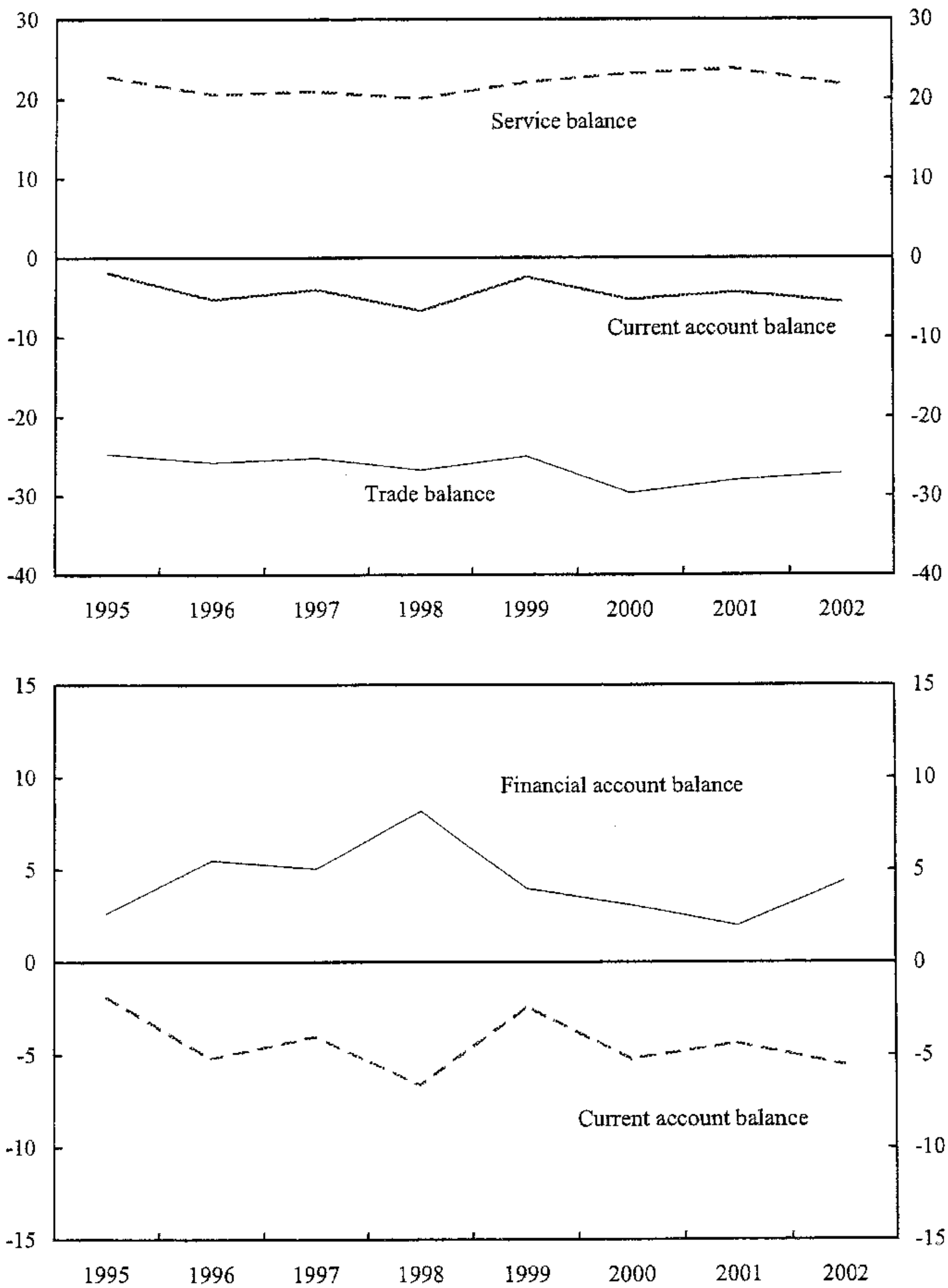


Source: IMF, *International Financial Statistics*.

1/ Monthly data through October 2002.

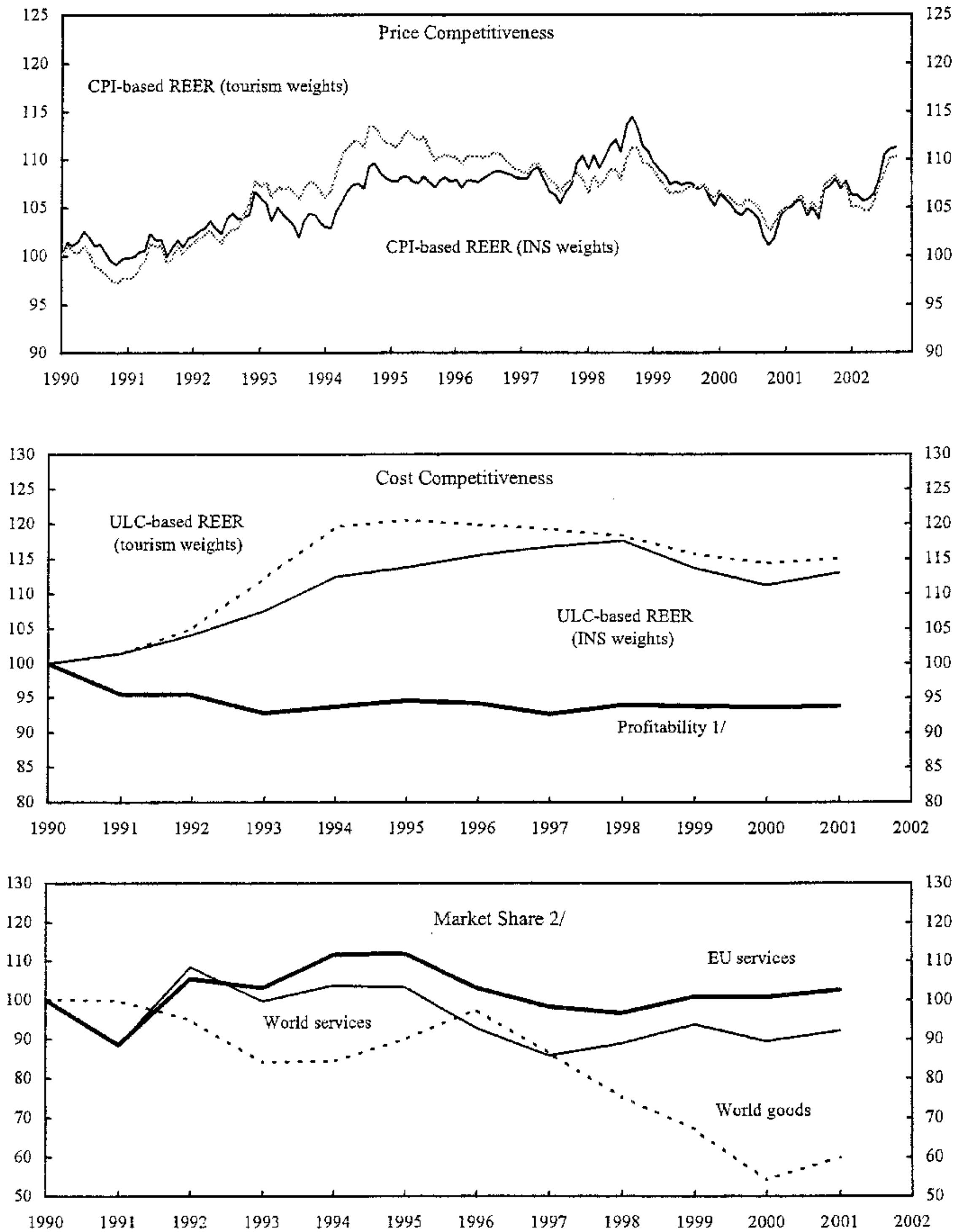
2/ Increase represents appreciation.

Figure 4. Cyprus: Balance of Payments, 1995–2002
(In percent of GDP)



Source: Central Bank of Cyprus.

Figure 5. Cyprus: Competitiveness Indicators, 1990-2002



Sources: IMF, *International Financial Statistics* ; WEO database; and Fund staff calculations.

1/ Defined as the ratio of the GDP deflator over unit labor cost.

2/ Share of Cyprus's exports over those of the EU and the world respectively.

with a risk-weighted capital ratio close to 14 percent in mid-2002, but the quality of their portfolios has significantly deteriorated—the ratio of nonperforming loans (over 270 days overdue) increased from 7.8 percent in 2000 to 9.5 percent in mid-2002. Direct stock market exposure of the banking sector was relatively small, but balance sheets suffered because of indirect exposure through loans for stock purchases and through insurance and financial services subsidiaries that had invested heavily in stocks.

III. Report on the Discussions

10. The discussions focused on the policy challenges posed by the economic and institutional changes entailed by EU accession—at a time when an unsettled external environment risked complicating the implementation of the government's medium-term policy strategy, outlined in the August 2002 Pre-Accession Economic Program (PEP, Table 3). At the time of the consultation, discussions on the implications of a peace settlement were hindered by the absence of specifics on the features of a possible plan. Shortly after the end of the consultation mission, the UN presented a plan, envisaging the creation of a common state with two component states, as well as the restitution of some territory to Greek Cypriots. Interested parties have in principle agreed to it as a framework for negotiations. Box 3 briefly summarizes its possible economic implications; a more detailed assessment is premature, not least because several key aspects remain to be fully fleshed out. Staff report projections consequently reflect a continuation of the status quo.

11. **The authorities estimated growth for 2003 to exceed 4 percent, but saw significant downside risks to growth projections stemming from the unsettled external environment**. Recovery is expected to originate from a rebound in external demand, particularly tourism, and a pick-up in private consumption, driven by an improved economic climate. Notwithstanding the acceleration in growth, the current account deficit was projected to decline below 4 percent of GDP, helped by fiscal consolidation and the recovery in tourism. However, political tension in the Middle East, rising oil prices, and a slower than expected economic recovery in Europe imply significant downside risks. On the positive side, EU accession and a possible peace settlement could boost confidence, with positive repercussions on private consumption, investment, and growth. Staff agreed with the overall economic assessment, but had more conservative assumptions on external demand. It saw 2003 average growth rising above 3 percent if the expected recovery of the global economy materializes, sustained by a gradual increase to potential (around 4 percent) during the second half of the year.

Box 3. The UN Peace Plan: Economic Features and Implications

The UN peace plan envisages the creation of a common state with two component states, a Greek Cypriot and a Turkish Cypriot. The common state's primary functions would include external relations and defense; common state finances and economic and trade policy; central banking, and communications. The fiscal implications of the plan, albeit difficult to quantify, would arise from:

- Sharing of indirect tax revenues. Component states would receive no less than 50 percent of indirect tax revenues which are not transferred to the EU, in proportion to their population. This would imply substantial revenue redistribution, given that GDP per capita is much higher in the South;[1]
- Provisions related to the compensation to be paid to refugees. The amounts involved could be substantial;
- Public investment in areas returned to Greek Cypriots, in Turkish Cypriot areas and joint development areas.

The Board of the Central Bank would have three members, one from each component state plus (possibly) a foreigner, and Central Bank branches could be established in each component state. A provision establishes that "the Central Bank should exchange Turkish lira-denominated deposits held in Cyprus banks into Cyprus pounds at the rate at which the Bank of Turkey shall credit the relevant amounts to the Bank of Cyprus in euros." In addition to currency conversion, financial sector supervision is another major outstanding issue, given financial sector problems in the Turkish-Cypriot area.

The overall economic impact of a settlement is subject to pronounced uncertainty. A settlement would be likely to spur investment and growth, especially in the Turkish Cypriot area and in areas returned to Greek Cypriots, while implying larger fiscal and external imbalances. Its impact would also hinge on the structure of the monetary and financial system, the degree of external assistance, the size of the public sector, the degree of wage convergence and labor mobility, and the ability of domestic residents to undertake investment in the other component state.

[1] Assuming that GDP per capita in the North is ¼ of the level in the South, and that 60 percent of VAT revenues are redistributed in proportion to population, net VAT transfers to the North could amount to well over 10 percent of its GDP.

A. Monetary and Exchange Rate Policy

12. **The authorities maintained a cautious monetary policy stance in 2002, in light of potential inflationary pressures.** While the increase in inflation due to indirect tax increases was not a cause for concern, given low core inflation, the authorities feared the emergence of inflationary pressures in 2003, as the indexation mechanism will transmit to wages the price increases caused by VAT changes. Headline inflation is expected to rise to around 4.5 percent in 2003 as the VAT rate is raised again in January. Staff viewed monetary policy conduct as appropriate, with abundant liquidity conditions indicating that monetary policy had not acted as a constraint on economic recovery. The 50 basis points reduction in interest rates adopted on December 13, following the ECB rate cut, was an appropriate response given lower than expected inflation and persistent economic weakness.

13. **Looking ahead, the authorities stated their intention of joining the euro area at the earliest possible date**. They considered this the appropriate course of action for a small open economy closely integrated in international financial markets. During the transition to the common currency, monetary policy would be guided by the objective of maintaining core inflation at euro-area levels, within the existing exchange rate framework and, upon accession, the European Union's Exchange Rate Mechanism. The authorities judged the current level of the exchange rate to be broadly in line with fundamentals, on the basis of price indicators, market shares, and overall economic performance. Staff agreed, but stressed the need to closely track these indicators and external sector developments going forward, and to monitor the consistency of the exchange rate parity with core inflation objectives.[2]

14. **Staff concurred with the objective of joining the euro area as soon as possible, but noted that, as remaining capital account restrictions are dismantled, capital flow volatility may pose difficult challenges to monetary policy**. Discussions focused on the appropriate monetary and exchange rate policy response to macroeconomic and external developments in the run-up to EU accession. The authorities indicated that the exchange rate had not come under pressure since the widening of the band in mid-2001 and that they would respond to a resumption of strong capital inflows by gradually reducing the interest rate differential vis-à-vis the euro area. Staff noted that, in the presence of inflationary pressures, the appropriate response may call for letting the exchange rate strengthen, and that a tightening of fiscal policy would alleviate the burden on monetary policy, reducing pressure on the real exchange rate and easing interest rate convergence. The authorities concurred, arguing that they would stand ready to use the fluctuation margins for the exchange rate in either direction should the need arise. However, they reiterated their commitment to the central euro parity as a medium-term anchor.

B. Fiscal Policy

15. **The 2003 budget, currently under discussion in parliament, envisages a reduction in the general government deficit to 2.2 percent of GDP**. The target, somewhat less ambitious than the 1.9 percent of GDP indicated in the PEP, is to be achieved through stronger revenues generated by the envisaged recovery (albeit weaker than in the PEP), a reduction in defense spending, and lower grain subsidies, kept high in 2002 by the bumper crop. Social transfers are slated to rise, to compensate for the adverse distributional effects of the tax reform. Public sector wage negotiations, still underway, could add an additional ½ percent of GDP to the 2003 budget deficit, but the authorities assured that they would be fully offset by higher taxes or expenditure reductions.

16. **Staff argued that the measures currently envisaged in the budget would be insufficient to meet the fiscal target, and that overruns could exceed 1 percent of GDP**.

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[2] The evolution of competitiveness indicators is discussed in the Selected Issues paper.

The 2002 deficit is forecast to reach 3.6 percent of GDP (exceeding the 2.8 percent of GDP level on which the 2003 budget was based), despite sizable one-off measures, such as a fine to the telecommunications company for abuse of monopoly power, a temporary hike in the corporate tax rate for semigovernment organizations, and a delay in the implementation of social compensatory measures, altogether accounting for around 1 percent of GDP. As the effects of these measures disappear, the budget deficit is poised to remain above 3 percent of GDP in 2003 (Tables 1 and 4). Staff urged the adoption of measures to keep fiscal consolidation on track, aiming for a deficit of around 2½ percent of GDP (adjustment scenario in Table 1), thus setting public debt (which is estimated to have risen by 3 percentage points of GDP between 2001 and 2002) firmly on a downward path.[3] Although this would result in lower domestic demand than in the staff's baseline projection, its long-run benefits in terms of policy credibility and increased confidence would outweigh short-run costs. The authorities were more sanguine about budget prospects, noting that revenue projections were conservative, and that tax reform could lead to better compliance, thanks to tax simplification and lower direct tax rates. They nonetheless reaffirmed their commitment to fiscal consolidation, vowing to take measures, if necessary, to meet the budget targets.

17. **For the medium term, the authorities' Pre-Accession Program envisages a close-to-balanced budget by 2005**. This target is to be achieved with expenditure control, in particular for wages and salaries as well as defense, which should decline following EU accession. Fiscal consolidation is expected to be associated with a sharp reduction in current account imbalances (Table 3). A wide political consensus exists on the need to meet EU commitments, and the authorities were confident that consolidation would be implemented regardless of electoral outcomes.

18. **Staff endorsed the authorities' medium-term targets, but urged them to address persistent expenditure pressures and ensure that fiscal consolidation remained on track**. With GDP fluctuations in Cyprus historically wider than in most other EU countries, the medium-term plan would allow the country to comfortably meet the fiscal criteria it would be subject to upon EU accession, leaving room for the operation of automatic stabilizers while keeping the deficit below 3 percent of GDP. Achieving these targets will require firm expenditure control, given the upward drift in the ratio of expenditure to GDP in general, and of current transfers in particular (Table 4). In this regard, staff suggested the adoption of a multiyear fiscal framework, based on prudent macroeconomic objectives, with annual expenditure targets broken down by major spending categories.

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[3] The required additional fiscal measures would amount to some 1 percent of GDP, and could include a reduction in subsidies, a containment of overruns on current transfers, and some further increase in indirect taxes. Staff estimates that the resulting reduction in government consumption would be partly offset by lower imports and a crowding in of private consumption, with GDP growth some ¼ percent below the baseline projection of 3½ percent.

19. **Fiscal consolidation would also contribute to the needed strengthening of external accounts.** This is illustrated in the adjustment scenario in Table 1, where fiscal consolidation is assumed to be faster than in the staff's medium-term baseline scenario (Table 3).[4] Even though public sector external exposure is limited (text table), the level of reserves is comfortable, and the current account deficit in 2002 partly reflects temporary factors, higher public saving and the concomitant reduction in public debt would help reduce net external borrowing and exposure to external risk.

Public Debt Level and Composition

(In Percent of GDP)

	1999	2000	2001	2002 1/
Net debt level	56.9	54.8	54.6	57.6
Of which				
Domestic	40.0	39.9	41.6	44.4
Nonbank	15.5	15.2	14.2	15.2
Banks	19.2	16.1	23.6	21.2
Central Bank	5.3	8.7	3.8	8.0
Foreign	17.0	15.0	13.0	13.2
Short-term	22.0	19.5	15.8	6.5
Government-guaranteed debt	11.1	9.7	10.5	10.1

Source: Ministry of Finance.
1/ Staff forecast.

20. **A balanced budget over the medium term and prompt action on pension reform would also be needed to alleviate pressures on public finances arising from demographic trends.** While no severe problems arise from a medium-term debt sustainability analysis (Annex), the impact of aging on public finances would be substantial, with the old-age dependency ratio expected to almost double between now and 2030. Cyprus has a pay-as-you-go social security system with assets of around 40 percent of GDP, held in treasury bills (and therefore netted out of general government debt). A 2002 actuarial report shows that on the basis of current legislation the social security fund would be solvent only until 2020, and that the contribution rate would need to increase from 16.6 to 33 percent to ensure sustainability.

21. **The authorities concurred with the need to be forward-looking in containing long-term expenditure pressures, and with the usefulness of a formal fiscal framework to this end.** For the social security system, reform options under consideration included increasing the retirement age (currently 60 years for public sector workers and 63 for the private sector), indexing pensions to inflation instead of wage growth, and raising private sector contributions (currently 12.6 percent). Staff pointed out the importance of undertaking reforms expeditiously, as they take time to have effects and early action would reduce adjustment costs.[5]

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[4] The baseline scenario assumes fiscal consolidation in 2004–05 of the same magnitude as the PEP, but from a higher initial deficit. The current account deficit improves by less than the fiscal balance, reflecting a wider private saving/investment gap.

[5] See the Selected Issues chapter on long-term sustainability.

C. External Vulnerabilities and the Financial Sector

22. **As capital account liberalization proceeds, further strengthening the banking system and monitoring foreign exchange exposure become central tasks.** Discussions on the external accounts focused on Cyprus's international investment position—for which partial data is now available—and its implications for medium-term current account sustainability. Gross external indebtedness is relatively high (text table), primarily on account of large short-term foreign currency deposits in the domestic banking system (around 80 percent of GDP).[6] However, these have proved resilient to previous economic shocks, and the authorities emphasized that banks had to invest at least 70 percent of such deposits—and ¾ starting in March 2003—in liquid foreign currency assets, and ensure that liquid assets exceed deposits maturing within 30 days. In addition, strict prudential regulations apply to banks' open foreign exchange positions. Staff acknowledged that the level of external liabilities was manageable (Table 5; and Annex), but stressed the need to reduce current account imbalances, so as to reduce the vulnerability of the economy to swings in capital flows, and encourage direct investment flows, which have been lower than in most accession countries. The authorities agreed, emphasizing the importance of fiscal consolidation and capital account liberalization for these purposes. Staff welcomed the authorities' efforts to bring balance of payments statistics in line with Manual 5, helped by Technical Assistance from the IMF Statistics Department, and urged them to complete the process and join the SDDS as soon as feasible.

International investment position, 2001
Debt instruments 1/
(percent of GDP)

	Assets	Liabilities
Portfolio investment: debt instruments	16.2	16.0
Other investment 2/	47.3	108.2
of which: currency and deposits	42.8	83.9
Reserves	26.6	n.a.
Gross debt position	90.1	124.2

Source: Central Bank of Cyprus.
1/ Excluding offshore sector.
2/ Excludes assets and part of liabilities of nonfinancial private sector.

23. **Monitoring financial sector vulnerabilities and bringing legislation in line with EU accession requirements are the key objectives of financial sector supervision.** The authorities emphasized that financial sector supervision and regulation were at an advanced stage of harmonization with international standards, and that progress had been achieved in all financial sector areas. They also reiterated their interest in a Financial Sector Assessment Program (FSAP), as suggested by staff, with the timing depending on the priorities that a peace settlement would entail.

- With regard to **banking**, the EU directive on capital adequacy and the contractual netting directive are due to be implemented at the beginning of 2003; and upon accession, the banking law is to be fully harmonized with EU standards.

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[6] Around ⅓ of these deposits are held by nonfinancial offshore companies, and the rest by foreign banks, shipping companies, and other nonresidents.

- Following the bursting of the stock market bubble, reforms have tightened the regulation and strengthened the supervision of **securities markets**: the independence, supervisory powers and administrative capacity of the Securities and Exchange Commission (SEC) were enhanced, and the supervision of all nonbank financial firms is to come directly under the SEC, resolving overlap problems with the Cyprus Stock Exchange (CSE).

- New **insurance sector** legislation comes into effect in January 2003, harmonizing it with EU requirements, addressing existing weaknesses, and increasing the powers of the insurance supervisor. Most insurance companies had significant exposure to the stock market, and authorities saw scope for consolidation in the sector.

- New legislation is under preparation to strengthen supervision of **Cooperative and Credit Societies** (CCSS). These institutions, specializing in residential mortgage lending and small retail loans, do not fall under CBC's supervision and need to be brought into full alignment with the relevant EU directives after a transitional five-year period. Their asset quality is estimated to be poor—the ratio of loans overdue is about 18 percent—but loans are collateralized. Some CCSS are not expected to meet the EU capital adequacy requirements for credit institutions, and would have to merge or join the Cooperative Central Bank as permanent affiliated members.

24. **Staff welcomed progress in financial sector supervision, highlighting the key role of coordination and cooperation between the several financial sector supervisory authorities, but expressed concern about the recent deterioration in asset quality**. The authorities acknowledged the worsening of financial sector balance sheets, but noted that banks had adequately provisioned for nonperforming loans, and that they were strengthening risk management and undertaking efforts to improve credit quality. Offshore banks, that can now undertake transactions with residents, could increase banking competition, but the authorities noted that these banks had so far shown limited interest in the small Cypriot market. The authorities pointed to the recent signing of a Memorandum of Understanding establishing more formal coordination between the Central Bank, the SEC, and the insurance supervisor. The mission called for enhanced supervision of Cooperative Credit Societies, in strict coordination with the CBC. Staff also stressed the importance of restoring investor confidence in the stock market, and called for quashing rumors of a bailout associated with stock market-related losses.

25. **The authorities reiterated their commitment to strengthening the reputation of the offshore sector, and highlighted that Cyprus fulfills international standards on anti-money laundering capabilities**. An Offshore Financial Center (OFC) Assessment published in August 2001 concluded that the supervision of the sector was generally effective and thorough, but noted that some licensed offshore banks were considered high risk and recommended strengthening supervisory resources and enhancing supervisory expertise. Since then, the authorities have taken steps to address these recommendations (Box 4). The phasing out of tax preferences for offshore companies, in line with OECD recommendations,

was not expected to significantly reduce Cyprus's attractiveness as an international business center, as corporate taxation remains low. Steps have been taken to ensure that beneficiaries for new accounts are identified, and that a customer identification process is undertaken on existing accounts whenever there is a significant movement of capital. All banks are required by law to have a money laundering compliance officer, reporting to the unit for combating money laundering and submitting an annual report to the CBC.

Box 4. Changes in Supervision and Regulation Following the 2001 IMF OFC Assessment

- Resources for the supervision of the offshore companies (OC) have been increased by adding two more officers and two more staff positions as a first step.
- CBC now requires a police clearance certificate from the country of origin for anyone who wants to set up or be employed by an OC, and letters of recommendation from past employers and foreign supervisors.
- The 90-days rule for nonperforming loans will be gradually introduced, starting January 2003.
- CBC has limited the number of OCs from high-risk countries, and has signed a number of memoranda of understanding with foreign supervisors to improve the monitoring of OCs from such countries.

D. The Labor Market and Other Structural Issues

26. **With close to full employment conditions the labor market has performed well, but rigidities in the wage formation mechanism can increase the persistence of inflationary shocks**. Increased demand for labor has been partly met through foreign workers, currently representing around 10 percent of the labor force. While labor market participation is high—over 70 percent—scope remains for raising participation rates among women, particularly by encouraging part-time employment, currently accounting for only 7 percent of total employment. Unions argued that the wage formation mechanism, characterized by centralized bargaining and backward-looking wage indexation (COLA), had contributed to labor market stability and wage claims in line with productivity, and noted that the COLA system had been amended to exclude the impact of excise tax changes. Employers were instead critical of the COLA, which they viewed as an element of rigidity and amplification of inflationary shocks, particularly indirect tax changes. They also voiced concerns about labor market shortages, which they thought could be alleviated by making it easier to hire foreign workers.

27. **Staff recognized that wage developments had been broadly in line with productivity, but argued that the indexation mechanism should exclude the effects on prices of VAT and terms of trade changes**. Workers had been compensated for the VAT increases through lower direct income taxes and other social measures. Staff therefore urged

unions to exercise moderation in their discretionary wage claims, to offset the undue part of automatic wage increases through the COLA system. While staff supported moving toward a more forward-looking wage formation mechanism, the authorities saw limited political scope for substantial changes in the COLA.

28. **While Cyprus is well advanced in meeting the requirements of the *acquis communautaire*, the authorities recognized that progress in liberalization remains uneven.** In particular, liberalization of utilities was trailing behind—as noted by the European Commission—but authorities emphasized the enactment of new legislation liberalizing telecommunications and postal services starting January 2003, the establishment of a new regulator in this sector, and the sale of a second mobile telephone license scheduled for 2003. In addition, staffing and powers of the Commission for the Protection of Competition had been strengthened. Remaining price controls were being phased out, water prices for consumers had been raised, and that there were plans to reduce cross-subsidization of petroleum products. While recognizing the progress achieved since the last consultation, staff noted that structural impediments to competition were still hampering the performance of the Cypriot economy, particularly in sectors such as air travel, telecommunications, and energy. It accordingly urged further liberalization, progress on the divestiture of remaining public sector enterprise holdings, and the full phasing out of remaining price controls and cross-subsidization, underscoring the need for prices to reflect relative scarcity.

29. Trade policy in Cyprus is shaped by EU accession requirements, and complies with UN resolutions. All relevant chapters for harmonization with EU trade policy have been closed, and remaining high duties for agricultural products will be gradually reduced by accession.

IV. Staff Appraisal

30. **Since the last consultation in 2000, Cyprus has successfully withstood adverse shocks while maintaining macroeconomic stability, and achieved substantial progress on the reform agenda.** The interest rate ceiling was abolished; the central bank was granted legal independence; capital account liberalization has proceeded without jeopardizing domestic and external stability; and the tax system has been reformed, reducing direct taxes and increasing indirect taxes. These achievements have been recognized by the European Council, which at the Copenhagen summit of December 2002 invited Cyprus to join the EU.

31. **These achievements, and the possibility of a peace settlement, have opened new challenges, all the more demanding in an unsettled external environment.** As a small, tourism-dependent open economy, Cyprus is vulnerable to external shocks, and especially to turbulence in the Middle East—all the more so in the context of capital account liberalization. A peace settlement would open new opportunities, but differences in development, macroeconomic and financial stability between the two parts of Cyprus pose significant policy challenges. Strengthening domestic policies, increasing the economy's

flexibility, and reducing external and financial vulnerabilities are key to ensuring success in meeting these challenges.

32. **Adopting early measures to rein in fiscal slippages is essential to regain momentum toward fiscal consolidation, meet the 2003 budgetary targets, and reduce external imbalances**. Prompt action is needed to contain expenditure overruns, particularly on current transfers, and contain the 2003 fiscal deficit to 2½ percent of GDP, thus putting the public debt on a downward path, in line with the authorities' medium-term balanced-budget target. While debt and external sustainability are not critical problems at this stage, present and prospective expenditure pressures and the vulnerability to external shocks underscore the need for a prudent policy course. Strengthening public finances would also ensure that European Union's fiscal criteria are easily satisfied.

33. **A sustained reduction in the ratio of public debt to GDP and early pension reform would strengthen Cyprus's ability to face expenditure pressures arising from demographic trends as well as from a possible settlement**. Measures to buttress the long-term sustainability of the pension system and of public finances in general should be adopted expeditiously, containing the persistent growth in transfers.

34. **The credibility of fiscal policy can be enhanced by establishing a multiyear fiscal framework**, based on prudent macroeconomic objectives, with annual expenditure targets broken down by major spending categories. Such a framework would allow to choose among competing spending priorities in a transparent and efficient manner.

35. **While monetary policy conduct has been prudent and the exchange rate is in line with fundamentals, the Central Bank should stand ready to respond flexibly to external developments**. The authorities' reliance on a nominal exchange rate anchor has served Cyprus well, but could be challenged by increased capital mobility following the removal of remaining restrictions. Authorities should stand ready to use their available policy tools, including exchange rate movements within the fluctuation band, to respond to capital flow volatility and other external shocks. The authorities' objective of joining the euro area as soon as possible is appropriate, and within reach given their established record of monetary and exchange rate stability.

36. **Cyprus is well placed to take full advantage of the opportunities for international portfolio diversification that capital account liberalization affords, but as remaining restrictions are dismantled, further strengthening of the banking system and monitoring external vulnerability become even more essential**. Its large financial sector, educated workforce, efficient legal system, and strategic position make Cyprus an attractive destination for foreign capital, and dismantling capital controls will allow domestic residents to diversify their portfolios internationally, improving risk sharing. While financial sector legislation and supervision have appropriately been strengthened, the weakening of financial sector balance sheets highlights the need for authorities to closely monitor foreign exchange exposure and maturity mismatches in the financial system and among corporates, and stand

ready to take prudential action if vulnerabilities arise. Together with fiscal consolidation, these steps are crucial to reduce external vulnerabilities.

37. **Coordination and cooperation between Cyprus's multiple financial sector supervisory authorities are essential for financial sector stability**. The interlinks between provision of banking services, financial services, and insurance in Cyprus's universal banks require supervision on a consolidated basis, and consequently close supervisory cooperation. The supervision of Cooperative Credit and Savings Societies should be enhanced, their capital base should be strengthened and consolidation in the sector encouraged, reinforcing its ability to cope with market pressures and meet EU directives. Strengthened legislation and enhanced supervision can help restore confidence in the stock market, and a clear signal should be sent that stock market investment losses will not be covered by a concerted bailout.

38. **Reforming the wage formation mechanism can help reduce the persistence of inflationary shocks**. The automatic indexation of wages to past inflation fails to exclude the impact on prices of VAT increases, and will therefore unduly cause second-round inflationary effects in 2003. Similar effects could be generated by international oil price increases. Greater priority should be assigned to the adoption of a forward-looking wage formation mechanism that would allow the economy to respond more flexibly to shocks.

39. **Further progress on structural reform is necessary**. While antitrust legislation and enforcement has been strengthened, more remains to be done to foster competition in sectors such as air travel, electricity, and telecommunications. Together with measures to promote competition, the removal of remaining price controls and privatization of government holdings would also strengthen the market base of Cyprus's business sector.

40. While **data quality** is adequate for surveillance purposes, progress is needed to improve coverage, timeliness, and comprehensiveness of statistics, particularly in the external sector, and Cyprus is encouraged to subscribe to the Statistical Data Dissemination Standard as soon as possible. Timely and high-quality statistics, particularly in the area of external debt, the reserve template, and the international investment position, are key for the monitoring of external risks.

41. It is proposed that the next consultation be held on the 24-month cycle with an interim staff visit, unless a political settlement warrants earlier contacts and discussions.

Table 1. Cyprus: Selected Indicators, 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003	
							Estimates	Projections	
								Baseline	Adjustment
	(Contributions to annual growth)								
Output and prices									
Domestic demand	4.9	1.3	9.1	1.0	5.7	4.7	3.3	3.4	2.7
Private consumption	2.2	2.6	5.5	2.1	5.8	3.5	1.5	3.2	3.3
Public consumption	2.0	0.7	1.3	-1.4	-0.4	1.5	0.8	0.0	-0.7
Gross investment	0.6	-2.0	2.3	0.3	0.3	-0.3	1.0	0.2	0.2
Net exports	-1.6	0.2	-4.5	3.8	-0.8	-0.3	-1.6	0.1	0.5
	(Annual percentage change)								
Real GDP	1.9	2.4	5.0	4.6	5.1	4.0	1.7	3.5	3.3
Industrial production index	-3.0	-0.3	2.8	1.7	4.5	-0.6	-0.3	1.5	1.3
Tourist arrivals	-7.1	7.1	6.5	9.5	10.3	0.4	-10.0	3.0	3.0
Potential output	4.3	4.2	4.1	4.0	3.9	3.8	3.7	3.8	3.8
Unemployment (in percent)	3.1	3.4	3.4	3.6	3.4	3.0	3.3	3.2	3.2
CPI index (period average)	3.0	3.6	2.2	1.8	4.2	2.0	2.8	4.5	4.5
CPI index (end of period)	2.5	3.9	1.0	3.7	3.5	2.4	2.9	4.0	4.0
Real wages	2.8	2.9	2.8	2.9	3.0	2.8	2.1	2.0	2.0
	(In percent of GDP)								
Gross domestic investment	22.3	19.8	20.8	19.3	19.1	18.5	19.0	18.6	18.6
Of which private	16.9	15.3	15.5	14.3	13.8	13.6	14.3	13.9	13.9
Gross domestic saving	17.1	15.4	13.9	16.2	12.4	14.0	13.4	14.2	14.5
Of which private	17.0	17.0	15.6	16.3	11.3	13.1	13.3	14.0	13.3
	(In percent of GDP)								
Public finance 1/									
Total revenue	31.8	31.5	31.4	32.7	35.0	36.3	35.9	35.7	36.1
Expenditure and net lending	35.2	36.8	36.9	37.2	38.1	39.3	39.6	39.3	38.6
Of which defense spending	3.1	3.3	2.8	1.4	1.1	2.2	2.0	1.4	1.4
Overall balance	-3.4	-5.3	-5.5	-4.5	-3.1	-3.0	-3.6	-3.6	-2.5
Primary balance 2/	1.9	0.0	0.2	1.0	2.7	2.7	2.0	1.9	3.0
Public debt, net of intergovernmental debt	52.9	57.2	55.6	57.0	54.8	54.6	57.6	57.3	56.4
	(Annual percentage change)								
Money and credit									
Broad money	10.5	13.1	8.8	15.1	8.2	13.3	8.6	10.4	10.1
Reserve money	-8.8	0.6	16.2	15.0	11.1	7.5	8.6	8.8	8.5
Domestic credit	12.8	17.3	13.1	12.2	12.5	15.2	7.8	10.4	10.1
Broad money velocity	6.5	7.7	1.2	7.7	-1.1	6.0	3.7	2.1	2.0
Interest rates									
Deposit rates 2/	7.0	6.5	6.5	6.5	6.5	6.1	4.4 4/	...	...
Lending rates	8.5	8.0	8.0	8.0	8.0	7.6	7.2 4/	...	...
	(In percent of GDP)								
External sector									
Trade balance	-25.7	-25.2	-26.8	-25.0	-29.6	-28.0	-27.2	-26.2	-26.0
Current account	-5.2	-4.0	-6.7	-2.4	-5.2	-4.3	-5.5	-4.3	-4.0
Financial account 5/	5.5	5.1	8.2	4.0	3.1	2.0	4.4	2.5	2.3
Of which: Direct foreign investment, net	0.2	0.5	0.0	-0.3	-0.5	-0.6	0.6	0.5	0.5
Portfolio investment, net	-0.5	1.7	2.2	0.0	-2.3	0.8	0.3	-1.6	-1.6
Exchange rates									
Pounds per U.S. dollar (end-period)	0.47	0.51	0.52	0.54	0.62	0.64	0.55	...	...
Real effective exchange rate (CPI, 1995=100)	100.3	100.1	103.3	99.7	96.5	98.3	103.1 4/	...	...

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

1/ Central government for 1996-98 and general government from 1999 onwards.

2/ Includes interest on intra-government debt

3/ For 1 year fixed deposits over CYP 5,000.

4/ September 2002.

5/ Excluding commercial banks' net foreign assets position.

Table 2. Cyprus: Balance of Payments, 1996–2003

	1996	1997	1998	1999	2000	2001	2002 Est.	2003 Proj.
	(In millions of U.S. dollars)							
Current account balance	-462	-339	-604	-217	-460	-395	-563	-496
Trade balance	-2,296	-2,141	-2,430	-2,312	-2,613	-2,552	-2,767	-2,990
Exports	1,280	1,179	1,066	1,001	954	977	944	1,042
Imports	3,576	3,320	3,496	3,313	3,566	3,529	3,711	4,032
Fuel and lubricants	338	268	209	281	434	414	454	500
Services	1,834	1,786	1,825	2,046	2,052	2,169	2,224	2,515
Exports	3,063	2,959	2,959	3,194	3,215	3,355	3,512	3,952
Travel (mainly tourism)	1,673	1,642	1,718	1,910	1,943	2,007	2,012	2,284
Imports	1,228	1,173	1,135	1,148	1,163	1,186	1,288	1,437
Investment income, net	-40	-5	-29	-38	-26	-34	-46	-50
Transfers, net	33	26	29	87	126	22	25	28
Financial account balance	492	431	742	368	272	180	447	288
Direct foreign investment, net	19	43	0	-25	-40	-54	60	53
Portfolio investment, net	-48	143	197	2	-204	74	31	-180
Other investment, net	461	198	462	1,031	508	773	470	390
Reserve assets	60	47	83	-639	8	-613	-113	26
Net errors and omissions	-30	-92	-138	-151	169	215	115	0
Change in official reserves	-124	-177	-16	457	-107	526	758	-62
	(Percentage change)							
Memorandum items:								
Goods exports	17.0	1.5	-9.0	-1.5	9.0	6.1	-9.3	6.6
Goods imports	11.2	2.2	6.0	-0.6	23.2	2.5	-1.2	5.0
Tourism receipts	-3.7	8.1	5.4	16.6	16.4	7.0	-5.9	9.7
	(In percent of GDP)							
Trade balance	-25.7	-25.2	-26.8	-25.0	-29.6	-28.0	-27.2	-26.2
Current account	-5.2	-4.0	-6.7	-2.4	-5.2	-4.3	-5.5	-4.3
Financial account	5.5	5.1	8.2	4.0	3.1	2.0	4.4	2.5
Change in official reserves	-1.4	-2.1	-0.2	4.9	-1.2	5.8	7.4	-0.5
	(In millions of US. dollars, end-of-period)							
Gross official reserves	1,713	1,536	1,520	1,977	1,870	2,396	3,155	3,093
In months of imports GS	4.6	4.5	4.2	6.3	5.3	7.1	8.1	8.1
Total gross reserves (includes banks)	4,825	5,079	4,479	5,456	6,460	7,812	8,594	9,033
In months of imports GS	12.9	14.6	12.9	16.5	18.6	22.9	24.3	23.6
	(In billions of U.S. dollars)							
Gross domestic product	8.9	8.5	9.1	9.2	8.8	9.1	10.2	11.4

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

Table 3. Cyprus: Government Macroeconomic Scenario (PEP) and Staff Medium-Term Baseline Projections 1999–2005

	1999	2000	2001	2002		2003		2004		2005	
				PEP	Staff	PEP	Staff	PEP	Staff	PEP	Staff
						(Percent changes)					
Real GDP	4.6	5.1	4.0	2.8	1.7	4.6	3.5	4.6	4.5	4.7	4.5
Domestic demand	0.9	5.5	4.6	3.7	3.2	2.4	3.2	3.8	4.1	4.1	4.0
Private consumption	3.1	8.7	5.0	3.0	2.1	4.0	4.5	4.0	4.7	4.0	4.4
Public consumption	-7.7	-2.6	10.1	1.1	5.0	-1.6	0.2	-1.6	0.6	1.8	0.8
Investment	1.5	1.3	-1.3	8.4	5.4	0.0	1.1	7.2	4.7	6.0	4.8
Exports GNFS	6.3	9.3	3.9	-0.1	-3.8	7.2	5.6	7.4	5.3	7.4	5.7
Imports GNFS	-1.9	10.0	4.0	2.8	-0.4	2.9	4.7	4.9	4.3	5.7	4.5
Consumer price inflation (period average)	1.8	4.2	2.0	3.2	2.8	4.1	4.5	1.7	2.5	2.0	2.2
						(In percent of GDP)					
Public finances (general government)											
Total revenue	32.7	35.0	36.3	35.9	35.9	35.9	35.7	36.5	36.0	36.7	36.2
Total expenditure and net lending	37.2	38.1	39.3	38.5	39.6	37.8	39.3	37.1	39.0	37.0	38.4
Overall balance	-4.5	-3.1	-3.0	-2.6	-3.6	-1.9	-3.6	-0.6	-3.0	-0.3	-2.1
Primary balance	1.0	2.7	2.7	2.9	2.0	3.4	1.9	4.7	2.7	4.9	3.5
Public debt (net of intragovernment debt)	56.9	54.8	54.6	55.6	57.6	54.0	57.3	52.9	56.1	52.1	54.6
Balance of payments											
Trade balance	-25.0	-29.6	-28.0	-28.5	-27.2	-27.3	-26.2	-27.4	-25.8	-28.0	-25.6
Service balance	22.1	23.2	23.8	23.1	21.8	24.1	22.1	25.2	22.3	26.5	22.6
Current account balance	-2.4	-5.2	-4.3	-5.4	-5.5	-3.2	-4.3	-2.1	-3.9	-1.4	-3.5
Financial account 1/	4.0	3.1	2.0	2.4	4.4	1.4	2.5	2.0	2.5	2.4	2.8
Of which: Direct foreign investment, net	-0.3	-0.5	-0.6	0.6	0.6	0.5	0.5	0.7	0.8	0.9	0.8

Source: Pre-Accession Economic Program of the Republic of Cyprus (PEP) and staff estimates

1/ Excluding commercial banks' net foreign assets position.

Table 4. Cyprus: Consolidated Central Government Accounts, 1996–2003

(In percent of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
							Est.	Proj.
Total revenue	31.8	31.5	31.4	31.7	34.0	35.3	34.9	34.7
Current revenue	31.7	31.4	31.4	31.7	33.9	35.3	34.9	34.7
Tax revenue	25.4	24.5	25.0	25.6	26.5	28.3	28.6	28.9
Income and property	8.5	8.6	9.0	9.8	10.2	11.2	10.0	8.5
Social security contributions	4.7	4.7	4.7	4.5	4.4	4.7	4.6	5.1
Indirect taxes	12.2	11.3	11.4	11.2	11.9	12.3	13.9	15.3
Of which: VAT	4.8	4.7	4.8	4.7	5.4	5.8	7.2	8.4
Nontax revenue	6.3	6.9	6.3	6.1	7.4	7.0	6.3	5.8
Social security fund interest	2.0	2.2	2.3	2.4	2.2	2.1	2.0	1.8
Other	4.3	4.7	4.0	3.7	5.2	4.9	4.3	3.9
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign grants	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending	35.2	36.8	36.9	35.7	36.7	38.2	38.5	38.2
Current expenditure	31.7	33.0	33.1	31.8	32.6	34.2	34.7	34.5
Wages and salaries	9.5	9.8	9.8	9.6	9.6	9.5	9.9	10.0
Other goods and services	2.7	3.0	3.0	3.0	2.9	3.1	3.3	3.3
Subsidies	1.1	0.8	0.7	0.8	1.4	1.6	1.1	0.8
Interest payments	5.3	5.3	5.7	5.7	5.7	5.6	5.5	5.4
To social security fund	2.0	2.2	2.3	2.4	2.2	2.1	2.0	1.8
Other domestic	2.7	2.5	2.8	2.6	2.6	2.6	2.7	2.8
External	0.6	0.5	0.6	0.7	0.9	0.9	0.8	0.7
Social security payments	5.2	5.4	5.4	5.4	5.5	5.4	5.7	5.7
Current transfers	5.1	5.8	6.0	6.2	6.3	6.7	7.0	7.8
Other (unallocable-defence)	2.7	2.9	2.5	1.1	1.1	2.2	2.1	1.5
Capital expenditure	3.5	3.7	3.8	3.8	3.9	3.7	3.7	3.6
Investment	2.3	2.5	2.7	2.6	2.8	2.7	2.6	2.6
Transfers	1.1	1.2	1.1	1.2	1.1	1.1	1.1	1.1
Net lending	0.1	0.1	0.0	0.1	0.2	0.3	0.0	0.0
Overall balance	-3.4	-5.3	-5.5	-4.0	-2.7	-2.8	-3.5	-3.5
Primary balance	1.9	0.0	0.2	1.7	2.9	2.8	2.0	1.9
Without intragovernmental interest	-0.1	-2.2	-2.1	-0.7	0.7	0.6	0.0	0.1
Public debt, net	52.9	57.2	55.6	57.0	54.8	54.6	57.6	57.3
Domestic debt	43.2	45.4	41.5	40.0	39.9	41.6	44.4	44.8
Long-term	11.6	15.5	18.7	20.2	21.4	26.9	37.9	38.4
Short-term	31.6	29.9	22.8	19.8	18.5	14.7	6.4	6.4
Foreign debt	9.8	11.9	14.3	17.1	15.0	13.0	13.2	12.5
Long-term	6.8	8.9	12.3	14.7	13.9	11.9	13.0	12.4
Short-term	2.9	2.9	1.9	2.2	1.0	1.1	0.1	0.0

Sources: Ministry of Finance; and Fund staff estimates.

Table 5. Cyprus: Vulnerability Indicators, 1996-2002

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002 Est.
Financial indicators							
Public debt, net of intergovernmental debt	52.9	57.2	55.6	57.0	54.8	54.6	57.6
Broad money (percent change, 12-month basis)	10.5	13.1	8.8	15.1	8.2	13.3	8.6
Private sector credit, real (percent change, 12-month basis)	9.4	14.7	11.9	11.9	10.3	10.5	7.0
Domestic credit	110.1	122.9	129.3	135.8	139.7	150.5	154.8
Banks' nonperforming loans (percent of total loans)	7.8	8.4	8.7	8.4	8.5	7.9	9.5 1/
External indicators							
Exports G&NFS (percent change, in U.S. dollars)	-2.7	-4.3	-1.4	4.3	-0.3	3.9	2.3
Imports G&NFS (percent change, in U.S. dollars)	6.0	-6.5	4.5	-4.9	5.0	2.0	5.4
Current account balance	-5.2	-4.0	-6.7	-2.4	-5.2	-4.3	-5.5
Financial account balance	5.5	5.1	8.2	4.0	3.1	2.0	4.4
Of which: Direct foreign investment, net	0.2	0.5	0.0	-0.3	-0.5	-0.6	0.6
Portfolio investment, net	-0.5	1.7	2.2	0.0	-2.3	0.8	0.3
Other investment, net	5.2	2.3	5.1	11.1	5.7	8.5	4.6
Reserve assets	0.7	0.6	0.9	-6.9	0.1	-6.7	-1.1
Net errors and omissions	-0.3	-1.1	-1.5	-1.6	1.9	2.4	1.1
Change in official reserves	-1.4	-2.1	-0.2	4.9	-1.2	5.8	7.4
Net foreign assets of commercial banks (US$ billions)	3.1	3.5	3.1	3.2	4.6	5.3	6.3
Official foreign exchange reserves (US$ billions)	1.7	1.5	1.5	2.0	1.9	2.4	3.2
Official reserves in months of imports G&NFS	4.6	4.5	4.2	6.3	5.3	7.1	8.1
Reserve money/reserves (end-period, percent)	94.6	95.4	118.1	90.1	98.6	78.4	76.9
Broad money to gross official reserves (end-period, ratio)	5.2	5.9	6.8	5.2	5.5	4.6	4.5
Short-term external debt to gross official reserves (percentage) 2/	37.3	39.2	36.3	28.7	28.3	20.5	15.9
Total external debt 2/	29.3	32.7	34.1	36.5	34.0	39.4	39.9
Of which: Public sector debt	9.8	11.9	14.3	17.1	15.0	13.0	13.2
Total external debt to exports G&NFS (percentage) 2/	60.2	67.3	77.0	80.6	72.0	83.1	91.2
Total external debt service payments to exports G&NFS	10.4	8.6	8.9	6.7	8.7	10.3	8.4
Exchange rate (per US$, period average)	0.47	0.51	0.52	0.54	0.62	0.64	0.60
Real effective exchange rate (CPI, 1995=100)	100.3	100.1	103.3	99.7	96.5	98.3	103.1 3/
Financial market indicators (end-of-period)							
Stock market general index (percent change)	...	-7	18	688	-63	-47	-27
Long-term foreign currency debt rating (S&P)	AA-	AA-	A+	A+	A	A	A

Sources: Central Bank of Cyprus; National Statistical Office; Ministry of Finance; Bloomberg; and Fund staff calculations.

1/ June 2002.
2/ Does not include foreign exchange deposits.
3/ September 2002.

CYPRUS: FUND RELATIONS
(As of December 31, 2002)

I. **Membership Status**: Joined December 21, 1961. Cyprus accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement effective January 9, 1991.

II. **General Resources Account**:	SDR Million	Percent of Quota
Quota	139.60	100.00
Fund holdings of currency	90.49	64.82
Reserve position in Fund	49.11	35.18
Financial Transaction Plan transfers (net)	4.00	

III. **SDR Department**:	SDR Million	Percent of Allocation
Net cumulative allocation	19.44	100.00
Holdings	1.53	7.85

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	7/16/80	7/15/81	8.50	8.50

VI. **Projected Obligations to Fund**: None.

VII. **Exchange Rate Arrangements**: In June 1992, the peg of the Cyprus pound changed from a broad basket of currencies to the ECU. The central rate was set at ECU 1.7086 per £C with a margin of 2.25 percent on either side. From January 1, 1999, the euro replaced the ECU as the basis of the peg. From August 2001, the fluctuation margins increased to $\pm$15 percent, but the central rate remained unchanged. Subject to certain limitations, including a limit on spreads between buying and selling rates, authorized dealers (banks) are free to determine and quote their own buying and selling rates.

VIII. **Article IV Consultation**: The last Article IV consultation discussions were held in May 11–23, 2000 and the staff report (SM/00/173, 7/19/00) was discussed by the Executive Board on August 3, 2000.

IX. **Assessment of the Offshore Financial Sector**: In July 2001, the IMF undertook a Module 2 assessment in accordance with the procedures agreed by the IMF Executive Board in July 2000, including a Basel Core Principles assessment of the supervision of the offshore banking sector and an assessment of the provision of company services to the International Business Companies registered in Cyprus. The assessments were published by the Cypriot authorities on August 20, 2001.

X. **Technical Assistance**:

Dept.	Purpose	Date
MAE	Government debt management	Feb.– March, 1989
FAD	VAT training program	June–Oct., 1992
MAE	Financial sector liberalization	Nov.–Dec., 1993
MAE	Reform of government securities	April–May, 1994
STA	Special Data Dissemination Standard	August, 1997
STA	Balance of payments	March, 1999
STA	Balance of payments	May–July, 2001
STA	Balance of payments	Nov.–March, 2002
STA	Balance of payments	April–June, 2002

X. **Resident Representative**: None.

CYPRUS: STATISTICAL ISSUES

Cyprus has an open publication policy, and its statistical data are of a high quality and adequate frequency. However, weaknesses remain with respect to the requirements of the Special Data Dissemination Standard (SDDS), and some series are available with time lags that are longer than desirable. The authorities are committed to subscribing to the SDDS as soon as possible; outstanding issues are the full incorporation of the institutional breakdown of ESA 95 and of the new residency definition in all relevant sectors, the completion of all data categories required for the Reserve Template and External Debt, and complete coverage of the international investment position. Most of the offshore sector becomes resident for statistical purposes under the new definition, because it satisfies the one-year rule on physical presence, while it was considered nonresident under the previous capital controls-related definition.

National accounts exist on a quarterly frequency for data starting in 1995. Monthly indicators of economic activity exist (notably trade flows, tourism arrivals, and industrial production), but with a lag of several months for most such indicators. As of January 1999, the CPI is produced with the EU definition used to judge compliance with Maastricht treaty requirements.

Balance of payments accounts have been recently brought up to the standard (definitional and coverage) set in the *IMF Balance of Payments Manual*, fifth edition, assisted by a long-term technical assistance expert. Annual compilation in this format exist for data starting in 1995, while quarterly for data starting in the first quarter of 2001. Trade statistics are available on a monthly basis with a lag of about three to four months; current account statistics are available on a quarterly basis, and with a lag of 6 months. Partial data on the international investment position for 2001 based on the old residency definition—including reserves, portfolio assets, portfolio debt liabilities, and most other assets and other liabilities—is now available. Missing data includes foreign driect investment assets and liabilities, portfolio equity liabilities, positions on financial derivatives held by banks and other sectors, as well as stocks of other assets and a portion of external debt held by the non-financial private sector.

Fiscal data for the central government are of good quality and coverage. Monthly fiscal data are collected and are generally of high quality, but they are not always published on a timely basis. Consolidated general government accounts exist starting in 1998.

Financial sector data are timely and are disseminated efficiently. Electronic tables with monetary authority and commercial bank balance sheets, together with interest rate and other relevant information, are supplied to the Fund on a regular basis. Publication of data on official reserves has recently lagged several months.

Publication is generally open. A great deal of information is available through the internet, including both press statements and data files from the Statistical Service.

Cyprus: Core Statistical Indicators
as of January 6, 2003

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	01/6/03	10/30/02	10/30/02	8/30/02	8/30/02	01/6/03	December 2002	July 2002	June 2002	August 2002	Second quarter 2002	2001
Date Received	01/6/03	01/6/03	12/2/02	12/2/02	12/2/02	01/6/03	1/06/03	12/13/02	12/16/02	10/20/02	10/20/02	7/20/02
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Semi-annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	When Requested
Source of Update 1/	Reuters/ Bloomberg	CBC	CBC	CBC	CBC	CBC/ Reuters	CBC/ Reuters	CBC/ Reuters	CBC	MoF	MoF	MoF
Mode of Reporting	Internet/ Electronic	Electronic/ Fax	Electronic/ Fax	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic/ Fax	Fax/ Publication	Fax/ Publication	Fax	Fax
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Semi-annual

1/ Central Bank of Cyprus (CBC); Ministry of Finance (MoF).

Cyprus: Medium-Term Sustainability Analysis

1. Fiscal and external debt sustainability assessments were conducted over the medium term.

A. Fiscal Sustainability

2. The staff's baseline scenario predicts a decline in the public debt to GDP ratio from 57.5 in 2002 to 51.2 in 2007, and the different sensitivity tests suggest *medium-term* debt sustainability is not seriously at risk (Tables 1 and 2). When the historical average values of the real interest rate, real GDP growth, and primary balance are used throughout the projection period (scenario 1), the public debt ratio reaches 53.3 percent by 2007, around 2 percentage points above the baseline level. This is mainly explained by a projection in the baseline of primary surpluses as opposed to (marginal) deficits during the preceding 10-year period. However, the negative debt dynamics are dampened by the higher average real GDP growth rate experienced historically. Among the isolated shocks during the first two years of the projection horizon (scenario 2–4), the shock to the primary balance has the largest impact on the end-period debt ratio, while the shocks to real GDP and interest rate leads to a less significant deterioration in the debt dynamics. In all three cases, the debt ratio resumes its decline once the impact of the shocks fades. The same is true for the combination of these shocks (scenario 5). A one-time 30 percent real depreciation in 2003 (scenario 6) increases the debt ratio by around 6 percentage points from the 2002 level, but the debt stock declines once the depreciation shock wears off. The same is true for a one-time 10 percentage point of GDP increase in the public debt ratio (scenario 7). A severe adverse shock to public revenues (scenario 8), however, leads to a more sizable worsening of the debt dynamics.

B. External Sustainability

3. Under the baseline scenario the external debt to GDP ratio falls from 39.9 percent to 36.8 percent by 2007, which is achieved mainly through a change in the gross foreign-asset position and a decline in the current account deficit through fiscal consolidation. Positive debt dynamics—due to robust GDP growth and exchange rate appreciation—also play a role. Overall, the stress tests indicate some external sensitivity, but sustainability does not appear to be at serious risk (Tables 3 and 4). Under the stress test scenario 1 (interest rate, GDP growth, U.S. dollar deflator, non-interest current account, and non-debt creating flows as percentage of GDP are at historical average), the debt to GDP ratio rises to 40.8 percent by 2007, mainly due to higher levels of external borrowing and exchange rate depreciation during the 1990s. The external position is not seriously affected by the isolated stressing of interest and GDP growth rates (scenarios 2 and 3). However, the shocks to the U.S. dollar GDP deflator and current account (scenario 4 and 5) increase the debt ratio by around 15 and 12 percentage points compared to the baseline, while the combination of shocks to various macroeconomic and external variables (scenario 6) lead to (slightly) more adverse results. A one-time 30 percent depreciation also has a significant impact on the debt ratio in 2003, which initially increases to around 53 percent, but then declines as the impact of the shock fades away.

Table 1. Country: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						I. Baseline Medium-Term Projections					
1 Public sector debt 1/	57.2	55.6	57.0	54.8	54.6	**57.6**	**57.3**	**56.1**	**54.6**	**53.0**	**51.2**
Of which: foreign-currency denominated	11.9	14.3	17.1	15.0	13.0	13.2	12.5	12.6	12.4	12.2	12.1
2 Change in public sector debt	4.3	-1.5	1.3	-2.1	-0.2	3.0	-0.3	-1.2	-1.5	-1.6	-1.8
3 Identified debt-creating flows (4+7+12)	2.4	1.7	0.3	-2.2	-0.7	1.1	-0.9	-0.9	-1.5	-1.7	-1.9
4 Primary deficit	2.2	2.1	0.7	-0.6	-0.2	0.4	0.3	-0.4	-1.1	-1.4	-1.7
5 Revenue and grants	31.5	31.4	31.7	34.0	35.3	34.9	34.7	35.0	35.2	35.6	35.9
6 Primary (noninterest) expenditure	33.7	33.5	32.4	33.5	35.2	35.4	35.0	34.6	34.1	34.2	34.2
7 Automatic debt dynamics 2/	0.2	-0.3	-0.4	-1.7	-0.6	0.6	-1.2	-0.6	-0.4	-0.3	-0.2
8 Contribution from interest rate/growth differential 3/	0.5	-0.6	-0.3	-1.6	-0.5	0.6	-1.2	-0.6	-0.4	-0.3	-0.2
9 *Of which:* Contribution from real interest rate	1.7	2.1	2.1	1.1	1.5	1.5	0.7	1.8	1.9	1.9	1.8
10 Contribution from real GDP growth	-1.2	-2.7	-2.4	-2.7	-2.1	-0.9	-1.9	-2.4	-2.4	-2.2	-2.0
11 Contribution from exchange rate depreciation 4/	-0.3	0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	1.9	-3.3	1.0	0.1	0.5	1.9	0.6	-0.2	0.0	0.1	0.1
Public sector debt in percent of revenues 1/	181.7	177.3	179.6	161.3	154.5	164.9	165.3	160.2	154.9	148.9	142.6
Gross financing 5/	44.2	43.7	35.8	31.7	30.8	31.4	22.3	21.3	20.1	19.3	18.5
In billions of euros	3,200.0	3,396.4	2,977.6	2,952.8	2,988.1	2,980.8	2,478.5	2,575.7	2,611.3	2,684.1	2,747.0
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	2.4	5.0	4.6	5.1	4.0	1.7	3.5	4.5	4.5	4.3	4.0
Average nominal interest rate on public debt (in percent) 6/	6.1	6.4	6.3	6.3	5.9	5.9	5.9	6.0	6.0	5.9	5.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.5	4.1	4.2	2.3	3.1	3.0	1.4	3.5	3.8	3.7	3.7
Nominal appreciation (increase in euro value of local currency, in percent)	3.0	-1.5	0.9	0.6	0.2	-0.1	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.6	2.3	2.1	4.1	2.8	3.0	4.5	2.5	2.2	2.2	2.2
Growth of real primary spending (deflated by GDP deflator, in percent)	8.0	4.3	1.4	8.4	9.3	2.4	2.4	3.4	3.0	4.4	4.1
						II. Stress Tests					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07						**57.6**	**57.1**	**55.9**	**54.9**	**54.1**	**53.3**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						**57.6**	**59.6**	**59.7**	**58.2**	**56.5**	**54.8**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**57.6**	**59.7**	**61.4**	**59.7**	**57.9**	**56.0**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						**57.6**	**60.2**	**62.5**	**61.0**	**59.3**	**57.5**
5. Combination of 2-4 using one standard deviation shocks						**57.6**	**61.0**	**63.7**	**60.7**	**57.6**	**54.4**
6. One time 30 percent real depreciation in 2003 7/						**57.6**	**63.8**	**62.5**	**60.9**	**59.3**	**57.5**
7. 10 percent of GDP increase in other debt-creating flows in 2003						**57.6**	**67.3**	**66.0**	**64.4**	**62.7**	**60.9**
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						**57.6**	**64.1**	**69.9**	**68.3**	**66.6**	**64.8**
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						**164.9**	**229.6**	**250.5**	**193.8**	**187.2**	**180.4**

Historical Statistics for Key Variables (past ten years)	Historical Average	Standard Deviation
Primary deficit	0.1	1.6
Real GDP growth (in percent)	4.5	2.6
Nominal interest rate (in percent) 6/	6.3	0.2
Real interest rate (in percent)	2.6	1.6
Inflation rate (GDP deflator, in percent)	3.7	1.6
Revenue to GDP ratio	31.7	1.9

1/ Gross debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation.
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as rπ (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the denominator in footnote 2/ a$\alpha\varepsilon$(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Country: Public Sector Debt Sustainability Framework—Gross Public Sector Financing Need, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Projections											
Gross financing need 1/	42.5	41.6	34.3	30.9	29.3	27.9	21.4	20.7	19.7	19.0	18.3
(in billions of euros)	3,200.0	3,396.4	2,977.6	2,952.8	2,988.1	2,980.8	2,478.5	2,575.7	2,611.3	2,684.1	2,747.0
II. Stress Tests											
Gross financing need 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07						27.9	21.6	20.6	20.3	20.2	20.1
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						27.9	24.2	23.2	21.0	20.3	19.7
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						27.9	22.3	22.7	21.5	20.8	20.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						27.9	24.8	26.1	22.1	21.4	20.7
5. Combination of 2-4 using one standard deviation shocks						27.9	25.1	25.6	20.8	19.6	18.3
6. One time 30 percent real depreciation in 2003 3/						27.9	22.7	23.1	22.1	21.4	20.7
7. 10 percent of GDP increase in other debt-creating flows in 2003						27.9	23.4	24.4	23.4	22.7	22.0
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						27.9	29.5	31.9	24.9	24.2	23.5
Gross financing need in billions of euros 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07						2,987.7	2,532.3	2,589.1	2,723.5	2,888.9	3,071.0
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						2,987.7	2,807.9	2,878.6	2,791.4	2,876.5	2,953.0
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						2,987.7	2,478.5	2,575.7	2,611.3	2,684.1	2,747.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						2,987.7	2,879.8	3,247.3	2,930.6	3,025.2	3,112.1
5. Combination of 2-4 using one standard deviation shocks						2,987.7	2,867.3	3,057.9	2,653.0	2,658.4	2,644.7
6. One time 30 percent real depreciation in 2003 3/						2,987.7	1,724.5	1,882.1	1,918.8	1,980.7	2,037.6
7. 10 percent of GDP increase in other debt-creating flows in 2003						2,987.7	2,717.0	3,036.1	3,103.1	3,209.5	3,309.4
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						2,987.7	3,423.9	3,956.8	3,297.1	3,416.8	3,531.2

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

Table 3. Cyprus: External Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	32.7	34.1	36.5	34.0	39.4	**39.9**	**38.7**	**38.1**	**37.6**	**37.2**	**36.8**
2 Change in external debt	3.4	1.4	2.4	-2.6	5.5	0.5	-1.2	-0.6	-0.5	-0.5	-0.4
3 Identified external debt-creating flows (4+8+11)	3.5	0.7	5.5	7.3	3.6	-3.2	4.9	1.1	0.4	0.5	0.4
4 Current account deficit, excluding interest payments	2.9	5.5	1.2	3.8	2.9	4.0	2.8	2.0	1.6	1.3	1.1
5 Deficit in balance of goods and services	4.2	6.7	2.9	6.3	4.2	5.3	4.2	3.5	2.9	2.5	2.1
6 Exports	48.6	44.3	45.4	47.2	47.5	43.8	43.8	44.1	44.7	45.0	45.3
7 Imports	52.8	51.0	48.2	53.5	51.7	49.1	48.0	47.6	47.6	47.5	47.3
8 Net nondebt creating capital inflows (negative)	-2.2	-2.2	0.3	2.8	-0.2	-0.9	1.1	-0.2	-0.4	-0.3	-0.3
9 Net foreign direct investment, equity	0.5	0.0	-0.3	-0.5	-0.6	0.6	0.5	0.8	0.8	0.7	0.6
10 Net portfolio investment,equity	1.7	2.2	0.0	-2.3	0.8	0.3	-1.6	-0.6	-0.4	-0.4	-0.2
11 Automatic debt dynamics 1/	2.8	-2.6	4.0	0.7	1.0	-6.3	1.0	-0.7	-0.8	-0.5	-0.4
12 Contribution from nominal interest rate	1.1	1.2	1.2	1.4	1.5	1.5	1.5	1.9	1.9	1.9	1.8
13 Contribution from real GDP growth	-0.7	-1.4	-1.7	-1.8	-1.3	-0.6	-1.4	-1.6	-1.6	-1.5	-1.4
14 Contribution from price and exchange rate changes 2/	2.5	-2.4	4.6	1.2	0.9	-7.2	0.8	-0.9	-1.0	-0.8	-0.8
14 Residual, including change in gross foreign assets (2-3)	-0.1	0.8	-3.1	-9.9	1.9	3.6	-6.1	-1.7	-0.9	-1.0	-0.8
External debt-to-exports ratio (in percent)	67.3	77.0	80.6	72.0	83.1	91.2	88.4	86.4	84.2	82.7	81.2
Gross external financing need (in billions of U.S. dollars) 3/	1.2	1.5	0.9	1.3	1.2	1.4	1.2	1.3	1.4	1.4	1.5
In percent of GDP	14.7	15.8	10.5	14.3	13.6	12.0	10.7	11.0	10.5	10.2	10.0
Key macroeconomic and external assumptions											
Real GDP growth (in percent)	2.4	5.0	4.6	5.1	4.0	1.7	3.5	4.5	4.5	4.3	4.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-10.1	5.3	-13.7	-6.8	-5.1	18.9	-6.2	0.0	0.6	0.0	0.0
GDP deflator in U.S. dollars (change in percent)	-7.7	7.8	-11.8	-3.1	-2.5	22.5	-2.0	2.5	2.8	2.2	2.2
Nominal external interest rate (in percent)	3.5	4.1	3.1	3.9	4.4	4.8	3.9	5.3	5.3	5.3	5.3
Growth of exports (U.S. dollar terms, in percent)	-5.6	3.2	-5.6	6.0	2.1	14.9	1.5	8.0	8.7	7.3	7.0
Growth of imports (U.S. dollar terms, in percent)	-7.4	9.3	-12.7	13.0	-2.1	18.4	-0.9	6.4	7.4	6.3	6.0
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07						**39.9**	**36.0**	**36.7**	**38.0**	**39.3**	**40.8**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						**39.9**	**40.1**	**40.3**	**39.7**	**39.3**	**38.9**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**39.9**	**40.8**	**42.7**	**42.1**	**41.6**	**41.2**
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						**39.9**	**45.6**	**54.8**	**54.0**	**53.4**	**52.8**
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004						**39.9**	**44.9**	**51.4**	**50.6**	**50.0**	**49.5**
6. Combination of 2-5 using one standard deviation shocks						**39.9**	**46.1**	**56.2**	**55.3**	**54.6**	**54.1**
7. One time 30 percent nominal depreciation in 2003						**39.9**	**52.6**	**51.7**	**51.0**	**50.4**	**49.8**

Historical Statistics for Key Variables (past ten years)	Historical Average	Standard Deviation	Average 2002-07
Current account deficit, excluding interest payments	2.7	3.2	2.1
Net nondebt creating capital inflows	0.1	1.4	0.2
Nominal external interest rate (in percent)	3.0	2.2	5.0
Real GDP growth (in percent)	4.0	2.8	3.8
GDP deflator in U.S. dollars (change in percent)	-0.2	8.0	5.0

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

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) 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.

Table 4. Cyprus: External Sustainability Framework—Gross External Financing Need, 1997-2007

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						I. Baseline Projections					
Gross external financing need in billions of U.S. dollars 1/	1.2	1.5	0.9	1.3	1.2	1.4	1.2	1.3	1.4	1.4	1.5
In percent of GDP	14.7	15.8	10.5	14.3	13.6	12.0	10.7	11.0	10.5	10.2	10.0
						II. Stress Tests					
Gross external financing need in billions of U.S. dollars 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07						1.4	1.2	1.3	1.4	1.5	1.6
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						1.4	1.4	1.5	1.5	1.5	1.6
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						1.4	1.2	1.3	1.4	1.4	1.5
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						1.4	1.2	1.3	1.3	1.4	1.4
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004						1.4	2.0	2.5	1.8	1.9	1.9
6. Combination of 2-5 using one standard deviation shocks						1.4	1.6	1.8	1.5	1.6	1.7
7. One time 30 percent nominal depreciation in 2003						1.4	1.1	1.3	1.3	1.4	1.5
Gross external financing need in percent of GDP 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07						12.0	9.9	10.6	10.8	11.2	11.5
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						12.0	12.1	12.2	11.1	10.7	10.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						12.0	11.1	12.1	11.6	11.3	11.0
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						12.0	12.0	15.0	14.5	14.1	13.9
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004						12.0	17.2	20.1	13.6	13.3	13.0
6. Combination of 2-5 using one standard deviation shocks						12.0	15.2	18.5	14.8	14.4	14.2
7. One time 30 percent nominal depreciation in 2003						12.0	13.4	14.2	13.7	13.4	13.1

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

2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

Statement by the IMF Staff Representative on Cyprus
January 31, 2003

1. This statement provides an update on economic and policy developments since the staff report was issued. The new information does not change the thrust of the staff appraisal.

2. Recent indicators, including preliminary GDP estimates for the third and fourth quarter, tourism arrivals, and unemployment figures, suggest a pickup of GDP growth in the second half of 2002, and the authorities estimate GDP growth for the year to have reached 2.3 percent, around ½ percent higher than estimated in the staff report. Should these preliminary estimates be confirmed, higher GDP in the second half of 2002 would carry over to 2003, resulting in an upward revision to the baseline staff growth projection for this year. On the other hand, pervasive uncertainty related to rising tensions in the Middle East and the pace of recovery in advanced economies still pose significant downside risks to the growth outlook for 2003.

3. The general government deficit in 2002 is now estimated by the authorities to have been reduced to around 3 percent of GDP, primarily on account of transfers from semi-government organizations to the central government budget. The transfers (from the Cyprus Telecommunications Authority and the Electricity Authority of Cyprus) amount to £C 60 million (around 1 percent of GDP). On account of the lower fiscal deficit and somewhat lower accumulation of government financial assets than envisaged in the staff report, the ratio of public debt to GDP at end-2002 is now estimated to have fallen below 57 percent.

4. Wage increases for the public sector have been approved by parliament. The authorities estimate the net budgetary impact of this measure for this year to be around £C 30 million (½ percent of GDP), and confirmed their intention to offset the additional spending with expenditure reductions and/or revenue increases.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/13
FOR IMMEDIATE RELEASE
February 14, 2003

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

IMF Concludes 2002 Article IV Consultation with Cyprus

On January 31, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cyprus.[1]

Background

Over the last two decades economic performance has been impressive, with GDP per capita rapidly approaching the average level in EU countries. Strong growth has kept the unemployment rate below 4 percent for the past 2 decades, inflation has remained under control, and the fiscal deficit has averaged below 3.5 percent of GDP during the past decade. In recent years, Cyprus has achieved substantial progress on the reform agenda. The interest rate ceiling was abolished; the central bank was granted legal independence; capital account liberalization has proceeded without jeopardizing domestic and external stability; and the tax system has been reformed, reducing direct taxes and increasing indirect taxes. These achievements have been recognized by the European Council, which at the Copenhagen summit in December 2002 invited Cyprus to join the EU. Discussions on a United Nations peace plan are underway.

After four years of strong growth, economic activity has tailed off since late 2001, affected by the global economic slowdown, and the authorities estimate growth for 2002 to have declined to 2.3 percent, with falling tourist arrivals and weakening consumer and business confidence. Inflation has risen to 2.9 percent year-on-year in December on account of indirect tax increases,

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

but core inflation remains low. The current account deficit is expected to have deteriorated in 2002 to 5.5 percent, on account of lower tourism receipts and temporary factors.

After notable progress in 1999 and 2000, fiscal consolidation stalled in 2001 and 2002. Despite a favorable cyclical position, the 2001 general government deficit remained virtually unchanged from the previous year. In 2002 a tax reform further aligned indirect taxation with EU standards, while lowering direct taxation and harmonizing the corporate tax rates of domestic and foreign companies. The economic slowdown, compensatory social spending measures accompanying the tax reform, and slippages on the spending side were partly offset by higher transfers from semi-government organizations, and the general government deficit is estimated to have remained around 3 percent of GDP in 2002.

Monetary policy has successfully kept inflation under control. Restrictions on medium- and long-term capital movements have been lifted and liberalization of short-term flows should be completed by EU accession. The liberalization of foreign-currency borrowing for maturities over 2 years was followed by high capital inflows in early 2001, but lower interest rates and the widening of the exchange rate band to ±15 percent have since slowed net inflows. Banks are well capitalized, but their portfolio has been affected by the bursting of the stock market bubble and the economic slowdown. Initiatives are underway to strengthen financial sector regulation and supervision, and align them to EU standards—including for insurance and the stock market. While structural reform has proceeded, some obstacles to competition remain in sectors such as air travel, electricity, and telecommunications, and the automatic wage indexation mechanism fails to exclude the impact on prices of VAT increases and terms of trade changes.

Executive Board Assessment

Executive Directors commended Cyprus's long-standing record of strong economic growth, low inflation, and moderate unemployment, which had allowed the economy to successfully withstand adverse shocks while maintaining macroeconomic stability. They welcomed the substantial progress achieved on the reform agenda, including the abolition of the interest rate ceiling; the granting of legal independence to the central bank; continuing capital account liberalization; and the reform of the tax system. These achievements have helped pave the way for European Union membership in 2004. Directors also welcomed the prospect of a possible peace settlement, which would open new economic opportunities, while noting that differences in development and in macroeconomic and financial stability between the two parts of Cyprus would also pose significant policy challenges. They emphasized that strengthening domestic policies, increasing the economy's flexibility, and reducing external and financial vulnerabilities would be key to ensuring success in meeting these challenges in an unsettled external environment.

Directors noted that, after notable progress in 1999 and 2000, fiscal consolidation had stalled in 2001–02. The momentum towards fiscal consolidation needed to be regained, and Directors consequently urged the authorities to meet the 2003 budgetary target and reduce external imbalances. They noted that prompt action is needed to offset expenditure overruns, particularly on current transfers, so as to ensure the envisaged reduction in the fiscal deficit in 2003. These actions would serve to put the public debt on a downward path, in line with the authorities' medium-term balanced-budget target. While Directors considered that debt and external sustainability were not critical problems at present, Cyprus's vulnerability to external shocks called for a prudent policy course, and some Directors expressed concern about the large estimated current account deficit in 2002.

For the medium term, Directors underscored the need for a sustained reduction in the ratio of public debt to GDP, which would help contain external imbalances. Together with early pension reform, this would reinforce Cyprus's ability to face expenditure pressures arising from demographic trends. Directors emphasized that fiscal policy credibility could be enhanced by establishing a multiyear fiscal framework, based on prudent macroeconomic objectives. Such a framework would allow the authorities to choose among competing spending priorities in a transparent and efficient manner.

Directors praised the prudent conduct of monetary policy, and called on the Central Bank to stand ready to respond flexibly to external developments. They noted that the authorities' reliance on a nominal exchange rate anchor had served Cyprus well, but cautioned that the framework could be challenged by increased capital mobility following the removal of remaining restrictions. In this context, Directors encouraged the authorities to stand ready to use the available policy tools, including exchange rate movements within the widened exchange rate band, to respond to capital flow volatility and other external shocks. Continued prudent monetary policy management would be key to achieving the authorities' objective of joining the euro area as soon as possible.

Directors noted that Cyprus is well placed to take full advantage of the opportunities for international portfolio diversification that capital account liberalization affords. At the same time, Directors called for further strengthening of the banking system and monitoring of external vulnerabilities as remaining restrictions are dismantled. They welcomed the strengthening of financial sector legislation and supervision, in line with EU directives, and stressed the need to closely monitor foreign exchange exposure and maturity mismatches in the financial system and among corporates, particularly in light of the weakening of financial sector balance sheets after the bursting of the stock market bubble, and to take prudential action if needed. They viewed these steps, together with fiscal consolidation, as crucial to reducing external vulnerabilities.

Directors called for coordination and cooperation among Cyprus's multiple financial sector supervisory authorities. They welcomed the authorities' commitment to strengthening the reputation of the offshore sector, and the progress in addressing the supervisory issues identified in the Offshore Financial Center (OFC) Assessment published in August 2001. Directors noted that Cyprus fulfills international standards on anti-money laundering capabilities. They also welcomed the authorities' intention to participate in the FSAP.

While recognizing that the labor market in Cyprus has functioned well, Directors recommended curtailing the recourse to backward-looking wage indexation (the Cost of Living Allowance—COLA system) which they viewed as an element of rigidity and amplification of inflationary shocks (given also the continued inclusion of the impact on prices of VAT increases). While recognizing that Cyprus is well advanced in meeting the requirements of the *acquis communautaire,* Directors called for further progress on structural reform. They urged the authorities to speed up the liberalization of the air travel, electricity, and telecommunications sectors. The removal of remaining price controls and privatization of government holdings would also reinforce the market base of Cyprus's business sector.

Macroeconomic statistics in Cyprus are adequate for surveillance, and Directors welcomed recent progress in this area, particularly in the domain of balance of payments statistics. However, they highlighted the continued need to improve data coverage, timeliness, and comprehensiveness, particularly in the area of external debt, the reserve template, and the international investment position. The authorities were encouraged to subscribe to the Special Data Dissemination Standard as soon as possible.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Cyprus is also available.

Cyprus: Selected Economic Indicators

	1998	1999	2000	2001	2002 Est.	2003 Proj.
Real economy						
Real GDP (annual percent change) 1/	5.0	4.6	5.1	4.0	2.3	3.5
Tourist arrivals (annual percent change)	6.5	9.5	10.3	0.4	-10.0	3.0
Gross domestic investment (percent of GDP)	20.8	19.3	19.1	18.5	19.0	18.6
Unemployment rate (in percent)	3.4	3.6	3.4	3.0	3.3	3.2
Consumer prices (percent change, end-period)	1.0	3.7	3.5	2.4	2.9	4.0
Consumer prices (percent change, period average)	2.2	1.8	4.2	2.0	2.8	4.5
Real wages (annual percent change)	2.8	2.9	3.0	2.8	2.1	2.0
Public finance 2/						
Overall balance (percent of GDP)	-5.5	-4.5	-3.1	-3.0	-2.9	-3.6
Debt net of intragovernment debt (percent of GDP)	55.6	57.0	54.8	54.6	56.6	56.3
Money and credit						
Broad money (annual percent change)	8.8	15.1	8.2	13.3	8.6	10.4
Domestic credit (annual percent change)	13.1	12.2	12.5	15.2	7.8	10.4
Interest rates						
Deposit rates	6.5	6.5	6.5	6.1	4.4	...
Lending rates	8.0	8.0	8.0	7.6	7.2	...
Balance of payments						
Trade balance (percent of GDP)	-26.8	-25.0	-29.6	-28.0	-27.0	-26.1
Current account (percent of GDP)	-6.7	-2.4	-5.2	-4.3	-5.5	-4.3
Official foreign exchange reserves (millions of U.S. dollars)	1,520.1	1,976.6	1,870.0	2,396.4	3,154.8	3,093.2
(in months of GNFS imports)	4.2	6.3	5.3	7.1	8.1	8.1
Exchange rates						
Pounds per U.S. dollar (end-period)	0.5	0.5	0.6	0.6	0.5	...
Pounds per euro (end-period)	0.60	0.59	0.59	0.59	0.59	...
Nominal effective exchange rate (1995=100) 3/	108.3	106.0	102.2	106.0	110.0	...
Real effective exchange rate (CPI, 1995=100) 3/	103.3	99.7	96.5	98.3	103.1	...

Sources: Cypriot authorities; and IMF staff projections under the assumption of unchanged policies.

1/ Number for 2002 is authorities' estimate.
2/ Central government for 1998 and general government from 1999 onwards; staff projection for 2003 assumes no additional measures are taken as of the time of the consultation discussions.
3/ Data for 2002 are for September.

Statement by Jeroen Kremers, Executive Director for Cyprus
January 31, 2003

On behalf of the Cypriot authorities, I would like to thank staff for the constructive policy dialogue. In the authorities' opinion, the staff report is a comprehensive and sound assessment of developments and prospects of the economy as well as the policy challenges facing Cyprus in the period ahead. The additional analysis in the Selected Issues paper is equally welcome.

Introduction

Since the last Article IV Consultation in 2000, the Cypriot authorities have proven their steady commitment to achieve the strategy and objectives presented in the Pre-Accession Economic Program. Under these circumstances, Cyprus has successfully withstood adverse shocks while maintaining macroeconomic stability and achieved substantial progress on the market-oriented reform agenda. These efforts have borne fruit and at the Copenhagen summit in December 2002 Cyprus was invited to join the European Union.

The authorities are in broad agreement with the staff analysis as regards the direction of policies and recommendations. At the same time, the authorities are well aware of the challenges posed ahead, and wish to restate their determination to continue with the prudent policy aimed at ensuring long-term sustainable economic growth. Consequently, I would limit my comments to some areas of special importance for future developments in Cyprus.

Economic Performance

In the last years the Cypriot economy performed well, rapidly approaching the average level of GDP per capita in EU countries. In this respect, it is worth to mention that real income per capita has reached around 80 percent of the average EU level and is well above the level of other countries invited to join the EU; growth has been driven by steady diversification of the economy, with tourism and financial services developing rapidly.

Since mid 2001 Cyprus, as a small and open economy, has been affected by changes in the external environment. The global economic slowdown and effects of the September 11 attacks have clouded the economic performance, mainly through a reduction in tourism activity. The authorities have tried to find an appropriate policy mix to balance the need for reducing the impact of external shocks and continuing the EU integration process. Despite the adverse external conditions the authorities have made efforts to consolidate macroeconomic performance and substantial policy changes have been implemented to align the economy and its legal framework to EU requirements:

- the historical ceiling on interest rates was abolished,
- the exchange rate band was widened in response to substantial capital flows,

- new legislation was approved by Parliament, giving full independence to the Central Bank of Cyprus and prohibiting public sector borrowing from the central bank,
- a comprehensive tax reform was introduced recently in line with EU standards and,
- restrictions on medium- and long-term capital movements have been gradually lifted, the full liberalization being completed by EU membership.

A better economic performance in the last quarter of 2002 has brought encouraging signs for the year as a whole. Based on earlier information, staff has correctly pointed out that the real GDP decelerated during 2002, estimating a growth rate decline to 1.7 percent in 2002 compared with 4.0 percent in 2001. According to the most recent information, which included the provisional data for the fourth quarter, real GDP growth is estimated to be 2.3 percent in 2002, indicating a strengthening of real economic activity in the final months of the year. The authorities are confident that a steady recovery of the global economy and a peaceful and stable environment, would boost the growth rate in the near future to its normal potential.

Fiscal Policy

Fiscal policy has a key role to play and the authorities will stand ready to continue fiscal consolidation in line with macroeconomic requirements and their declared objective of balancing the budget over the medium term (by 2005). Nevertheless, the authorities largely agree with the staff analysis on fiscal developments. But, while the government budget deficit projected by the staff for 2002 is 3.6 percent of GDP, the Ministry of Finance is estimating a lower fiscal deficit of 2.8 percent of GDP, taking into consideration the most recent information covering budgetary developments in the first 11 months of 2002 and decisions affecting the budgetary accounts for the full year. This revised figure is attributable mainly to the higher tax collections in the last part of 2002 that reflected faster economic growth, the implementation of the tax reform, and the transfer of the excess surpluses of two semi-governmental organizations to the central government. These transfers resulted from the better-than-anticipated profits of the two organizations and were made in accordance with the law on semi-governmental organizations requiring that surpluses above provisioning for development projects and programs be transferred to the Central Government. Thus, in the authorities' view the revised estimation of the fiscal deficit would suggest that the extent of the stalling in the fiscal consolidation process in 2002 was not as great as implied by the fiscal estimates and analysis of the staff.

Nevertheless, the authorities would subscribe to the staff's view that renewed efforts must be made to ensure that the momentum of fiscal consolidation is strengthened so as to attain the short- and medium-term budgetary targets. In this connection, general price subsidies to the consumer to cover increases in prices of imported energy products have been terminated, and efforts are being made to contain the overruns of expenditure on current transfers.

For the medium-term, the Ministry of Finance is giving serious consideration to establishing a multiyear fiscal framework, so as to link more closely the budgetary process with the macroeconomic objectives specified in the Pre-accession Economic Program and future convergence programs with the European Union. The authorities are determined to continue the fiscal consolidation, which will remain at the center of their economic strategy in the next years, reaffirming the commitment to eliminate the fiscal deficit by 2005.

The Cyprus authorities welcome and agree with the findings of the study on "Aging and Long-Term Fiscal Sustainability in Cyprus" in the Selected Issues paper that focuses on the significant impact of the aging Cyprus population on the public finances. The findings are in line with the latest actuarial report examining the longer-term financial viability of the social security funds. Indeed, this study will reinforce the efforts of the Cyprus authorities to take prompt action on pension reform so as to alleviate future pressures on public finances arising from demographic trends.

Monetary Policy

Monetary policy conduct has been prudent and the nominal exchange rate anchor has served the economy well. At the same time, the central bank remains committed to maintaining the firm stance, acknowledging, in broad agreement with staff's opinion, that the demanding challenges associated with the removal of remaining capital account restrictions are indeed significant and allow no room for complacency. Moreover, the authorities will stand ready to use their available policy tools (including exchange rate movements within the fluctuation band) to respond to capital flow volatility and other external shocks. The authorities expressed their intention, supported by staff, to join the euro area as soon as it is possible and appropriate.

Financial Sector

The banking sector has been strengthened considerably and banking legislation is now at a high degree of alignment with EU and international standards and progress has been achieved in all financial sector areas. The authorities have focused their efforts on strengthening the legal framework for effective supervision and further development of banking supervision practices, thereby creating preconditions for the stability of the financial system over the medium term. Also, new legislation is under preparation to strengthen supervision of Cooperative and Credit Societies, which will bring these institutions in full alignment with EU directives. Following the recommendations of the Offshore Financial Center (OFC) Assessment published in 2001, steps have been taken to address the mentioned vulnerabilities, as presented in the Box 4 of the staff paper. Furthermore, in order to enhance the efficiency of financial supervision over the medium term and ensure the central bank's access to the necessary information for fulfilling its macro-prudential surveillance, a memorandum of understanding was recently signed by the Central Bank, the Securities Commission and the Insurance Companies' Control Service of Cyprus. As such, the memorandum constitutes a significant step towards improving and strengthening the institutional arrangements in Cyprus and its main goal is the improvement of institutional cooperation with the view to discharge functions and responsibilities of these institutions in a more effective and efficient manner. Moreover, all banks are required by law to strengthen the institutional and monitoring capacity with regard to money laundering.

Other Issues

At the conclusion of the last Article IV Consultation, Directors recommended changes in the collection of balance of payments statistics as necessary step for a better monitoring and in line with steps of capital account liberalization. Since that time, the authorities have made significant efforts to bring balance of payments statistics in line with the most recent IMF standards and in line with Eurostat and ECB rules. As a result, a new BOP collection and compilation system is now in operation which has greatly enhanced both the coverage and comprehensiveness of statistics. Under the new settlements based system, domestic banks are reporting to the Central Bank of Cyprus all transactions taking place between residents and non-residents, based on the Fifth Edition of Balance of Payments Manual's definition of residency. The compilation takes place in full accordance with the IMF methodology. Quarterly data for 2002 onwards are being produced on a ''geographical level 1 plus each of the EU 15'' and have been communicated to the IMF as well as to Eurostat and the ECB. Cyprus has also participated with success in the 2nd Coordinated Portfolio Investment Survey conducted under the aegis of the IMF. Moreover, the authorities are aware that significant demanding work is still lying ahead and the picture in the area of external debt statistics, the reserve template and the International Investment Position has yet to be completed and, therefore, are determined to continue efforts to reach this goal as soon as possible.

Concluding, I would like to reiterate that the Cypriot authorities are determined to take the necessary actions to ensure macroeconomic stability both in the short and medium term. They are also committed to undertaking further steps required for full membership of the European Union.