

INTERNATIONAL MONETARY FUND



# **Staff Country Reports**

**Cyprus: 2004 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 2004 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 29, 2004, 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 28, 2005. 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 February 18, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 18, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Cyprus.

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

Selected Issues Paper and Statistical Appendix

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](mailto:publicationpolicy@imf.org).**

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
700 19<sup>th</sup> Street, N.W. • Washington, D.C. 20431  
Telephone: (202) 623-7430 • Telefax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund  
Washington, D.C.**

*This page intentionally left blank*

INTERNATIONAL MONETARY FUND

CYPRUS

**Staff Report for the 2004 Article IV Consultation**

Prepared by Staff Representatives for the 2004 Consultation with Cyprus

Approved by Alessandro Leipold and Anthony R. Boote

January 28, 2005

<b>Mission dates</b>	October 18–29, 2004
<b>Team</b>	T. Richardson (head), A. Westin, and H. Hatanpaa (all EUR)
<b>Fund issues</b>	Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions (Appendix I).
<b>Data</b>	The data in this paper refer only to the government-controlled areas in the south (the GC areas), except where otherwise noted. Statistics for the GC areas are generally of good quality and are adequate for surveillance, though some improvements are needed and subscription to the SDDS would be welcome (Appendix II): <a href="http://www.mof.gov.cy/mof/CyStat">www.mof.gov.cy/mof/CyStat</a> , <a href="http://www.centralbank.gov.cy">www.centralbank.gov.cy</a> . Statistics for the areas in the north that are not under the control of the Government of the Republic of Cyprus (the NGC areas) are thought to be very weak: <a href="http://www.devplan.org">www.devplan.org</a> .
<b>Outreach and publication</b>	The mission met with members of parliament, trade unions, industry and banks, as well as the academic community. The authorities released the mission's concluding statement and, while a final decision is pending, they intend to consent to publication of the staff report.

Contents	Page
Executive Summary .....	<a href="#">4</a>
I Background to the Discussions .....	<a href="#">5</a>
II. Recent Economic Developments .....	<a href="#">5</a>
III. Report on the Discussions .....	<a href="#">6</a>
A. Macroeconomic Outlook .....	<a href="#">7</a>
B. Fiscal Policy .....	<a href="#">8</a>
C. Monetary Policy and the Financial Sector .....	<a href="#">11</a>
D. External Sector and the Euro Adoption Strategy .....	<a href="#">13</a>
E. Structural Policies .....	<a href="#">15</a>
IV. Issues Related to the Reunification of Cyprus .....	<a href="#">16</a>
V. Staff Appraisal .....	<a href="#">18</a>
Boxes	
1. Response to Previous Fund Advice .....	<a href="#">7</a>
2. Convergence Program .....	<a href="#">9</a>
3. The “Annan Plan” to Reunify Cyprus .....	<a href="#">17</a>
4. Prospects for IMF TA to the T/C Community .....	<a href="#">18</a>
Figures	
1. Macroeconomic Indicators, 1990–2004 .....	<a href="#">21</a>
2. Growth and Tourism, 1993–2004 .....	<a href="#">22</a>
3. Central Government Finances, 1993–2003 .....	<a href="#">23</a>
4. Monetary Conditions, 1998–2004 .....	<a href="#">24</a>
5. Competitiveness Indicators, 1990–2004 .....	<a href="#">25</a>
Tables	
1. Selected Indicators, 1999–2005 .....	<a href="#">26</a>
2. Balance of Payments, 1999–2008 .....	<a href="#">27</a>
3. Central Government Accounts, 1999–2005 .....	<a href="#">28</a>
4. Monetary Survey, 1999–2004 .....	<a href="#">29</a>
5. Medium-term Macroeconomic Framework, 2004–08 .....	<a href="#">30</a>
6. Vulnerability Indicators, 1999–2004 .....	<a href="#">31</a>
7. Financial Soundness Indicators for Banks, 1999–2004 .....	<a href="#">32</a>
8. Indices of Competitiveness in Tourism Sector, 2003 .....	<a href="#">33</a>
Annexes	
I. Medium-term Sustainability Analysis .....	<a href="#">34</a>
II. Economy of the Areas Not under Government Control (NGC) .....	<a href="#">38</a>

Appendices

I.	Fund Relations .....	<a href="#">40</a>
II.	Statistical Issues .....	<a href="#">42</a>

## EXECUTIVE SUMMARY

**Joining the European Union in May 2004 was a signal event for the Cypriot economy**, with adaptation to EU institutions and regulations bringing forward many important reforms. Though these changes have posed significant challenges for the authorities and the private sector, they have also set the stage for enhanced economic growth.

**After a period of relatively weak growth, the economy began to rebound in 2004**, with real GDP growth now expected at 3.5 percent for 2004 and 3.8 percent for this year. Unemployment remains low and—despite some recent pressures stemming from oil prices—inflation is subdued.

**Fiscal consolidation is the key macroeconomic challenge currently facing Cyprus**, given slippages in recent years and the authorities' ERM2 ambitions. Demographic pressures over the medium term also underscore the importance of bringing down the debt ratio. If assiduously implemented, the consolidation strategy laid out in the Convergence Program, which contains several politically difficult but essential measures, would put Cyprus back on the road to fiscal sustainability. Over the medium term, policy credibility would be buttressed by establishing an explicit multi-year fiscal framework. The authorities' interest in a fiscal ROSC is welcome.

**Cyprus appears well-placed to join ERM2 in 2005 as intended**, provided that the fiscal adjustment effort is resolutely maintained and structural reforms continue to advance. The long-standing use of an ERM2-type exchange rate regime provides continuity, and the current parity seems broadly in line with fundamentals, given continued full employment and the rebound in tourism.

**More remains to be done on the structural reform agenda**, despite the fact that Cyprus has made significant strides to meet the requirements of the EU. In particular, there is a need to foster competition and promote efficiency, including in the public enterprise sector. In labor markets, the centralized wage bargaining system needs to be reformed to enhance competitiveness. Although financial sector regulation is generally strong, supervision of the cooperative sector should be strengthened. The authorities are encouraged to undertake a Financial Sector Assessment (FSAP).

**IMF activities, including technical assistance, could help support reunification** and contribute to improving the living standards of all Cypriots. The authorities' consent to provide IMF technical assistance to the Turkish Cypriot community in northern Cyprus could help establish a baseline for advancing all of Cyprus toward best practices in a number of areas.

## I. BACKGROUND TO THE DISCUSSIONS

1. **For the past few years, Cypriot politics have been dominated by EU accession and attempts to reunify the country**, issues that are linked in complex ways. A divided Cyprus joined the EU on May 1, just a week after the rejection of a UN-sponsored referendum on the “Annan Plan” for reunification. Although Turkish Cypriots (T/C) approved the plan by a margin of 2:1, Greek Cypriots (G/C) opposed it by 3:1, citing concerns over proposed security arrangements, potentially large fiscal costs, and the perceived hasty preparation of some aspects of the plan. (Issues related to the T/C community are taken up in section IV.)

2. **The Cypriot authorities need to deliver a strong fiscal adjustment if they are to succeed in their objective of early euro adoption.** The Minister of Finance has shown particular determination in this regard, despite pressures on the center-left governing coalition from traditionally strong trade unions. President Papadopoulos of the centrist DIKO party was elected in February 2003 and rules in coalition with the socialist AKEL, the largest party in Cyprus.

## II. RECENT ECONOMIC DEVELOPMENTS

3. **Growth has begun to rebound following the relatively weak performance of 2002–03**, recovering in real terms to about 3½ percent in 2004 (Figure 1). The recovery has been led by consumption, fed by fiscal easing (particularly in late 2003) as well as a possible confidence effect from EU accession, but with a drag from net exports. Driven by a stronger European economy, tourism has picked up, though per-tourist spending appears to have remained sluggish (Figure 2 and Table 1). Unemployment remains very low by European standards, while inflation has crept up modestly on rising energy prices. The current account deficit has oscillated between 3½ and 4½ percent of GDP for several years, and is likely to have remained on that order in 2004 (Table 2).

4. **Reversing considerable fiscal slippage is the main challenge to the authorities’ objective of early euro adoption.** The general government deficit deteriorated from

2.3 percent of GDP in 2001

to 6.3 percent of GDP

in 2003, driven in the first

instance by overruns on

current expenditure.

Improved revenue

performance associated with

the 2002–03 tax reform was

more than offset by

increased social spending to

compensate for VAT rates

that were raised to the EU

minimum of 15 percent,

contributing to an increase in the expenditure-to-GDP ratio of more than 7 percentage points

since 2000 (Figure 3 and Table 3).

Cyprus: General Government, 2000-05  
(in percent of GDP)

	2000	2001	2002	2003	2004 est.	2005 proj.
Revenue	35.3	36.6	36.1	39.1	39.0	40.2
<i>of which</i>						
Taxes	23.8	24.6	24.7	26.2	27.2	27.5
Social contributions	6.7	6.9	6.8	7.1	7.1	7.2
Expenditure	37.7	38.9	40.6	45.4	43.8	43.2
<i>of which</i>						
Current expenditure	34.1	35.4	37.0	41.4	41.0	40.4
Gross fixed capital formation	3.0	3.0	3.0	3.4	2.4	2.3
Overall balance	-2.4	-2.3	-4.5	-6.3	-4.8	-3.0
Primary balance	1.1	1.1	-1.3	-2.8	0.4	2.2

Sources: Ministry of Finance; 2004 Convergence Program; and staff estimates.



**5. The debt-to-GDP ratio has continued to diverge from the Maastricht threshold, rising to almost 70 percent**

**in 2003.** Some of the increase in indebtedness is due to stock-flow adjustments, rather than above-the-line deficit-inducing transactions. The bulk of these adjustments stem from the accounting treatment of sinking funds that until 2003 were required under domestic law in order for the government to place long-term domestic currency bonds.<sup>1</sup>

Cyprus: Stock-Flow Adjustments  
(in percent of GDP)

	2000	2001	2002	2003
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	0.6	0.2	0.5	0.7
2. Adjustments in liquid assets	2.4	3.8	0.8	1.8
3. Adjustments in shares and other equity	-0.7	0.0	0.0	0.0
4. Exchange rate adjustment	0.1	0.0	0.2	0.1
<b>STOCK-FLOW adjustment</b>	<b>2.4</b>	<b>4.0</b>	<b>1.5</b>	<b>2.5</b>

Sources: Ministry of Finance

**6. Monetary policy has remained vigilant in the face of continued fiscal laxity and completion of capital account liberalization on May 1.** Modest but persistent outflows in the weeks leading up to EU accession—exacerbated by the uncertainty attending the UN referendum—led the Central Bank of Cyprus (CBC) to act decisively on April 30, 2004 (Figure 4 and Table 4). It successfully calmed the market when it hiked policy rates by 100 b.p. – bringing them to 250 b.p. above the corresponding euro area policy rates. Although this monetary tightening came on top of the Cypriot pound’s appreciation in 2003 (versus the U.K. pound and the U.S. dollar), market participants in Cyprus were almost unanimous in praising the move. Given that inflation has crept upward on higher oil prices, the CBC has left rates high since April, despite some appreciation and capital inflows, as well as an increase in borrowing abroad.

### III. REPORT ON THE DISCUSSIONS

**7. The need for credible fiscal adjustment and the strategy for adopting the euro were recognized to be the key challenges facing the government.** The widening fiscal deficit of recent years triggered an EU excessive deficit procedure shortly after accession. Cyprus aspired to be part of the first wave of new members to adopt the euro, but was not among the group that joined ERM2 in June 2004, and is now looking to join in the first part of 2005. In this context, the discussions also emphasized external competitiveness, medium-term external and fiscal sustainability, and the structural reforms required for strong performance in a monetary union.

<sup>1</sup> The government was required to set aside money to repay the bonds in the future, which it would accomplish mainly by borrowing from the central bank, thus increasing the gross (but not the net) debt. The Central Bank became independent in July 2001, after which the government borrowed from commercial banks. The sinking funds will be extinguished by 2008, but will contribute to the stock-flow adjustment until then.

### **Box 1. Response to Previous Fund Advice**

The authorities have generally concurred with the thrust of IMF policy advice, including the need for fiscal consolidation, structural reforms, and improvements in financial sector supervision. Nevertheless, implementation of this advice has been appreciably better when reinforced by EU directives.

**Fiscal policy:** Apart from 2004, slippage in achieving fiscal adjustment targets has occurred in each of the past several years, due mainly to the growth in current spending, despite Fund calls to tighten the fiscal stance. Staff suggestions to establish a medium-term fiscal framework have also not yet been taken up, owing partly to limited capacity, as institutions strived to comply with the requirements of EU accession.

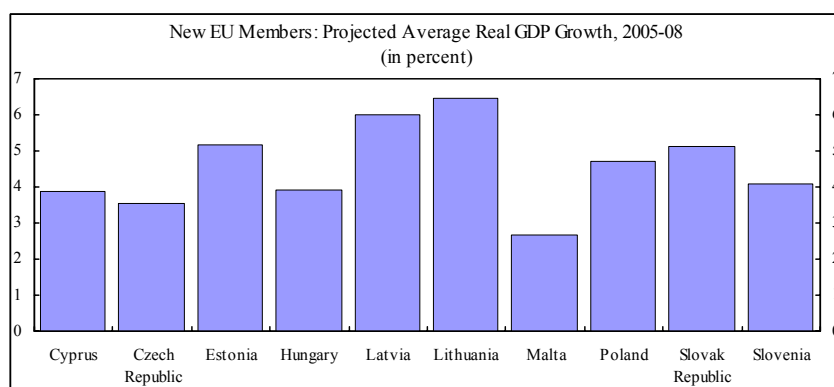
**Financial sector:** Compliance with EU directives has induced interest rate liberalization and some financial sector reforms in line with IMF advice. For example, coordination among different supervisory bodies has been stepped up, though there is still room for improvement in this area (including the need to align prudential regulations for the cooperative sector with those faced by the banks).

**Structural policies:** Backward-looking wage indexation remains a fixture of Cypriot labor relations, notwithstanding IMF concerns that it builds in significant rigidities. At the same time, there has been significant progress with liberalization of air travel, electricity and the telecommunications sector.

### **A. Macroeconomic Outlook**

8. **Near-term growth prospects were jointly viewed as broadly positive.** Real GDP growth in 2004 is estimated at about 3½ percent, and staff projects growth of 3.8 percent for 2005, close to the authorities' forecast of 4 percent. The authorities saw more robust growth being driven by an improved external environment, as well as confidence effects following EU accession. At the same time, they also recognized several downside risks to the forecast. If sustained, higher oil prices could slow growth in Europe and drive up air travel costs, thereby dampening tourism demand. Moreover, geopolitical uncertainties in the region could divert some travelers to other destinations. Despite pressures coming from higher energy prices (which could be exacerbated via pass-through to wages given widespread indexation), inflation was expected to remain in the neighborhood of 2½ percent as a result of the continued restrained stance of monetary policy. Unemployment was jointly seen as holding steady at around 3½ percent, with foreign workers (about 13 percent of the labor force) acting as a buffer.

9. **Medium-term growth prospects are subject to a high degree of uncertainty**, given a lack of clarity on the reunification issue, as well as on the ultimate impact of EU accession.<sup>2</sup> The authorities' medium-term projections are somewhat more optimistic than those of staff, who project growth to average about 4 percent during 2006–08, predicated on a durable recovery in the EU and some moderation in oil prices (Table 5).



## B. Fiscal Policy

10. **In May 2004, the authorities adopted an ambitious and detailed Convergence Program (CP) aimed at redressing the fiscal slippage of recent years** (Box 2 and Table 5). The CP targeted a significant adjustment (to a deficit of 5.2 percent of GDP) in 2004 and an even more substantial retrenchment (to 2.9 percent of GDP) in 2005, with further tightening to take place in the out-years. Staff welcomed a number of politically difficult measures in the program, including a significant increase in public sector retirement ages and a freeze on new government positions. At the same time, the authorities were keenly aware that their fiscal performance would be judged against the backdrop of recent failures to deliver fiscal adjustment under successive Pre-Accession Economic Programs, and recognized that they could not afford another episode of slippage.

General Government Budget Balance: Program Targets and Outcomes, 2001-08

	2001	2002	2003	2004	2005	2006	2007	2008
2001 Pre-Accession Program	-2.2	-1.9	-0.4	-0.1	...	...	...	...
2002 Pre-Accession Program	...	-2.6	-1.9	-0.6	-0.3	...	...	...
2003 Pre-Accession Program	...	...	-5.4	-3.7	-2.8	-2.2	...	...
2004 May Convergence Program	...	...	...	-5.2	-2.9	-2.2	-1.6	...
2004 Dec Convergence Program	...	...	...	-4.8	-2.9	-1.7	-1.5	-0.9
Actual budget balance 1/	-2.3	-4.5	-6.3	-4.8	...	...	...	...

Sources: Ministry of Finance, 2001-03 Pre-Accession Economic Programs and 2004 Convergence Programs; and staff estimates.

1/ 2004 is an estimate.

<sup>2</sup> Staff projections assume neither a settlement to the “Cyprus problem” nor a significant fallout from the lack of one.

## Box 2. Convergence Program

According to the revised Convergence Program of December 2004, expenditure measures dominate the first year while revenue measures are more prominent in 2005. Although the new CP is more ambitious than the May version, it is less specific about the expected yield of measures in 2006 and beyond. Policies that are expected to have an impact over the medium term include: the tax amnesty and its expected widening of the tax base; regularization of the dividend policy for semi-government organizations; and collecting fees for issuance of title deeds for buildings with minor irregularities.

The CP is characterized by a large number of, in many cases, relatively small measures. This may be viewed as a form of “diversification,” ensuring the headline outcome is delivered in the event some measures do not pass. However, there is also a risk in reliance on a large number of small measures—both in terms of administrative complexity and because of the cumulative effect of even a little optimism in the calculation of the yield from each one.

Budgetary Impact 2004-05 (as percent of GDP)

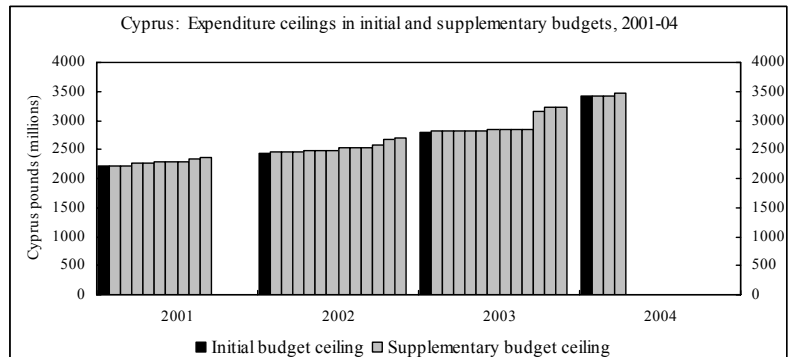
Measures	Status	2004	2005
<b>Revenue measures -- total</b>		<b>0.0</b>	<b>1.9</b>
Introduce land improvement fees for zoning changes	Study being prepared	...	...
Increase land and survey fees for title deeds, mortgaging, etc.	Bill to be submitted	...	0.1
Introduce taxation on non-developed land inside Town areas	Study being prepared	...	...
Introduce mobile phone tax	Under negotiation	...	0.1
Improve tax administration	Partly implemented	...	0.1
Introduce legislation on bank secrecy and tax amnesty	Implemented	...	0.6
Amend title deed legislation for cases with minor irregularities	Partly implemented	...	0.4
Regularize dividend policy for public enterprises	Under negotiation	...	0.6
Improve utilization of government property	Study to be prepared	...	...
<b>Expenditure measures -- total</b>		<b>1.2</b>	<b>0.9</b>
Freeze on new government positions	Implemented in 2005 budget	...	0.1
Wage freeze	Under negotiation	0.2	0.2
Limit increase in current spending in 2005 to 3%	Implemented in 2005 budget	...	...
• Agricultural subsidies - abolish pre EU-accession aid		...	...
• Freeze grants to public enterprises		...	...
Limit increase in capital spending in 2005 to 4%	Implemented in 2005 budget	...	...
Contain defense spending	Implemented	1.0	...
Contain increase in transfers (pensions, allowances) to inflation	Implemented in 2005 budget	...	0.2
Abolish unemployment benefit for public sector retirees	Study being prepared	...	...
Raise retirement age for public employees from 60 to 63	Under negotiation	...	0.2
Raise retirement age limit for Soc. Ins. Fund from 63 to 65	Under negotiation	...	0.2
Harmonize public ent. pension scheme with private sector	Not yet implemented	...	...
Contain public sector overtime compensation	Status unclear	...	...
Introduce specific eligibility criteria for social benefits	Proposal being prepared	...	...
<b>Total impact of measures</b>		<b>1.2</b>	<b>2.8</b>

Source: Convergence Programme of the Republic of Cyprus, 2004-08 ([www.mof.gov.cy](http://www.mof.gov.cy))

11. **The authorities cited preliminary data for 2004 as evidence that the need for fiscal prudence is taking hold.** After 10 months, the central government posted a deficit of about 3 percent of GDP, and the authorities were confident they would overperform relative to the deficit target in the May CP (achieving a deficit for the year of about 4¾ percent of GDP). As a result, in December they approved an update to the CP that is more ambitious than the May program. Most of the budgetary improvement in 2004 stemmed from better revenue performance—especially VAT and excises—though delayed public investment also played a role.<sup>3</sup> In each of the

past few years, fiscal slippage has occurred when the initially-approved budget was repeatedly amended during the year.<sup>4</sup> However, in 2004, the finance minister pointedly rejected a large supplemental budget in July, and has generally resisted

calls to loosen the stance since then.<sup>5</sup> With the support of the president, he has continued to press for public sector wage restraint, arguing that to do otherwise would undermine chances of adopting the euro. At the same time, the trade unions, while professing only lukewarm support for early euro adoption, complained to the mission that the CP had been approved without consultation, and that labor was meant to shoulder a disproportionate share of the adjustment burden.



12. **Looking forward, staff found that the CP measures—if fully implemented—should yield the authorities’ targeted improvement in public finances.** The 2005 deficit, in particular, would fall to about 3 percent of GDP, assuming all of the CP measures are passed and scrupulously implemented. The authorities recognized the existence of downside risks, including the fiscal impact of higher oil prices and a conceivable slowdown in tourism in the event of further geopolitical tensions in the region.<sup>6</sup> In this regard, they agreed to take additional measures if the CP seems unlikely to yield the programmed adjustment profile. For

<sup>3</sup> Preliminary data suggest that some of the CP measures are having a greater effect than originally expected; the tax amnesty, for instance, had yielded £C60 million (0.8 percent of GDP) by early December—well beyond the original projection.

<sup>4</sup> For example, the figure above shows that the 2003 budget initially passed by parliament and signed into law was amended twelve times during the year. In 2004, it was amended only three times.

<sup>5</sup> Only one significant supplementary budget has passed in 2004. Consistent with the new deficit target, a C£60 million appropriation for agricultural subsidies (among other things) was approved in November.

<sup>6</sup> The authorities estimate that sustained high oil prices could worsen public finances by about 0.2 percentage points of GDP relative to the baseline deficit path.

its part, the mission proposed: better targeting of social benefits; more aggressive collection of tax arrears; widening the tax base to ensure full coverage of sectors currently subject to preferential treatment (such as commercial businesses owned by the church or the cooperatives); further broadening and revision of fees for government services; and if necessary, a further increase in the VAT rate from the current EU-minimum of 15 percent (relative to an EU-average standard rate of 19.4 percent). The authorities indicated that they would be prepared to consider most of these measures. (For example, the December CP proposes tighter eligibility criteria for social benefits.)

13. **Medium-term fiscal sustainability depends strongly on the implementation of the convergence program.** Under the CP, public debt is set to decline rapidly toward 60 percent of GDP from 2005 onward (Annex I), while without the CP measures the authorities recognize that the debt might quickly achieve unsustainable levels. Projected health and pension outlays underscore the urgency of implementing the CP, which proposes significant (but politically difficult) parametric reforms to both the public and general pension systems.<sup>7</sup>

14. **The authorities seem willing to consider a medium-term fiscal framework.** They recognize that the Cypriot budget system—including the practice of frequent revisions to spending ceilings in the form of supplementary budgets—is outmoded, and they are likely to request a fiscal ROSC during 2005.

### C. Monetary Policy and the Financial Sector

15. **The authorities confirmed their intention to maintain a cautious stance of monetary policy.** Credit growth slowed in 2002–03 (falling to 5–6 percent per annum from an average of over 13 percent during 1999–2001), and is expected to rebound slightly in 2004–05. The authorities noted that inflationary pressures had crept up during the summer on higher oil prices, and that ongoing uncertainty in this regard made it inappropriate to relax policies at this time. Staff agreed with this approach, particularly in view of the authorities' plans to participate in ERM2 in the course of 2005.

16. **The authorities have adopted a number of measures to bring financial sector regulations in line with EU norms, and prudential regulation seems solid.** Securities market supervision has been strengthened following the stock market crash of 2000, as disclosure rules and listing requirements were made more stringent. Similarly, the insurance sector has witnessed some consolidation following introduction of new EU-compliant legislation in January 2003.<sup>8</sup> In the financial sector, minimum reserve requirements on foreign currency deposits have been raised, while the need for provisioning has increased, as the

---

<sup>7</sup> Without measures, health and pension spending could rise by 4–5 percent of GDP over the medium term. (See IMF Country Report No. 03/31, Chapter II.)

<sup>8</sup> Tougher supervision and higher minimum capital requirements have led some insurance companies to close, while licenses have been withdrawn from four others over the last two years.

threshold for declaring an overdue loan to be nonperforming is being reduced (from 12 to 9 months in 2003, 6 months in 2004, and to 3 months in 2006). As a result, NPL ratios—already high because of weak recovery rules—have risen modestly (Tables 6 and 7).<sup>9</sup> Nevertheless, prudential oversight seems strong, and the ratings of key Cypriot banks remain above investment grade.

**17. Staff viewed bifurcated supervision of the financial sector as source of vulnerability.** Despite holding a quarter of the financial system's deposit base, the cooperative and credit societies (CCSs) continue to fall outside the CBC's supervisory remit and they face a tax and regulatory regime that is very lenient compared with that of banks. The CCSs specialize in mortgage lending and small retail loans—all of which are said to be collateralized.<sup>10</sup> Many of the CCSs are undercapitalized, though they are to be brought into alignment with the relevant EU directives by the end of a 5-year transitional period. They are supervised by a special institution (the Cooperative Societies Supervisory and Development Authority) that must liaise with the CBC, but the locus of lender-of-last-resort responsibilities remains unclear. The CBC—and private banks—concurred with staff that supervision of financial institutions should be consolidated in one institution, though the cooperative sector itself disagreed, arguing that coordination among supervisory bodies was already adequate.

**18. Other potential vulnerabilities for the financial sector include interactions with the offshore sector and a run-up in real estate prices.** Tax preferences for offshore institutions were phased out on January 1, 2003,<sup>11</sup> and the reputation of the sector has improved since the 2001 OFC assessment.<sup>12</sup> Staff expressed some concern about the fact that real estate prices have strengthened (rising by about 7 percent in 2004) and related lending has been robust.<sup>13</sup> As of end-August 2004, 17 percent of outstanding credit pertained to the construction sector and another 44 percent to the household sector, most of which is for mortgages.<sup>14</sup> Nevertheless, the mission welcomed the CBC's issuance of a circular in late 2003 tightening collateral requirements for real estate lending, as well as the fact that they

---

<sup>9</sup> The authorities reported that recovery of a nonperforming asset takes about 10 years on average, as against 6-9 months in many other EU members.

<sup>10</sup> The availability of prudential data on the CCSs is limited, even to the authorities. Thus, there is no reliable data on their NPL or recovery ratios, and a uniform provisioning policy is not possible at present.

<sup>11</sup> Offshore institutions that were operating in Cyprus at end-2001 were grandfathered until end-2005.

<sup>12</sup> MFD plans to update the 2001 OFC Assessment in early 2005, after which the authorities plan to request an FSAP.

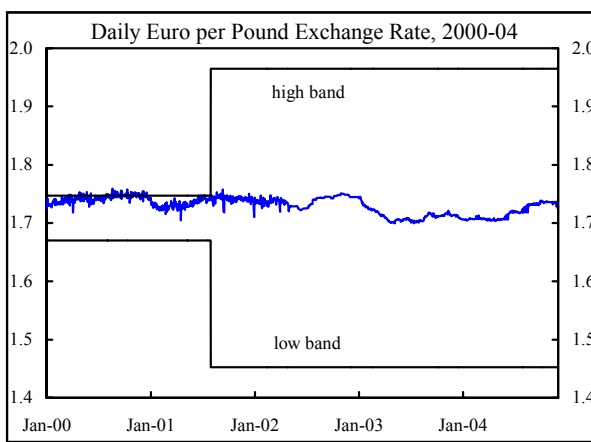
<sup>13</sup> However, a reliable real estate price index is only now under development by the statistical service.

<sup>14</sup> During the first eight months of 2004, 57 percent of new credit to households and the self-employed was used to finance house purchases.

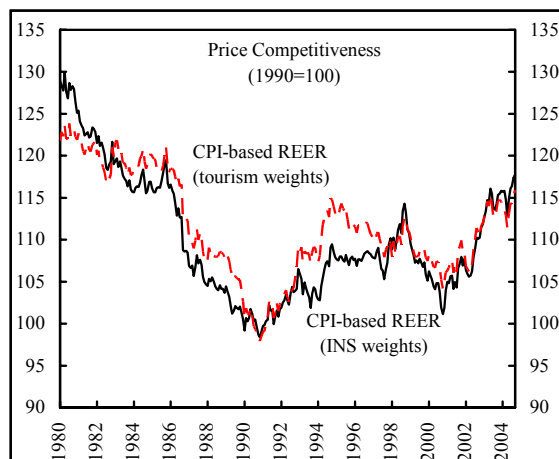
had sounded a similar note of caution in the statement following the September Monetary Policy Committee meeting.

#### D. External Sector and the Euro Adoption Strategy

19. **The authorities reiterated their intention of adopting the euro as soon as possible, including by joining ERM2 in the first part of 2005.**<sup>15</sup> While mindful of the concern that a prolonged stay in ERM2 could pose risks, the authorities emphasized that Cyprus has long employed an exchange regime similar to ERM2 (i.e., a formal  $\pm 15$  percent corridor, but with movements that for years have stayed within a de facto narrow band around the central parity of €1.7086 : £C1). They noted that a move to a new regime (say, inflation targeting) would send confusing signals to the market. Moreover, they emphasized that the near-term target of ERM2 participation would help forge political will in favor of fiscal adjustment, while the current juncture—with the governing coalition safely in power through 2006—afforded a favorable political economy setting for reforms. Staff supported the authorities' euro adoption strategy, conditional on their stated readiness to take additional fiscal measures should the CP yield less adjustment than programmed. For successful performance in EMU, there would also be a need for strengthened structural reform efforts (Section E).



20. **The authorities viewed the current exchange rate parity as appropriate.** They acknowledged that there had been modest competitiveness losses over the past two years, and that Cyprus had lost some market share to cheaper tourism destinations in the Mediterranean (Figure 5).<sup>16</sup> At the same time, they emphasized that, viewed over a longer horizon, the real effective exchange rate remains near its historic equilibrium level. While exports of goods have continued a secular decline over many years (and now comprise less than a quarter of total exports), exports of services—particularly nontourism (e.g.,



<sup>15</sup> ERM2 procedures are well-advanced in European institutions, but it is unlikely that Cyprus will join before the spring of 2005 (possibly with Latvia).

<sup>16</sup> The ULC-based REER index (with tourism weights) has appreciated by 13 percent since 2002.



financial and legal) services—have held up well.<sup>17</sup> While yielding ground on price to lower-cost destinations such as Egypt and Tunisia, Cyprus remains relatively competitive regarding various other aspects of tourism quality (Table 8). Staff noted that—although the 2002–03 decline in tourism arrivals was reversed in 2004 (rising by 3 percent year-on-year to end-October)—tourism *spending* has been sluggish. In response, the authorities pointed to a possible measurement problem with the data on spending, as there are also indications of very robust spending by individuals holding foreign credit cards.

**21. Staff agreed that the parity appeared to be broadly in line with fundamentals, given that the economy is near full employment and the reserve position remains strong.** Over the past decade, the real exchange rate has appreciated against the euro, but average real growth rates in Cyprus have far outstripped those of the euro area, suggesting real convergence effects have been significant.<sup>18</sup> In this context, staff noted that the Cypriot growth differential versus the euro zone had fallen in 2002–03, while inflation had exceeded that of the euro area. However, staff agreed with the authorities that exchange rate pass-through effects would quickly erase any competitive gains from a change in the parity, and that fiscal adjustment and deeper structural reforms were more appropriate ways to enhance competitiveness.

**22. Medium-term external sustainability scenarios indicate that shocks of plausible magnitudes would leave Cyprus in a relatively comfortable position.** While staff sounded a note of caution regarding the growing burden of external liabilities, the authorities noted that for now Cyprus can clearly finance modest current account deficits, given its strong growth record and EU membership (Annex I). At the same time, they recognized the need over the medium term to reduce the external imbalance. They also pointed to a sovereign Eurobond placement of €500 million during the summer—priced at 23 b.p. over the comparable German bund benchmark—that was significantly oversubscribed.

**23. Cypriot trade policy has been gradually brought in line with EU requirements, and the impact of adopting the EU common trade policy is likely to be limited.** The effects of removing tariffs on imports resulted in moderate revenue loss, while the application of EU tariffs on imports originating from outside the EU had only a marginal impact on revenues, given that average tariffs in Cyprus were already close to those applied in the EU. However, the agricultural sector that has been previously protected by high tariffs will need to adjust to the new environment governed by the Common Agricultural Policy. To ease this adjustment, Cyprus was granted a transitional period to provide certain supplementary state aid to farmers until 2010. The forthcoming elimination of Multi-Fiber Agreement quotas is expected to have only a modest impact on Cypriot exports, as the share of textiles and

---

<sup>17</sup> However, recent revisions to the balance of payments methodology make it difficult to assess underlying developments in the services account.

<sup>18</sup> See the selected issues paper for this consultation, as well as IMF Country Reports 03/31 and 98/98.

clothing in total exports has already declined considerably (from over 20 percent in 1998 to less than 10 percent in 2003), with the remaining exports typically concentrated in certain niche markets.

### **E. Structural Policies**

24. **The need to be in compliance with the EU's *acquis communautaire* has prompted the authorities to undertake a number of important structural reforms.** For example, air transport was liberalized on May 1, 2004, while liberalization of the electricity sector was advanced through the establishment in April 2004 of an independent Transmission System Operator (to ensure nondiscriminatory access to the network). As a result, the number of airlines flying to Greece and the UK has increased and airfares have fallen, while electricity cross-subsidization (of households by industry) has been reduced. A few remaining price controls (cement and petroleum products) were abolished in May 2004, while water management is being enhanced through higher prices to encourage conservation and cost recovery.

25. **The authorities were not prepared to push ahead with comprehensive public enterprise reform.** About 8 percent of GDP is produced in the public enterprise (PE) sector, with the main PEs being the Electricity Authority, Cyprus Telecom, and Cyprus Airways, of which only the latter is incorporated.<sup>19</sup> The authorities reported that they were considering options to restructure the airline, which now faces heightened competition from other European carriers, including the possible privatization of one of its subsidiaries. However, the authorities did not agree with staff on the need to modernize corporate governance of the PEs through corporatization (much less privatization, which is firmly opposed by the trade unions).

26. **The authorities considered that the present wage bargaining framework had worked well and ensured harmonious labor relations.** Consequently, they were not ready to consider staff proposals to revise the automatic backward-looking wage indexation (COLA) system. Staff noted that—with ERM2 and (potentially) euro adoption in the offing—medium-term prospects for low inflation were excellent. As a result, the present juncture may afford a window of opportunity to eliminate this structural rigidity (if only partially by removing energy costs and changes in the VAT from the COLA calculations).<sup>20</sup> While unpersuaded by these arguments, the authorities were cognizant of the tendency of real wage growth to outstrip gains in productivity, and generally agreed with staff advice to limit increases beyond the COLA. However, politically-powerful social partners—including in particular the left-of-center trade union PEO (aligned with ruling coalition member AKEL)—

---

<sup>19</sup> As of end-2003, the government had guaranteed about 3½ percent of GDP in PE debt, mostly for the electricity authority (out of total government guaranteed debt of about 10 percent of GDP).

<sup>20</sup> See the selected issues paper for this consultation.

saw neither the need for increased labor market flexibility nor even for real wage growth to match productivity gains.

27. **A key labor market issue is the impact of opening the “green” line separating northern and southern Cyprus.** At present, estimates of the number of Turkish Cypriots traveling to work in the south daily through the three crossing points range from 2,300-10,000 (with the correct figure probably in the middle). But proposals to expand the number of crossing points substantially raise the prospect that T/C workers could eventually compete with their G/C counterparts in significant numbers. The authorities felt that further expansion of T/C employment in the government-controlled areas would be possible without dislocations, given very low levels of unemployment and the possibility of scaling back the present guest-worker program.

#### IV. ISSUES RELATED TO THE REUNIFICATION OF CYPRUS

28. **There continues to be international interest in finding a solution to the thirty-year old “Cyprus problem.”** Since the partition of the island in 1974, IMF Article IV consultations have been conducted with the government of the Republic of Cyprus, the recognized government of the member. They have thus not covered the areas in the north not under government control (NGC).<sup>21</sup> However, in early 2004, under UN auspices, IMF staff participated in background work for the negotiations leading to the “Annan Plan” (see Box 3), providing technical advice on a macroeconomic framework for the unified country, as well as on fiscal management and banking system reform. In this, staff collaborated with officials of the UN, other IFIs, bilaterals, and the G/C and T/C sides, visiting both parts of Cyprus. After rejection of the “Annan Plan” by Greek Cypriot voters in the referendum of April 2004, the international community has sought to reduce the isolation of Turkish Cypriots, including through provision of aid and technical assistance. The EU is in the process of approving an aid package of €259 million for 2005–07 that would emphasize infrastructure and technical assistance in support of compliance with the *acquis*, while the United States has appropriated \$31 million for energy, banking sector reform, and small and medium-size enterprise development. Absorption is an issue, however, as these two aid packages sum to about 1/4 of estimated 2003 GNP in the NGC areas.

29. **During the UN negotiations, it became clear that the paucity of authoritative macroeconomic data on the NGC areas has complicated prospects for reunification.** During the mission staff was unable to collect data and hold discussions on the economy of the north. The authorities were concerned that such contacts might be seen as a first step toward a separate consultation, and might be construed as a form of recognition of the NGC areas. The issue of staff conducting analytical macroeconomic work on the economy of the NGC areas was also raised in the context of discussions on possible provision of IMF TA to the T/C community (Box 4).

---

<sup>21</sup> On this occasion, summary information on the economy of the NGC areas, based on publicly available sources, is included in Annex II.

### Box 3. The “Annan Plan” to Reunify Cyprus

Cyprus has been divided since 1974, with Greek Cypriots (G/C) in the south and Turkish Cypriots (T/C) in the north, separated by a ½ mile-wide buffer zone. Over a number of years, the UN has sponsored a series of reunification talks under the good offices of the Secretary General, leading to the opening of border crossings in 2003 and partial agreement on aspects of a settlement—the *Annan Plan*—that envisaged a “bicommunal, bizonal federation” entitled the United Cyprus Republic (UCR). The UCR would be comprised of two constituent states with a federal structure.

Motivated by a desire to see a united Cyprus join the EU on May 1, all parties agreed in February 2004 to a timetable envisaging completion of the talks by end-March. In the event, a comprehensive solution was not achieved, but the February agreement included a provision according to which the Secretary-General would fill in the missing elements of the “Foundation Agreement,” which would then be put to simultaneous referenda on April 24.\*

The proposed agreement attempted to address harmonization of policies and institutions with the EU, restitution of property and population relocation, and security concerns on both sides. A new central bank was to be created and a budget systems law enacted. Under the plan, up to 20 percent of the G/C population would have the right—over 18 years—to return to their pre-1974 communities in the north, and a number of people now living in the NGC areas would need to be compensated for the loss of their homes.

During the Article IV mission, the authorities explained that they did not view the Annan Plan as economically and financially viable and pointed to a number of institutional arrangements proposed under the plan that they viewed as being detrimental to macroeconomic stability, including:

- *Insufficient fiscal capacity of the federal government*, which might be called upon to guarantee the debt of the two constituent states (despite the absence of an internal “stability pact” to limit the size of budget deficits);
- *Ambiguity regarding the framework for monetary policy*—including political appointees to the monetary policy committee, the role of the T/C branch of the new central bank, and whether or not the Cypriot pound would be replaced by a new currency; and
- *Large uncertainty about the need for fiscal transfers to the north*—including the possible need to recapitalize T/C banks—as well as uncertain prospects for international donors to help finance the process.\*\*

While recognizing the existence of some risks, the staff’s view—as set out in a statement to a donors’ meeting prior to the referendum—was that, with firm implementation and goodwill on both sides, the plan was economically and financially viable.

\* See [www.AnnanPlan.org](http://www.AnnanPlan.org).

\*\* The authorities estimate the cost of rebuilding infrastructure in the north at £C5 billion (69 percent of 2004 GDP in the G/C areas).

#### **Box 4. Prospects for IMF TA to the T/C Community**

Following rejection of the Annan Plan in April, representatives of the T/C community inquired about the possibility of IMF technical assistance (TA) in the Fund's areas of competence. They were informed that—consistent with the Articles of Agreement—staff could only do so with the consent of the government of the Republic of Cyprus, the recognized government of the member.

Prior to and during the mission, staff sought this approval, positing that IMF TA to the T/C community would be in the best interest of all Cypriots, and aiming to reach an understanding that would reassure the G/C side on the sovereignty question while also being sensitive to T/C concerns about confidentiality of data provided to TA missions. The G/C authorities agreed with staff on the need to improve economic management in the NGC areas, and discussions with them are continuing on a framework under which IMF TA could be brought to bear on these problems.

### **V. STAFF APPRAISAL**

#### **30. Joining the EU in May 2004 was a signal event for the Cypriot economy.**

Adaptation to European Union institutions and harmonization with the *acquis communautaire* have brought forward many welcome—and in some cases long-overdue—reforms. For example, the capital account has been liberalized in line with EU directives, while financial sector legislation has been strengthened. Though these changes have posed significant challenges for the authorities and for the private sector, they have also laid a foundation for enhanced economic growth in Cyprus.

**31. After a period of relatively weak growth, the Cypriot economy began to rebound in 2004.** While sluggish European growth and geopolitical concerns in the Middle East contributed to subdued growth in 2002–03, particularly in the tourism sector, tourist arrivals and output growth recovered gradually in 2004. Unemployment remains low, and, despite some recent pressures stemming from oil prices, inflation is subdued.

**32. Fiscal consolidation needs to be the first order of business, in light of slippages in recent years and the authorities' ERM2 ambitions.** Striving to contain the deficit and reduce public debt is clearly important to the euro adoption strategy. But more fundamentally, the economic situation of Cyprus would call for fiscal retrenchment quite apart from the requirements for euro adoption. Demographic pressures over the medium term, in particular as regards projected pension and health care costs, underscore the importance of bringing down the debt ratio. Previous efforts to contain the fiscal deficit have been disappointing, and by overperforming on their deficit objective for 2004, the authorities have shown the needed determination to establish policy credibility, which will now need to be maintained.

**33. If assiduously implemented, the consolidation strategy laid out in the authorities' Convergence Program would put Cyprus back on the road to fiscal sustainability.** Several of the CP measures are politically difficult but extremely important—such as the significant increase in public sector retirement ages, moderation in public sector wage growth, and the freeze on new government positions. These steps will help limit the deficit and are needed to

pave the way for euro adoption. In light of the disappointing performance of previous adjustment efforts, follow-up on the authorities' stated readiness to take further measures if needed to achieve their fiscal adjustment targets will be essential.

**34. Over the medium term, credibility and policy formulation would be buttressed by establishing an explicit multi-year fiscal framework.** Such a framework—based on realistic economic assumptions, clear fiscal objectives, and specific measures to achieve them—would provide the basis for choosing among competing spending priorities in a transparent and efficient manner. The authorities' interest in a fiscal ROSC, undertaken by most other new EU members, is welcome.

**35. Cyprus appears well-placed to join ERM2 at an early stage, subject to the condition that the fiscal adjustment effort is resolutely maintained.** The long-standing use of an exchange regime similar to ERM2 provides the advantage of continuity, while the current parity seems broadly in line with fundamentals, given continued near-full employment and the strong reserve position. Nonetheless, aggressive pursuit of structural reforms—particularly in the labor market—is needed to enhance competitiveness.

**36. Although financial sector regulation is generally strong, supervision of the cooperative sector should be strengthened.** Supervision of the cooperative credit and saving institutions should be brought under the same roof as that of the banks, and their capital base should be strengthened; in general, consolidation in the sector should be encouraged. Bringing loan classification definitions in line with European best practices is welcome, but the legal framework must be revised to ensure more timely recovery of collateral on bad loans. The authorities are encouraged to undertake an early FSAP in order to advance these reforms.

**37. Despite making major strides to meet the requirements of the *acquis*, Cyprus faces a challenging structural reform agenda.** In particular, more remains to be done to foster competition and promote efficiency, including in the public enterprise sector. The electricity authority and the telecommunications company should be corporatized at an early stage, and—over time—the authorities should consider their privatization.

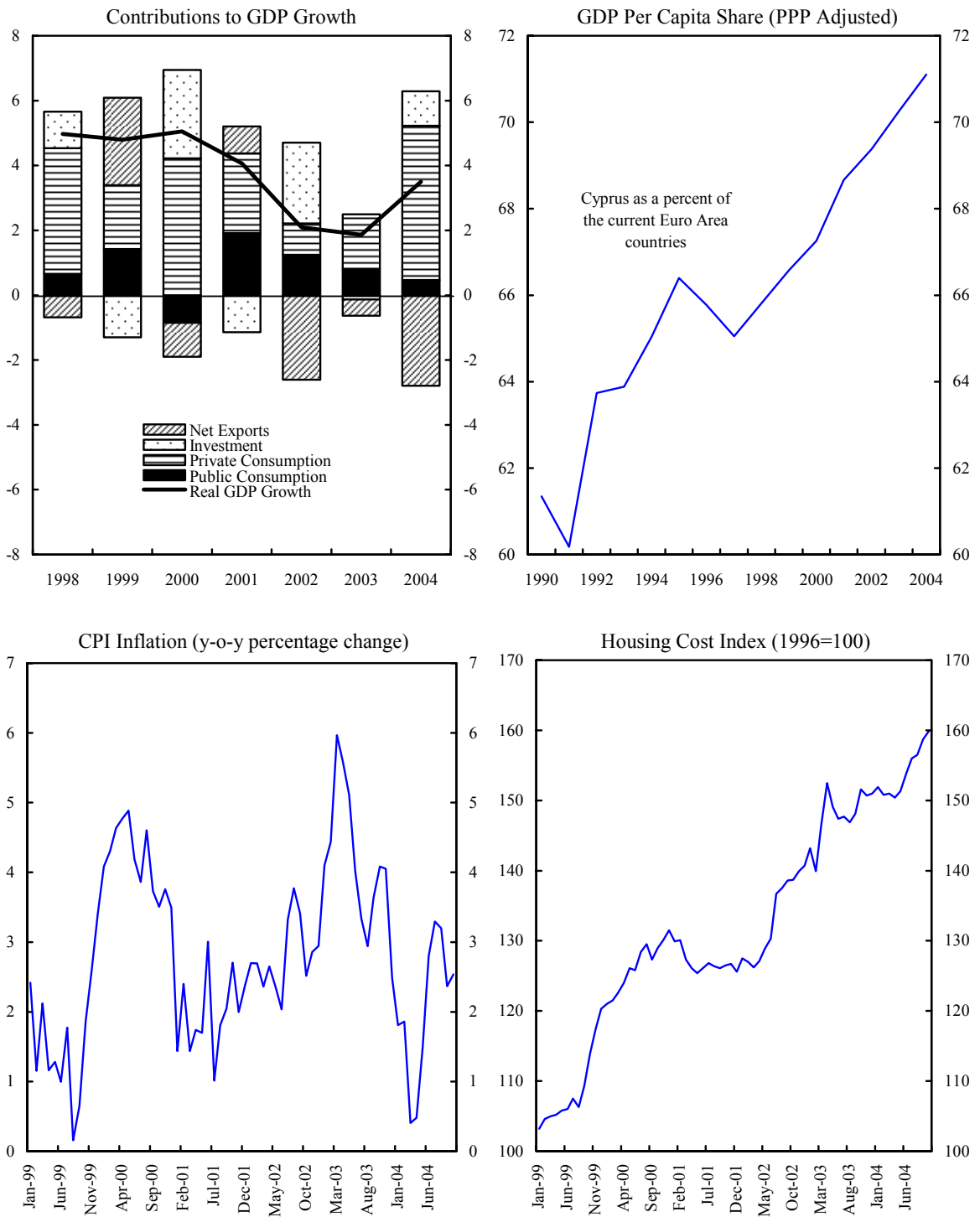
**38. With near full employment conditions, labor markets have performed well, but there is still scope for policies to improve their performance.** In particular, the centralized wage bargaining system is in need of reform. As currently constituted, the COLA system—especially when coupled with seniority-based rules governing salary increases in the public sector—builds in a structural upward drift in the real wage bill, thereby leading to a loss of competitiveness on external markets. Moreover, this system affords employers little scope for providing performance-related compensation increases. As a first step, the COLA system could be redesigned to exclude changes in the VAT and energy prices.

**39. IMF activities, including technical assistance, could support reunification and contribute to improving the living standards of all Cypriots.** The authorities' consent to provide technical assistance to the T/C community in the Fund's areas of specialization (and also to carry out macroeconomic analytical work) could help establish a baseline for advancing all of Cyprus toward best practices in a number of areas.

40. **While Cypriot statistics are generally of good quality (with the exception of the NGC areas), improvements are possible in a few areas regarding the timeliness, consistency and definitions used by the authorities.** Moving promptly toward subscription to the SDDS could facilitate improvements in this area.

41. It is proposed that the next Article IV consultation be held on the current 24-month cycle.

Figure 1. Cyprus: Macroeconomic Indicators, 1990-2004<sup>1/</sup>

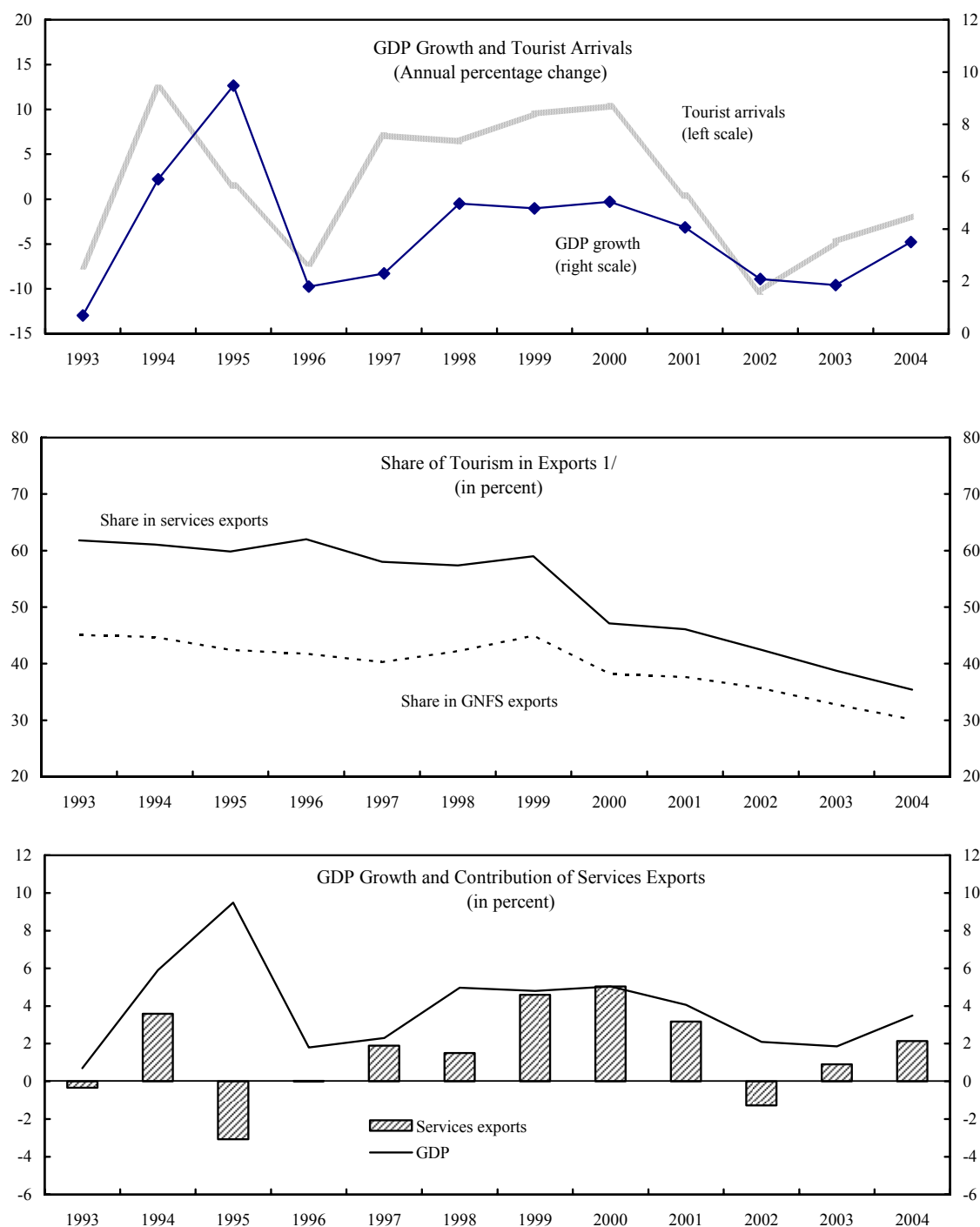


Source: IMF, *World Economic Outlook*; Bloomberg; and staff estimates.

<sup>1/</sup> GDP data for 2004 are projections.



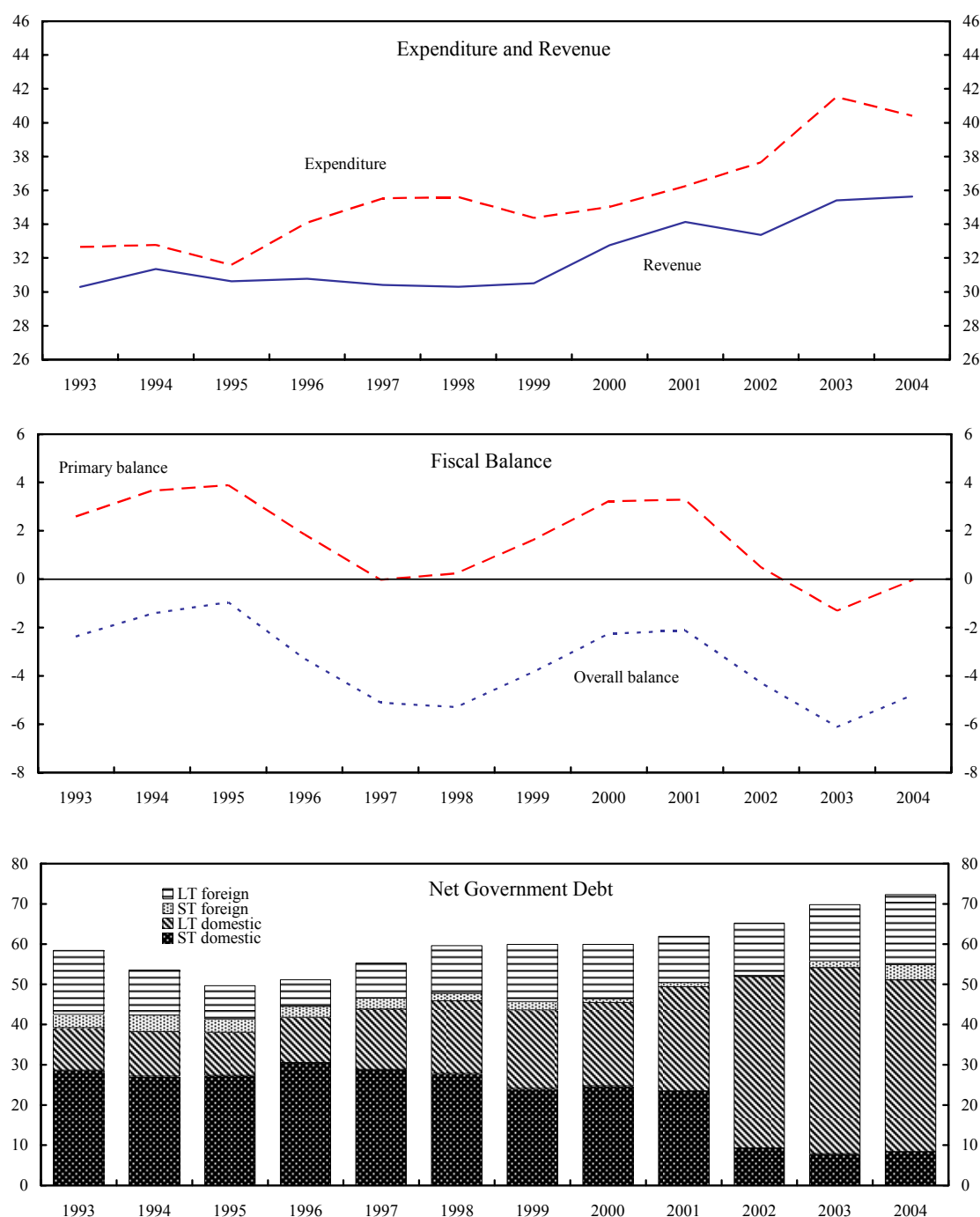
Figure 2. Cyprus: Growth and Tourism, 1993–2004



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

1/ A new residency definition has been applied to data from 2000, leading to an upward shift in services exports.

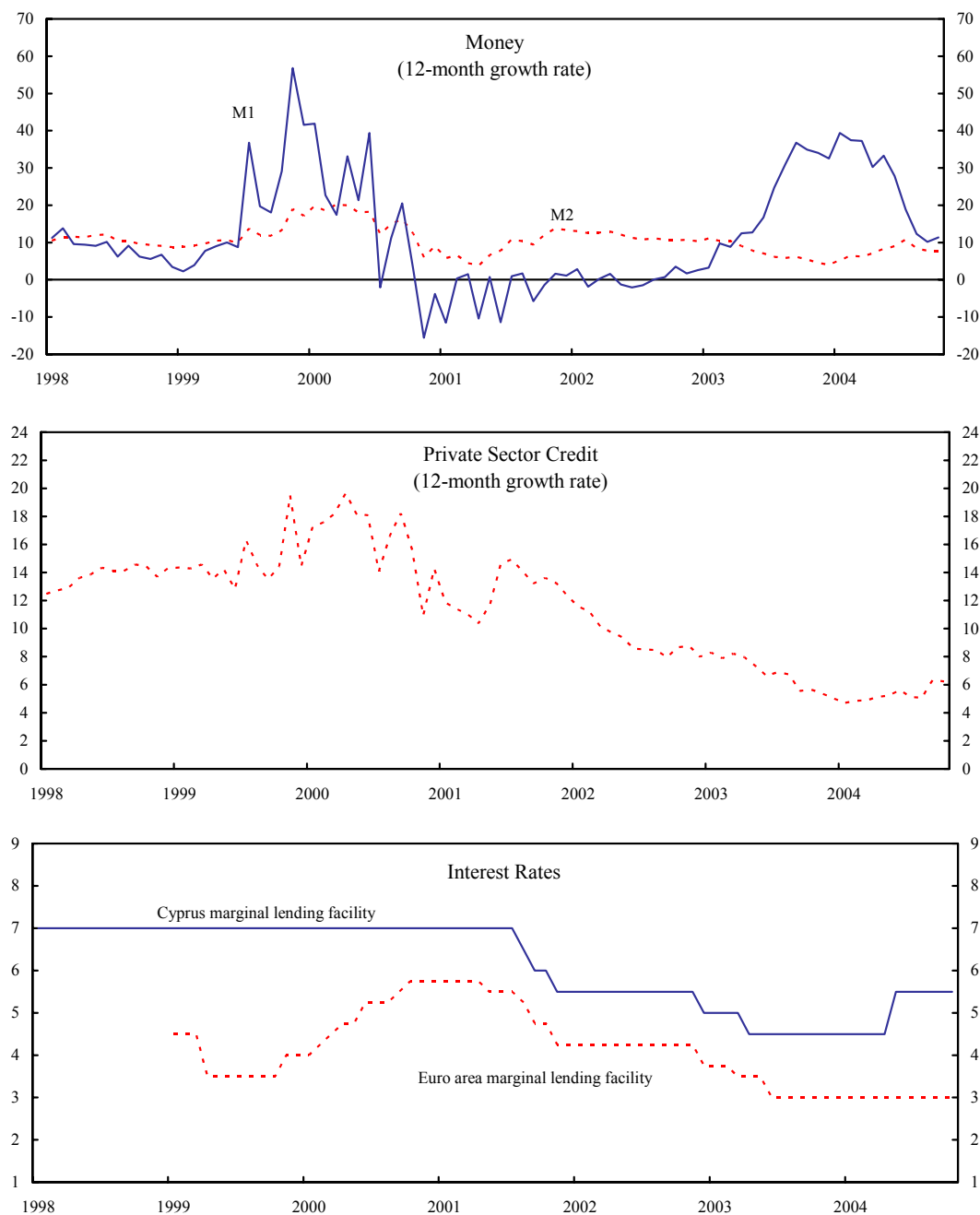
Figure 3. Cyprus: Central Government Finances, 1993–2004<sup>1/</sup>



Source: Ministry of Finance.

1/ Consolidated central government budget, public loans fund, social security funds, sinking funds, and defence fund. Data for 2004 are estimates.

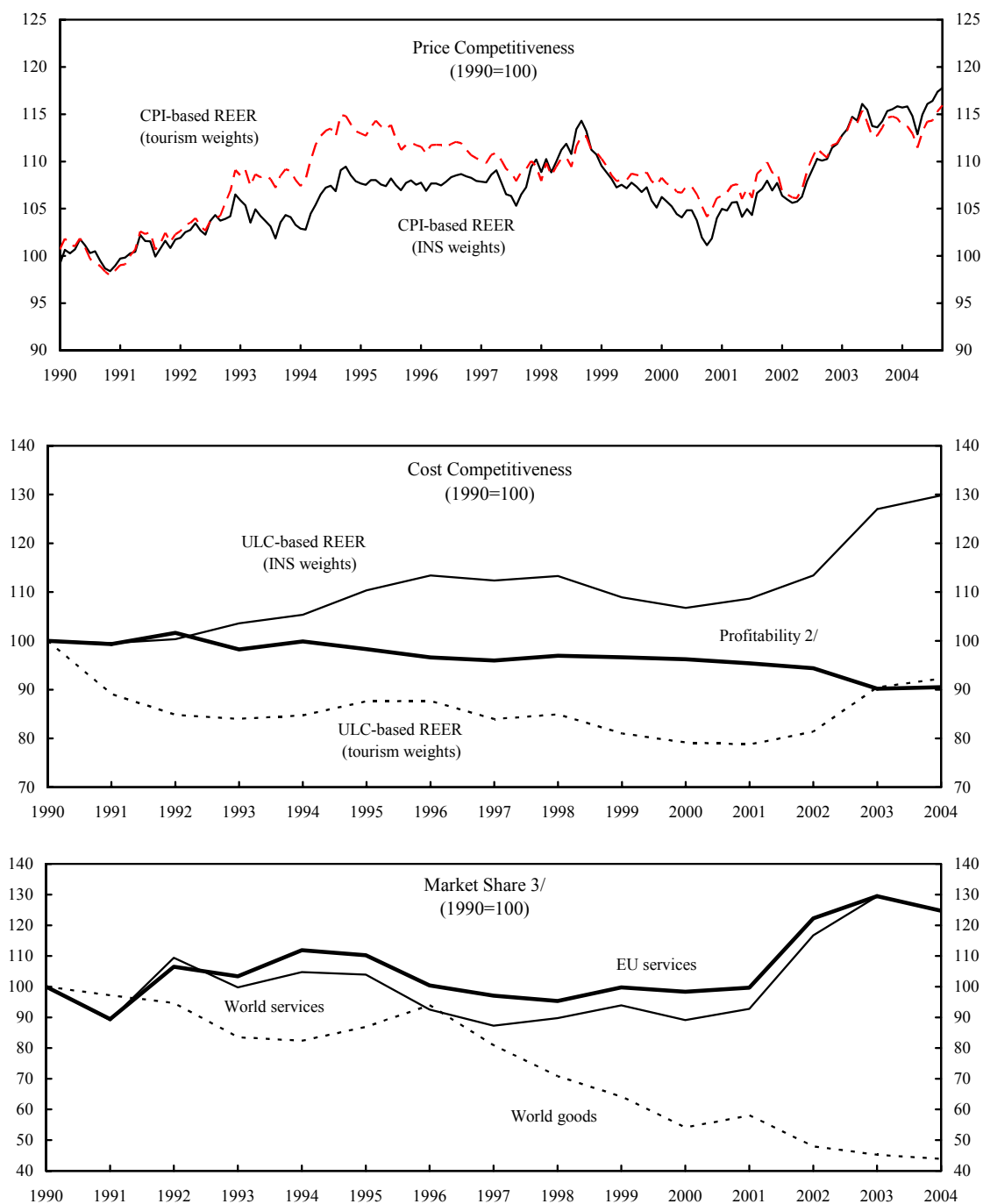
Figure 4. Cyprus: Monetary Conditions, 1998–2004<sup>1/</sup>  
(in percent; unless otherwise stated)



Source: IMF, International Financial Statistics; and the Central Bank of Cyprus.

<sup>1/</sup> Monthly data through October 2004.

Figure 5. Cyprus: Competitiveness Indicators, 1990-2004<sup>1/</sup>



Sources: IMF, *International Financial Statistics*; IMF, *World Economic Outlook*; and staff estimates.

1/ Data for 2004 are projections.

2/ Defined as the ratio of the GDP deflator to unit labor cost.

3/ Index of the share of Cyprus's exports over those of the EU and the world respectively.

Table 1. Cyprus: Selected Indicators, 1999-2005

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projections
(Annual percentage change)							
<b>Output and prices</b>							
Demand and supply (in constant prices):							
Gross domestic product	4.8	5.0	4.1	2.1	1.9	3.5	3.8
Domestic demand	2.1	6.1	3.2	4.7	2.3	6.1	1.6
Private consumption	3.0	6.5	3.7	1.5	2.6	7.2	1.1
Public consumption	8.7	-5.0	12.6	7.5	4.7	2.6	3.2
Gross investment	-6.7	16.0	-6.0	14.6	-0.7	5.7	2.0
Net exports 1/	0.8	-0.3	0.6	-2.1	-2.5	-5.3	-3.0
Exports of goods and NFS	8.5	10.6	6.3	-5.2	-1.4	4.3	6.6
Imports of goods and NFS	2.9	12.9	4.7	-0.5	-0.4	9.4	2.2
Industrial production index 2/	1.7	4.5	1.8	3.9	2.3	-0.2	...
Tourist arrivals 3/	9.5	10.3	0.4	-10.3	-4.8	2.9	...
Unemployment (in percent)	3.6	3.4	2.9	3.2	3.5	3.4	3.2
CPI index (period average)	1.6	4.1	2.0	2.8	4.1	2.5	2.5
CPI index (end of period)	3.7	3.5	2.4	2.9	2.5	2.7	2.5
Real wages	3.0	2.9	3.1	1.8	1.4	...	...
(In percent of GDP)							
Output gap 4/	4.0	4.3	4.5	2.7	0.7	0.3	0.1
Gross domestic investment	17.1	18.4	16.5	18.7	17.9	18.3	18.0
Of which private	14.2	13.5	13.5	14.6	12.7	14.6	14.4
Gross domestic saving	15.6	19.5	19.3	19.6	17.1	17.2	17.1
(In percent of GDP)							
<b>Public finance 5/</b>							
Total revenue	33.0	35.3	36.6	36.1	39.1	39.0	40.2
Expenditure and net lending	37.4	37.7	38.9	40.6	45.4	43.8	43.2
Overall balance	-4.4	-2.4	-2.3	-4.5	-6.3	-4.8	-3.0
Primary balance	-1.3	1.1	1.1	-1.3	-2.8	0.4	2.2
Public debt 6/	59.9	59.9	61.9	65.2	69.8	72.3	69.5
(Annual percentage change)							
<b>Money and credit</b>							
Broad money	17.2	9.0	13.3	10.3	4.0	8.4	8.9
Reserve money	15.0	11.1	7.5	22.7	4.8	6.6	6.9
Domestic credit	12.7	12.0	14.9	9.5	5.9	7.2	7.5
Broad money velocity	-4.5	-5.5	-1.2	-6.4	-0.5	-1.9	-2.1
<b>Interest rates</b>							
Deposit rates 7/	6.5	6.5	6.0	4.8	3.8	4.2	...
Lending rates 8/	8.0	8.0	7.5	7.2	6.9	7.9	...
(In percent of GDP)							
<b>External sector</b>							
Trade balance	-24.0	-28.6	-27.2	-27.2	-23.8	-24.6	-24.5
Service balance	21.3	27.2	28.8	26.0	22.2	21.5	21.6
Current account balance	-2.3	-5.3	-3.3	-4.5	-3.4	-4.3	-4.0
Capital and Financial account	3.8	5.9	3.7	5.3	3.1	4.3	4.0
Of which: Direct foreign investment, net	-0.3	7.5	7.3	5.7	3.7	2.8	2.4
Portfolio investment, net	0.0	-3.1	2.9	-4.9	2.2	-5.3	0.9
<b>Exchange rates</b>							
Pounds per U.S. dollar (end-period) 9/	0.57	0.62	0.65	0.55	0.46	0.43	0.43
Real effective exchange rate (CPI, 2000=100) 3/	103.2	100.0	101.8	104.2	110.2	113.2	...

**Social indicators**

**GDP per capita** (in current US dollars, 2003): 16,062; **Life expectancy at birth** (2002): 75.8 (male) and 80.5 (female); **Automobile ownership** (2000): 574 per thousand; **CO2 emissions** (ton per capita, 2000): 8.5; **Population density** (2002): 82.8 inhabitants per sq. km; **Population** (2003): 796 thousands.

Sources: Ministry of Finance; Central Bank; World Bank, *World Development Indicators*; and Fund staff estimates.

1/ Change as a percentage of previous year's GDP.

2/ Data for 2004 as of August.

3/ Data for 2004 during January till October.

4/ Defined as the difference between actual real GDP and potential GDP, as a share of potential GDP.

5/ General government.

6/ Excludes intragovernmental debt and short-term liabilities of the Central Bank.

7/ For 1-year fixed deposits over CYP 5,000. Data for 2004 as of October.

8/ For enterprises' secured loans. Data for 2004 as of October.

9/ Data for 2005 as of Jan. 4.

Table 2. Cyprus: Balance of Payments, 1999–2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						Est.	Proj.	Proj.	Proj.	Proj.
(In millions of U.S. dollars)										
Current account balance	-217	-488	-315	-468	-452	-642	-644	-574	-558	-551
Trade balance	-2,309	-2,606	-2,579	-2,836	-3,125	-3,716	-3,924	-4,231	-4,491	-4,762
Exports	1,000	951	977	854	955	1,052	1,087	1,123	1,188	1,255
Imports	3,310	3,557	3,555	3,690	4,080	4,768	5,011	5,355	5,679	6,017
Fuel and lubricants	281	433	414	394	314	432	416	403	419	436
Services	2,043	2,483	2,735	2,709	2,914	3,236	3,452	3,860	4,143	4,426
Exports	3,190	4,068	4,351	4,458	5,184	6,024	6,514	7,140	7,604	8,079
Travel (mainly tourism)	1,882	1,918	2,006	1,894	2,010	2,132	2,255	2,389	2,560	2,736
Imports	1,147	1,585	1,616	1,750	2,270	2,788	3,062	3,279	3,461	3,653
Investment income, net	-38	-542	-526	-449	-383	-386	-390	-417	-419	-416
Transfers, net	87	177	54	108	142	224	218	214	208	202
Capital and Financial account balance 1/	367	543	354	557	406	642	644	574	558	551
Capital account, net	0	5	6	-5	20	51	37	37	37	37
Direct foreign investment, net	-25	683	695	596	487	424	382	343	301	259
Portfolio investment, net	2	-284	274	-506	285	-795	146	147	147	147
Other investment, net	1,030	128	-8	925	-618	1,350	464	363	468	468
Reserve assets	-639	8	-612	-402	215	-365	-392	-324	-403	-368
Net errors and omissions	-150	-52	-38	-89	47	0	0	0	0	0
Change in official reserves 2/	456	-107	527	777	285	794	502	477	523	484
(Percentage change)										
Memorandum items:										
Goods exports	-6.0	-4.9	2.7	-12.5	11.8	10.2	3.3	3.3	5.8	5.6
Goods imports	-5.2	7.5	0.0	3.8	10.6	16.9	5.1	6.8	6.1	6.0
Tourism receipts	11.0	1.9	4.6	-5.6	6.1	6.1	5.7	6.0	7.2	6.9
(In percent of GDP)										
Trade balance	-24.0	-28.6	-27.2	-27.2	-23.8	-24.6	-24.5	-24.6	-24.5	-24.4
Current account	-2.3	-5.3	-3.3	-4.5	-3.4	-4.3	-4.0	-3.3	-3.0	-2.8
Financial account	3.8	5.9	3.7	5.4	2.9	3.9	3.8	3.1	2.8	2.6
Change in official reserves 2/	4.8	-1.2	5.6	7.4	2.2	5.3	3.1	2.8	2.9	2.5
(In millions of US. dollars, end-of-period)										
Gross official reserves	1,977	1,870	2,397	3,174	3,459	4,253	4,755	5,232	5,755	6,239
In months of imports GS	5.3	4.4	5.6	7.0	6.5	6.8	7.1	7.3	7.6	7.7
Total gross reserves (includes banks)	3,131	4,217	5,298	4,896	5,356	5,561	5,779	5,962	6,184	6,389
In months of imports GS	15.5	15.8	19.1	17.7	19.6	18.5	17.9	17.5	17.1	16.7
(In billions of U.S. dollars)										
Gross domestic product	9.6	9.1	9.5	10.4	13.1	15.1	16.0	17.2	18.3	19.6

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

1/ Includes financial derivatives.

2/ Includes valuation effects.

Table 3. Cyprus: Central Government Accounts, 1999–2005 1/

(In percent of GDP)

	1999	2000	2001	2002	2003	2004	2005
					Prel.	Est.	Proj.
Total revenue	30.5	32.8	34.1	33.4	35.4	35.6	36.7
Current revenue	30.5	32.7	34.1	33.3	35.3	34.7	35.7
Tax revenue	24.6	25.6	27.2	27.4	28.7	29.4	29.7
Income and property	9.5	9.8	10.8	10.1	8.6	8.4	8.5
Social security contributions	4.4	4.3	4.6	4.8	4.7	4.8	4.9
Indirect taxes	10.8	11.5	11.8	12.5	15.4	16.2	16.3
Nontax revenue	5.9	7.1	6.9	5.9	6.6	5.3	6.0
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending	34.4	35.0	36.3	37.7	41.5	40.4	39.6
Current expenditure	30.6	31.2	32.7	34.0	37.0	37.4	36.7
Wages and salaries	9.3	9.3	9.2	9.4	10.7	11.3	11.2
Other goods and services	2.8	2.8	3.0	3.2	3.6	3.5	3.5
Subsidies	0.7	1.4	1.5	1.0	1.3	1.0	0.7
Interest payments	5.5	5.5	5.4	4.8	4.8	4.8	4.7
Social security payments	5.2	5.4	5.2	5.6	5.7	5.8	5.9
Other transfers	6.0	6.1	6.5	7.6	9.3	10.1	9.8
Other	1.1	0.8	1.9	2.5	1.7	1.0	0.9
Capital expenditure	3.7	3.8	3.6	3.6	4.5	3.0	2.9
Investment	2.5	2.7	2.5	2.7	3.2	2.1	2.1
Transfers	1.2	1.1	1.0	0.9	1.3	0.8	0.8
Net lending	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-3.9	-2.3	-2.1	-4.3	-6.1	-4.8	-3.0
Primary balance	1.6	3.2	3.3	0.5	-1.1	-0.1	2.1
Cyclically adjusted balance	-0.7	-0.6	-0.6	-1.2	-1.9	-2.0	-2.1
Public debt 2/	59.9	59.9	61.9	65.2	69.8	72.3	69.5
Domestic debt	43.6	45.5	49.4	51.9	54.2	51.2	50.2
Long-term	19.4	20.7	25.9	42.6	46.3	42.7	42.3
Short-term	24.2	24.8	23.5	9.3	7.9	8.4	7.9
Foreign debt	16.3	14.5	12.5	13.3	15.6	21.1	19.3
Long-term	14.2	13.5	11.4	13.0	13.9	17.4	16.5
Short-term	2.1	1.0	1.0	0.3	1.6	3.8	2.8
Memo items:							
General government revenue	33.0	35.3	36.6	36.1	39.1	39.0	40.2
General government expenditure	37.4	37.7	38.9	40.6	45.4	43.8	43.2
General government overall balance	-4.4	-2.4	-2.3	-4.5	-6.3	-4.8	-3.0
GDP (in millions of Cyprus pounds)	5214.2	5679.0	6103.6	6370.3	6801.7	7213.7	7671.9

Sources: Ministry of Finance; and Fund staff estimates.

1/ Consolidates central government budget; public loans fund; social security funds; sinking funds; and defence fund.

2/ Excludes intragovernmental debt and short-term liabilities of the Central Bank.

Table 4. Cyprus: Monetary Survey, 1999–2004  
(in millions of Cyprus pounds)

	1999	2000	2001	2002	2003	2004 1/
(End-of-period stocks)						
Foreign assets, net	306.6	397.1	562.2	483.7	835.8	1,098.2
Official (net) 2/	1,107.1	1,138.2	1,532.1	1,726.5	1,600.0	1,729.5
All banks (net)	-800.5	-741.1	-969.9	-1,242.8	-764.1	-631.2
Claims on domestic economy, net	6,840.2	7,661.0	8,804.1	9,642.4	10,209.7	10,554.7
Claims on public sector	1,138.0	1,145.1	1,484.1	1,738.3	1,907.7	1,951.9
Central government	1,163.0	1,177.8	1,512.0	1,778.4	1,956.9	1,994.9
Advances and loans	351.3	453.1	570.0	1,030.9	1,050.0	1,066.2
Treasury bills and securities	1,187.9	1,241.6	1,567.5	1,413.8	1,730.1	1,727.4
Government deposits	-376.1	-517.0	-625.6	-666.3	-823.1	-798.8
Government agencies	2.8	-4.2	0.9	-3.6	-2.9	-10.5
Claims on private sector	5,702.2	6,516.0	7,320.1	7,904.1	8,302.0	8,602.8
Unclassified items	-1,153.8	-1,525.6	-1,963.7	-1,960.9	-2,551.9	-2,803.3
Broad money (M2)	5,993.0	6,532.6	7,402.6	8,165.2	8,493.6	8,849.6
Money supply (M1)	1,041.1	1,001.5	1,012.4	1,038.8	1,377.1	1,397.0
Currency in circulation	313.6	333.3	356.5	392.8	467.2	475.8
Demand deposits	723.5	662.3	647.9	628.2	865.9	830.5
Foreign currency	4.1	5.9	8.0	17.8	44.0	90.7
Quasi-money	4,951.9	5,531.1	6,390.2	7,126.4	7,116.5	7,452.6
Savings deposits	185.2	200.4	219.9	239.5	294.6	305.5
Time deposits	4,584.1	5,064.8	5,829.0	6,553.5	6,438.7	6,552.8
Foreign currency	182.7	266.0	341.4	333.4	383.2	594.4
(Percentage change over preceding 12 months)						
Foreign assets, net	223.1	29.5	41.6	-14.0	72.8	31.4
Claims on domestic economy, net	12.7	12.0	14.9	9.5	5.9	3.4
of which: claims on private sector	14.4	14.3	12.3	8.0	5.0	3.6
Broad money (M2)	17.2	9.0	13.3	10.3	4.0	4.2
Money supply (M1)	41.5	-3.8	1.1	2.6	32.6	1.4
Quasi-money	13.1	11.7	15.5	11.5	-0.1	4.7
Memorandum items:						
Income velocity of M2 3/	0.9	0.9	0.9	0.8	0.8	0.8
Income velocity of M1 3/	5.9	5.6	6.1	6.2	5.6	5.2
Deposits with cooperatives 4/	2,570.7	2,821.6	3,109.1	3,513.4	3,985.9	4,136.1
annual percentage change	6.4	9.8	10.2	13.0	13.4	3.8
Loans by cooperatives 4/	2,410.2	2,483.9	2,519.1	2,670.3	2,947.0	3,055.9
annual percentage change	13.0	3.1	1.4	6.0	10.4	3.7

Source: Central Bank of Cyprus.

1/ Stock as of October 2004 and change during January-October 2004.

2/ Includes reserve position in the IMF.

3/ Nominal GDP/average money stock at beginning and end of year.

4/ In millions of Cyprus pounds; data for 2004 as of June and change during January-June 2004.



Table 5. Cyprus: Medium-term Macroeconomic Framework, 2004-08

	2004		2005		2006		2007		2008	
	CP	Staff	CP	Staff	CP	Staff	CP	Staff	CP	Staff
	(Percent change in constant prices)									
Real GDP	3.6	3.5	4.0	3.8	4.4	4.0	4.5	4.0	4.5	4.0
Potential GDP	4.5	3.9	4.5	4.0	4.5	4.0	4.5	4.0	4.5	4.0
Domestic demand:										
Private consumption	4.5	7.2	4.0	1.1	4.0	4.0	4.0	3.3	4.0	2.4
Public consumption	-2.7	2.6	2.0	3.2	2.8	-0.2	3.9	4.3	2.2	7.9
Gross fixed capital formation	5.0	5.8	5.8	2.0	5.9	4.5	6.0	5.3	6.1	3.8
Change in inventories	1.7	4.2	-0.2	0.8	-0.2	3.8	-0.5	4.0	-0.1	4.0
Exports goods and services 1/	4.7	4.3	6.2	6.6	7.0	5.1	7.1	3.6	7.1	4.0
Imports goods and services 1/ 2/	7.3	9.4	5.5	2.2	6.1	3.9	6.1	3.3	6.1	3.3
Consumer price index (period average)	2.1	2.5	2.6	2.5	2.2	2.5	2.1	2.5	2.0	2.5
GDP deflator	1.9	2.5	2.4	2.5	2.1	2.5	2.1	2.5	2.1	2.5
	(In percent of GDP)									
Public finances 3/										
Revenue	39.0	39.0	40.1	40.2	40.5	40.2	40.6	40.3	40.6	40.3
Expenditure	43.8	43.8	43.0	43.2	42.2	43.0	42.1	42.9	41.5	42.7
Overall balance	-4.8	-4.8	-2.9	-3.0	-1.7	-2.8	-1.5	-2.6	-0.9	-2.4
Cyclically-adjusted balance	-4.3	-2.1	-2.7	-2.2	-1.7	-2.2	-1.5	-2.2	-0.9	-2.2
Gross public debt	74.9	72.3	71.9	69.5	69.2	66.4	65.7	63.5	58.1	62.3
External current account balance 4/	-4.1	-4.3	-3.7	-4.0	-3.2	-3.3	-3.0	-3.0	-2.0	-2.8

Source: Convergence Program of the Republic of Cyprus (CP), December 2004, and Fund staff estimates.

1/ For staff estimates, goods and nonfactor services.

2/ For the CP imports exclude aircrafts and defense.

3/ General government.

4/ For 2007-08, the CP does not provide exact projections; the CP figures are staff estimates based on the discussion in the text of the CP.

Table 6. Cyprus: Vulnerability Indicators, 1999-2004

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004 Est.
<b>Financial indicators</b>						
Public debt, net of intergovernmental debt	59.9	59.9	61.9	65.2	69.8	72.3
Broad money (percent change, 12-month basis)	17.2	9.0	13.3	10.3	4.0	8.4
Private sector credit, real (percent change, 12-month basis)	12.6	9.7	10.2	5.0	0.9	5.2
Domestic credit	131.2	134.9	144.2	151.4	150.1	151.7
Share of foreign exchange loans in total bank lending (in percent) 1/	10.3	9.2	13.3	13.2	12.5	13.7
Share of foreign exchange deposits in total bank deposits (in percent) 1/	3.1	4.2	4.7	4.3	5.0	7.7
Share of foreign currency denominated liabilities in banks' total liabilities (in percent) 1/	2.7	2.3	4.0	3.2	4.0	4.5
<b>External indicators</b>						
Exports G&NFS (percent change, in U.S. dollars)	4.3	19.8	6.2	-0.3	15.5	15.3
Imports G&NFS (percent change, in U.S. dollars)	-3.6	15.4	0.6	5.2	16.7	19.0
Current account balance	-2.3	-5.3	-3.3	-4.5	-3.4	-4.3
Financial account balance	3.8	5.9	3.7	5.4	2.9	3.9
Of which: Direct foreign investment, net	-0.3	7.5	7.3	5.7	3.7	2.8
Portfolio investment, net	0.0	-3.1	2.9	-4.9	2.2	-5.3
Other investment, net	10.7	1.4	-0.1	8.9	-4.7	8.9
Reserve assets	-6.7	0.1	-6.5	-3.8	1.6	-2.4
Net errors and omissions	-1.6	-0.6	-0.4	-0.9	0.4	0.0
Change in official reserves	4.8	-1.2	5.6	7.4	2.2	5.3
Net foreign assets of commercial banks (US\$ billions) 1/	-1.4	-1.2	-1.5	-2.3	-1.6	-1.4
Official foreign exchange reserves (US\$ billions)	2.0	1.9	2.4	3.2	3.5	4.3
Official reserves in months of imports G&NFS	5.3	4.4	5.6	7.0	6.5	6.8
Reserve money/reserves (end-period, percent)	90.2	98.6	78.4	86.4	97.8	92.4
Broad money to gross official reserves (end-period, ratio)	5.3	5.7	4.8	4.7	5.3	5.1
Short-term external debt to gross official reserves (percentage)	24.5	22.3	16.6	16.0	22.1	29.3
Total external debt	32.9	30.4	35.6	47.7	51.9	57.2
Of which: Public sector debt	15.0	16.1	20.2	26.5	24.1	23.8
Total external debt to exports G&NFS (percentage)	71.3	55.8	62.7	104.6	123.7	136.8
Total external debt service payments to exports G&NFS	6.5	7.3	8.8	7.2	6.8	12.9
Exchange rate (per US\$, period average)	0.54	0.62	0.64	0.61	0.52	0.48
Real effective exchange rate (CPI, 2000=100) 2/	103.2	100.0	101.8	104.2	110.2	113.2
<b>Financial market indicators (end-of-period)</b>						
Stock market general index (percent change) 3/	688	-63	-47	-27	-15	-15
Long-term foreign currency debt rating (S&P)	A+	A	A	A	A	A

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

1/ Data for 2004 as of October.

2/ Data for 2004 as of September.

3/ Data for 2004 as of August.

Table 7. Cyprus: Financial Soundness Indicators for Banks, 1999-2004 1/  
(In percent)

Indicator	1999	2000	2001	2002	2003	2004 2/
<b>Core Set</b>						
Regulatory capital to risk-weighted assets	12,7	13,5	14,0	12,7	11,7	11,4
Regulatory Tier I capital to risk-weighted assets	11,6	13,7	11,6	10,1	10,0	9,8
Nonperforming loans net of provisions to capital 3/	N/A	N/A	N/A	N/A	99,4	72,0
Nonperforming loans to total gross loans 3/	8,4	8,5	7,9	9,5	11,3	11,7
Return on assets	2,4	1,5	0,6	-0,7	-0,3	0,2
Return on equity	30,3	17,4	8,4	-11,1	-4,7	4,3
Interest margin to gross income	32,3	56,3	57,5	38,7	32,6	46,1
Noninterest expenses to gross income	45,2	61,9	68,2	68,6	66,6	62,7
Net open position in foreign exchange to capital	2,9	7,6	5,8	1,9	2,9	N/A
<b>Additional Indicators</b>						
Capital to assets	7,8	8,4	7,7	6,5	5,9	5,5
Trading income to total income	29,0	-4,4	-0,8	3,9	4,8	3,9
Personnel expenses to noninterest expenses	61,3	59,2	60,6	63,4	63,0	64,0
Customer deposits to total (non-interbank) loans	131,9	133,1	137,0	132,0	127,6	140,9

Source: Central Bank of Cyprus

1/ Data for domestically-controlled and foreign-controlled banks on a cross-border and cross-sector consolidation basis; does not include credit cooperative sector or international banking units. The compiled FSIs are consistent with the definitions and specifications provided in the IMF's "Compilation Guide on Financial Soundness Indicators",

2/ Data for 2004 as of end-June.

3/ In 2004, deposit takers were required to suspend interest on all loans which were in arrears for more than 6 months and were not 100 percent secured (in 2003 the threshold was 9 months and prior to this 12 months). These loans are classified as "Non-Performing Loans." As from 2006, the CBC will reduce the time period beyond which interest will be suspended to 3 months. Furthermore, the CBC has given advance warning to deposit-takers that, in order to fully harmonize the existing regulations with the provisions of the the European Union Capital Requirements Directive, the relevant regulations will be amended so that the existence of adequate security will not be taken into account.

Table 8. Cyprus and Selected Countries: Indices of Competitiveness in Tourism Sector, 2003 1/

		Price 2/ Development 3/	Human Development 3/	Infrastructure 4/	Environment 5/	Technology 6/	Human Resources 7/	Openness 8/	Social 9/
Cyprus	Index value	42	100	76	49	94	66	79	70
	Ranking	85	6	7	86	41	56	13	52
Croatia	Index value	41	n/a	n/a	62	75	68	68	68
	Ranking	88	n/a	n/a	34	64	51	57	55
Egypt	Index value	67	28	62	59	16	23	39	41
	Ranking	37	75	36	45	149	120	118	125
Greece	Index value	36	64	n/a	54	99	79	70	73
	Ranking	93	37	n/a	69	31	29	49	42
Israel	Index value	13	49	n/a	51	100	76	65	83
	Ranking	123	55	n/a	79	20	38	74	28
Italy	Index value	20	50	n/a	64	100	84	70	78
	Ranking	111	52	n/a	27	26	19	48	32
Malta	Index value	48	100	69	38	100	68	78	76
	Ranking	72	7	16	130	27	51	14	36
Spain	Index value	23	68	n/a	74	94	94	71	77
	Ranking	107	32	n/a	2	40	12	40	33
Tunisia	Index value	70	59	n/a	67	24	35	70	46
	Ranking	27	45	n/a	21	138	107	46	107
Turkey	Index value	60	31	59	46	70	45	64	59
	Ranking	46	73	41	101	67	93	77	79

Source: The World Travel and Tourism Council (<http://www.wttc.org/>).

1/ Index values on 0-100 scale, with 100 representing the best possible score. Rankings: most competitive=1; least competitive=212.

2/ Based on a weighted average of hotel price index, the purchasing power parity index, adjusted consumer price index, and taxes on goods and services.

3/ Measures the achievement of human development in terms of tourism activity by measuring the level of tourism impact on a country and the level of tourism participation within that country.

4/ Measures the competitiveness of infrastructure and is calculated using information on road quality, access to improved sanitation facilities, access to improved drinking water, and the railways.

5/ Measures governments' awareness towards environmental aspects of development using population density, CO<sup>2</sup> emissions and the ratification of environmental treaties as appropriate indicators.

6/ Measures the advances in modern technological systems and infrastructure using data regarding telephone mainlines, mobile phones, high technology exports and Internet hosts.

7/ Measures the competitiveness of human resources using data regarding life expectancy, illiteracy rates, education, employment, population, training, skills and gender indicators.

8/ Measures tourism openness using data on visa requirements, the extent to which a country is open to international tourism, trade openness and taxes on international trade.

9/ Measures a country's development in social issues using data from daily newspapers, personal computers, television sets and total crimes recorded.

## **MEDIUM-TERM SUSTAINABILITY ANALYSIS**

### **A. Fiscal Sustainability**

1. Assuming implementation of the CP, the staff's baseline scenario predicts a decline in the public debt-to-GDP ratio from 72 percent in 2004 to 61 percent in 2009, suggesting that risks to *medium-term* debt sustainability would be addressed by the CP (Annex I Table 1). When the historical average values of the real interest rate, real GDP growth, and primary balance are used throughout the projection period (scenario A1), the debt ratio falls only to 66 percent by 2009. Keeping the primary balance unchanged over the projection period (A2) raises the debt ratio to 71 percent by 2009. The most significant "bounds test" is the shock to real GDP growth (B2), while the shocks to the real interest rates and to the primary balance lead to a somewhat smaller deterioration in the debt dynamics. A one-time 30 percent real depreciation in 2006 (B5) increases the debt ratio the most, raising it to 80 percent in 2009.

### **B. External Sustainability**

2. Under the baseline scenario the external debt-to-GDP ratio falls from 57 percent to 51 percent by 2009, achieved mainly through automatic debt dynamics reflecting robust GDP growth and a residual that includes the effect of the slight appreciation of the Cyprus pound against the U.S. dollar over the projection period. Overall, sustainability does not appear to be at serious risk under shocks of plausible magnitudes (Annex I Tables 2 and 3). Under scenario A1 (interest rate, GDP growth, U.S. dollar deflator, non-interest current account, and non-debt creating flows as percentage of GDP are at historical averages), the debt-to-GDP ratio falls to 50 percent by 2009. The external position is not seriously affected by shocks to interest and GDP growth rates (tests B1 and B2). However, the shock to the U.S. dollar GDP deflator (B3) increases the debt by about 29 percentage points. A one-time 30 percent depreciation (bound test B6) also has a significant impact on the debt ratio in 2005, but the ratio gradually declines as the impact of the shock fades.

Annex I Table 1. Cyprus: Public Sector Debt Sustainability Framework, 1999-2009  
(in percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 11/ 0.8
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	
I. Baseline Projections												
1 Public sector debt 1/ o/w foreign-currency denominated	59.9	59.9	61.9	65.2	69.8	72.3	69.5	66.4	63.5	62.1	60.7	0.8
	35.1	32.8	37.9	39.1	41.8	39.9	39.7	39.8	39.4	38.8	38.3	
2 Change in public sector debt	0.3	0.0	2.0	3.3	4.6	2.5	-2.8	-3.1	-2.9	-1.4	-1.4	
3 Identified debt-creating flows (4+7+12)	4.8	1.7	4.3	-3.1	-1.5	5.0	-2.7	-1.2	-2.2	-5.8	-1.5	
4 Primary deficit	-1.6	-3.2	-3.3	-0.5	1.3	0.0	-1.7	-1.9	-2.0	-2.3	-2.3	
5 Revenue and grants	30.5	32.8	34.1	33.4	35.4	35.6	36.7	35.9	36.1	36.8	37.0	
6 Primary (noninterest) expenditure	28.9	29.5	30.9	32.9	36.7	35.7	34.9	34.0	34.1	34.6	34.6	
7 Automatic debt dynamics 2/ Contribution from interest rate/growth differential 3/ Of which contribution from real interest rate Of which contribution from real GDP growth	6.4	2.6	3.6	-4.1	-5.3	0.8	0.4	0.6	0.6	0.8	0.9	
	1.5	0.1	1.8	1.8	0.4	0.8	0.4	0.6	0.6	0.8	0.9	
	4.2	2.9	4.1	3.1	1.5	3.1	2.9	3.2	3.1	3.2	3.2	
	-2.7	-2.8	-2.3	-1.2	-1.1	-2.3	-2.6	-2.6	-2.5	-2.4	-2.3	
11 Contribution from exchange rate depreciation 4/ Other identified debt-creating flows	4.9	2.4	1.7	-6.0	-5.7	...	...	...	...	...	...	
	0.0	2.4	4.0	1.5	2.5	4.1	-1.3	0.1	-0.7	-4.3	0.0	
12 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	2.4	4.0	1.5	2.5	4.1	-1.3	0.1	-0.7	-4.3	0.0	
16 Residual, including asset changes (2-3) 5/ Public sector debt-to-revenue ratio 1/ Gross financing need 6/ in billions of U.S. dollars	-4.5	-1.7	-2.3	6.5	6.1	-2.4	-0.1	-1.9	-0.8	4.4	0.1	
	196.3	182.9	181.2	195.4	197.1	202.9	189.7	185.0	175.8	168.7	164.1	
	34.3	29.5	29.3	31.4	20.3	20.3	20.5	19.3	18.3	17.2	16.4	
	3.3	2.7	2.8	3.3	2.7	3.1	3.3	3.3	3.3	3.4	3.4	
Key Macroeconomic and Fiscal Assumptions												
Real GDP growth (in percent)	4.8	5.0	4.1	2.1	1.9	4.2	2.4	3.5	3.8	4.0	4.0	3.9
Average nominal interest rate on public debt (in percent) 7/ Average real interest rate (nominal rate minus change in GDP deflator, in percent)	9.8	10.0	9.7	8.1	7.9	9.7	1.0	7.2	6.9	7.2	7.5	7.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	7.6	5.5	7.4	5.3	2.6	6.4	2.0	4.8	4.4	5.0	5.1	5.0
Inflation rate (GDP deflator, in percent)	-13.3	-6.8	-5.1	18.9	17.5	1.7	11.3	...	...	...	...	...
Growth of real primary spending (deflated by GDP deflator, in percent)	2.2	4.5	2.3	2.8	5.3	3.3	1.3	2.4	2.5	2.2	2.5	2.4
Primary deficit	0.8	6.5	9.8	8.2	13.2	7.2	3.5	0.6	1.6	1.4	4.3	2.9
	-1.6	-3.2	-3.3	-0.5	1.1	-1.7	1.8	0.1	-2.1	-1.9	-2.0	-1.7
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2005-09 8/ A2. No policy change (constant primary balance) in 2005-09	72.3	70.7	68.6	66.8	66.5	66.2						1.3
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 9/ A4. Selected variables are consistent with market forecast in 2005-09	72.3	71.1	70.0	69.2	70.1	71.2						1.0
	72.3	69.6	66.6	63.7	62.3	60.9						0.8
	72.3	69.5	66.4	63.5	62.1	60.7						0.8
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006 B4. Combination of B1-B3 using one standard deviation shocks B5. One time 30 percent real depreciation in 2005 10/ B6. 10 percent of GDP increase in other debt-creating flows in 2005	72.3	73.6	74.3	71.5	70.3	69.2						1.0
	72.3	74.2	77.7	77.9	80.0	82.1						1.1
	72.3	73.2	74.0	71.2	70.0	68.8						0.9
	72.3	75.5	78.5	75.6	74.4	73.2						1.0
	72.3	88.2	85.2	82.5	81.5	80.5						1.1
	72.3	79.6	76.5	73.6	72.4	71.1						1.0

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as  $[(r - \pi(1+g) - g + \alpha\epsilon(1+r))/(1+g+\pi+gr)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\epsilon$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as  $\alpha\epsilon(1+r)$ .

5/ For projections, this line includes exchange rate changes.

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

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ The key variables include real GDP growth, real interest rate, and primary balance in percent of GDP.

9/ The implied change in other key variables under this scenario is discussed in the text.

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

11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

## ANNEX I

e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ For projection, line includes the impact of price and exchange rate changes.

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

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

Annex I Table 3. Cyprus: External Sustainability Framework--Gross External Financing Need, 1999-2009

	1999	2000	Actual 2001	2002	2003	Projections					
						2004	2005	2006	2007	2008	2009
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/ in percent of GDP	0.9 9.8	1.2 13.2	1.0 11.0	1.2 10.0	1.3 8.7	2.3 13.4	2.8 15.4	2.6 13.6	2.7 13.1	2.8 12.6	2.8 12.1
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						2.3	2.9	2.9	3.2	3.4	3.6
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						2.3	3.3	3.1	2.9	3.0	3.0
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						2.3	2.7	2.6	2.7	2.7	2.8
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006						2.3	2.7	2.5	2.6	2.7	2.7
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006						2.3	3.4	3.8	3.1	3.2	3.2
B5. Combination of 2-5 using one standard deviation shocks						2.3	3.3	3.4	3.0	3.1	3.1
B6. One time 30 percent nominal depreciation in 2005						2.3	2.6	2.5	2.6	2.7	2.7
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						13.4	15.6	14.5	14.2	13.9	13.6
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						13.4	18.2	16.2	14.1	13.6	13.0
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						13.4	15.9	14.7	14.1	13.7	13.1
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006						13.4	18.8	21.1	20.2	19.6	18.8
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006						13.4	19.1	19.5	14.9	14.5	13.8
B5. Combination of 2-5 using one standard deviation shocks						13.4	20.8	22.3	18.4	17.8	17.0
B6. One time 30 percent nominal depreciation in 2005						13.4	20.8	18.6	17.9	17.3	16.6

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

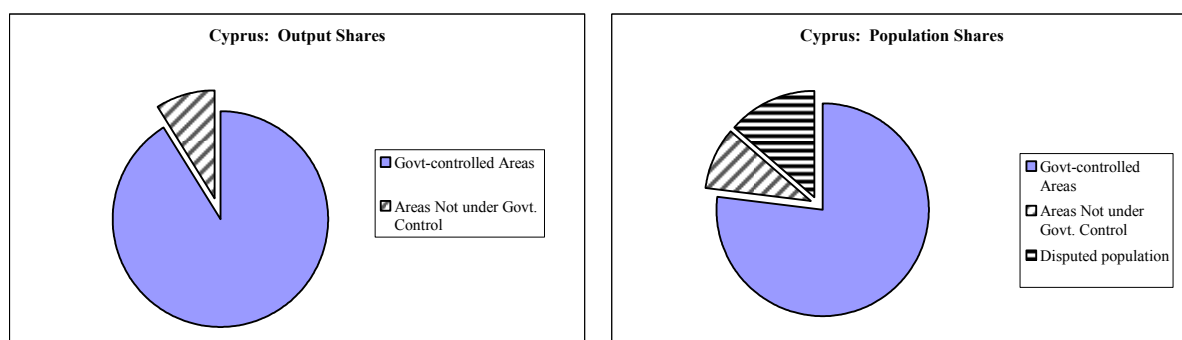
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous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

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



## ECONOMY OF THE AREAS NOT UNDER GOVERNMENT CONTROL (NGC)<sup>22</sup>

1. The NGC areas comprise 1/3 of the land area of Cyprus and about 22 percent of the population of the island, a large fraction of which the G/C authorities do not consider to be legal inhabitants of Cyprus. The NGC areas produce less than 10 percent of the combined GDP of Cyprus, with output concentrated in the public sector, tourism, agriculture, and commerce (Annex II Table). During the 1980s, growth averaged about 5 percent p.a., with some slowing in the 1990s. Volatility in Turkey led to a sharp contraction in 2000–01, followed by fairly robust growth in 2002–03. Most external trade—including for tourism—takes place with Turkey, which is the only country to recognize the NGC areas as a separate state. (Tourism arrivals typically number over 400,000 per year, of which three fourths come from Turkey.)



2. Public finances in the NGC areas are heavily dependent on transfers and loans from Turkey. Indeed, expenditures of just under half of GDP—1/3 of which go to civil service wages—are covered in roughly equal measure by domestic revenue and foreign grants and loans.

3. The Turkish lira circulates in the NGC areas, meaning that the most important monetary task consists of supervision of the financial sector, including offshore institutions. The economic slowdown after 1999 led to some financial sector consolidation, but there remains a need for significant banking sector restructuring.

4. Cyprus joined the EU on May 1, 2004, but with a derogation allowing non-application of the *acquis* in the NGC areas.

<sup>22</sup> Data in this Annex are from publicly-available sources.

Annex II Table. Cyprus: Areas Not under Government Control (NGC)  
Selected Economic Indicators, 1999-2003

	1999	2000	2001	2002	2003
<b>Output and prices</b>					
Nominal GNP (TL trillion)	407	651	1070	1419	1907
Nominal GNP (US \$ million)	964	1040	909	984	1284
Real GNP (percent change)	7.4	-0.6	-5.4	6.9	5.4
CPI (Dec to Dec, percent change)	55.3	53.2	76.8	24.5	12.6
<b>Sectoral breakdown of GNP</b>					
Total, o/w:	100	100	100	100	100
Agriculture	8	7	7	8	9
Industry	11	11	11	13	15
Trade and tourism	17	16	15	17	16
Transport and communication	11	13	13	12	12
Public services	23	24	19	17	21
<b>Tourism</b>					
Arrivals (thousands), o/w:	414	433	365	426	470
from Turkey	334	348	278	316	340
Net tourism revenue (US \$ million)	193	198	94	114	117
<b>External sector (US \$ million)</b>					
Exports of goods (fob), o/w:	52	50	35	48	51
to Turkey	28	19	13	18	23
Imports of goods (fob), o/w:	413	425	272	294	478
from Turkey	256	275	174	189	299
Tourism (net)	193	198	94	95	179
Current account balance	-90	-33	-17	-8	19
as percent of GNP	-9.4	-3.2	-1.9	-0.8	1.5
Capital account balance	132	47	143	140	263
Change in reserves (- = increase)	-32	23	-91	-111	-281
<b>Public finance (percent of GNP)</b>					
Domestic revenue	27.8	28.0	24.5	23.5	31.5
Foreign grants	7.6	9.9	5.5	5.8	8.6
Expenditure	47.2	51.0	46.1	44.0	53.9
Balance	-11.8	-13.1	-16.1	-14.7	-13.8
<b>Population of the NGC Areas</b>					
T/C estimate (thousand)	207	209	211	213	216
G/C estimate (thousand)	88	88	88	88	88
GNP per capita (US \$) of NGC Areas 1/	4666	4978	4303	4610	5949
<i>Memo items:</i>					
Population of Govt-controlled Areas (thousand)	690	698	706	715	730
GNP per cap. of Govt-controlled Areas (US \$)	13494	12404	12791	14116	17738

Source: Economist Intelligence Unit, Cyprus Country Profile 2003; and www.devplan.org.

1/ Assuming T/C estimates of population in the NGC areas.

# **CYPRUS: FUND RELATIONS**

As of December 31, 2004

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

<b>II. General Resources Account:</b>	SDR Million	Percent of Quota
Quota	139.60	100.0
Fund holdings of currency	92.33	66.14
Reserve position in Fund	47.28	33.87

<b>III. SDR Department:</b>	SDR Million	Percent of Allocation
Net cumulative allocation	19.44	100.0
Holdings	2.51	12.91

**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:** (SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/interest	0.38	0.38	0.38	0.38	0.38
Total	0.38	0.38	0.38	0.38	0.38

**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  $\pm 2.25$  percent. On January 1, 1999, the euro replaced the ECU as the basis of the peg. In 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 during October 23–November 4, 2002, and the staff report (Country Report No. 03/30, 1/16/03) was discussed by the Executive Board on January 31, 2003. Staff visits took place during October 10–13, 2003, and July 22–23, 2004.

**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 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:**

<b>Dept.</b>	<b>Purpose</b>	<b>Date</b>
MAE	Government debt management	February–March 1989
FAD	VAT training program	June–October 1992
MAE	Financial sector liberalization	November–December 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	November 2001–March 2002
STA	Balance of Payments	April–June 2002

**XI. Resident Representative:** None.

**XII. Exchange Restrictions:**

Pursuant to UN Security and EU resolutions, economic sanctions have been imposed against Iraq, the Taliban, Rwanda, Sudan, Burma (Myanmar), Congo, Somalia, Zimbabwe, Liberia, Sierra Leone, the Unita Movement in Angola as well as persons (natural or legal) associated with terrorism. Although sanctions against Serbia and Montenegro have been lifted, some bank balances belonging to the former National Bank of Yugoslavia remain frozen at the request of the Prosecutor of the International Criminal Tribunal for the former Yugoslavia. These restrictions are solely for the preservation of international security and the authorities will shortly update the Fund in accordance with Decision 144-(52/51).

## CYPRUS: STATISTICAL ISSUES

Cyprus has an open publication policy and its statistical data are generally of a high quality and adequate frequency. However, weaknesses remain with respect to the requirements of the Special Data Dissemination Standard (SDDS) such as for the international investment position, and some data series are only available with long time lags. The authorities intend to subscribe to the SDDS in the near future.

**National accounts** time series (1995–2003) are available online. Quarterly GDP growth rates are published with a delay of one quarter; annual national accounts are published with a delay of up to half a year. Monthly indicators of economic activity exist, notably on trade flows, tourism arrivals, and industrial production, but with a lag of several months for most indicators. Since January 1999, the CPI is compiled following the EU methodology for the Harmonized CPI. The national accounts data were recently revised to comply with the *1995 European System of Accounts*.

**Balance of payments** accounts are presented in the format specified by EuroStat in Balance of Payments Vade Mecum, which is based on the *IMF Balance of Payments Manual*, fifth edition (*BPM5*). From 1995 onwards, the BOP statistics have been compiled using the *BPM5* definition of residency. Trade statistics are available on a monthly basis with a lag of about three months; current account statistics are available on a quarterly basis, with a lag of about four months. Direct investment statistics are available on an annual basis. While the data are generally of good quality, some concerns remain regarding coverage and classification (especially on sectoral breakdown of portfolio investment) as well as timeliness and transparency of revisions.

**Fiscal data** for the central government are of good quality and coverage. Monthly fiscal central government data are generally of high quality but are not published on a timely basis. General government accounts exist from 1998 and are published on the internet on an annual and quarterly basis, although with a lag of a few months. Cyprus last reported data for publication in the *Government Finance Statistics Yearbook* in 1998. No data are currently reported for publication in *International Financial Statistics*.

**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 available with a lag of about one month.

**Publication** is generally open. A large amount of information is available through the internet, including press statements as well as data files from the Statistical Service, the Ministry of Finance, and the Central Bank of Cyprus.

**CYPRUS: CORE STATISTICAL INDICATORS**  
as of December 31, 2004

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	General Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	12/31/04	10/29/04	10/29/04	10/29/04	10/29/04	12/31/04	November 2004	July 2004	Q2 2004	Q3 2004	2003 revised	2003
Date Received	12/31/04	12/07/04	12/10/04	12/10/04	12/10/04	12/31/04	12/3/04	11/10/04	10/11/04	12/3/04	11/15/04	7/10/04
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Annual	Semi-annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	When Updated	When Requested
Source of Update 1/	Reuters/ Bloomberg	CBC	CBC	CBC	CBC	CBC/ Reuters	Stat. Serv. /Reuters	CBC/ Reuters	CBC	MoF	Stat. Serv.	MoF
Mode of Reporting	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic/ Fax	Internet/ Publication	Internet/ Electronic	Internet/ Electronic	Fax/ Electronic
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	Quarterly	When Updated	Semi-annual

1/ Central Bank of Cyprus (CBC); Ministry of Finance (MoF), Statistical Service

**Statement by the IMF Staff Representative  
February 18, 2005**

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 data for 2004 suggest that real GDP grew by 3.5 percent, in line with projections, while average CPI inflation was 2.3 percent, slightly lower than projected. At the same time, performance of the tourism sector was slightly weaker than expected, suggesting the projected 2004 current account imbalance will widen modestly.
3. The 2004 general government deficit is now estimated by the authorities to have been reduced to about 4.3 percent of GDP, well below the 4.8 percent target presented in the revised Convergence Program. This better-than-expected performance stems both from expenditure constraint (lower-than-budgeted defense and capital expenditures) and improved revenue performance, including the tax amnesty. Based on the revised Convergence Program and the 2005 budget, the Ecofin Council concluded on January 18, 2005, that Cyprus has taken effective action to correct and contain its fiscal imbalances, and that no further steps are necessary at this point under the excessive deficit procedure.
4. Looking ahead, the 2004 preliminary fiscal outturn and the ongoing implementation of the measures outlined in the Convergence Program bode well for achieving the 2005 general government deficit target of no more than 3 percent of GDP. According to the authorities, even conservative estimates suggest that the tax amnesty will yield more than 1 percent of GDP compared with a previous estimate of 0.6 percent. Furthermore, agreement has been reached on the regularization of the dividend policy of public enterprises, which should result in another 0.6 percent of GDP. Also, preliminary agreements have been reached with the relevant trade unions on the increase of the retirement age for employees in the public sector. Lastly, although the authorities feel there is a safety margin to ensure compliance with the deficit target of 3 percent of GDP, they have reiterated their readiness to take additional steps should the remaining measures outlined in the Convergence Program yield less than expected.
5. The authorities have formally requested a fiscal ROSC assessment, the timing for which is being discussed at present.
6. Discussions are ongoing between staff and the authorities on a framework under which the Fund could provide technical assistance in its areas of competence to the Turkish community in northern Cyprus.

**Statement by Jeroen J.M. Kremers, Executive Director for Cyprus  
and Lucian Croitoru, Senior Advisor to Executive Director  
February 18, 2005**

***The broad picture***

**The Cypriot authorities appreciate the staff report, which accurately assesses the country's performance and provides a realistic view of the policy challenges.** The authorities agree that the key macroeconomic challenges are a credible fiscal consolidation and the strategy for adopting the euro. The authorities also broadly agree with staff recommendations.

**Macroeconomic developments are encouraging, supported by sound macroeconomic policies.** Growth has begun to rebound following two years of relatively weak performance, recovering to about 3½ percent in 2004, and the authorities expect a growth of 4 percent in 2005. Consumption was the main engine of growth, fed by fiscal easing in 2003 and a possible confidence effect from the EU accession. Reforms that will be brought forward in the process of adaptation to EU institutions and regulations are expected to set the stage for enhanced economic growth. Tourism has picked up, unemployment remains very low even by European standards, and the current account deficit has not exceeded 4½ percent of GDP for several years. A moderate increase in the current account deficit is expected for 2004, in part due to one-off items, such as the higher than expected increase in the imports of cars due to the significant reduction of excise duties in November 2003. Inflation has crept upward on rising energy prices, but is expected to remain in the vicinity of 2½ percent as a result of the continued restrained stance of monetary policy. The central bank has left the interest rates high since April, when it raised them in response to modest outflows in the weeks preceding the EU accession, outflows that are now reversed. As a start of fiscal consolidation that the authorities are committed to implement over the medium term, the 2004 budget deficit was brought to 4.3 percent of GDP, well below the 4.8 percent target, and down from 6.3 percent of GDP in 2003. It is budgeted to be below the Maastricht threshold of 3 percent of GDP as of 2005. The increase of debt-to-GDP ratio beyond the Maastricht threshold was led mainly by technical reasons rather than above the line deficit-inducing transactions, and a downward trend is foreseen as of 2005.

**Looking forward, the authorities remain committed to implementation of the adjustments needed for an early accession in the monetary union.** Although it was not among the group that joined ERM2 in June 2004, Cyprus intends to be one of the first new members to adopt the euro. The authorities acknowledge that delivering a strong fiscal adjustment is a prerequisite for joining ERM2 in the first part of 2005 and for an early euro adoption. In addition, to support competitiveness and have a strong performance in the monetary union, the authorities will strengthen structural reforms.

***Fiscal policy***

**Acknowledging that medium-term fiscal sustainability depends on further fiscal consolidation, the authorities adopted an ambitious Convergence Program (CP) in May 2004.** The main features of the CP consist of targeting a significant adjustment (from a deficit



estimated at that time at 5.2 percent of GDP in 2004 to 2.9 percent of GDP in 2005 and 0.9 percent of GDP in 2008), and implementing a number of politically difficult measures, including parametric reforms to both the public and general pension systems (there already are preliminary agreements with the relevant trade unions on the increase of the retirement age for employees in the public sector). Under the CP, public debt is expected to decline rapidly to 60 percent of GDP by 2009.

**The authorities have begun restoring credibility in implementing fiscal adjustment after the fiscal slippages of the past.** Their fiscal prudence was reflected in a lower than envisaged deficit for the first 10 months of 2004, and in December the authorities approved an update to the CP that is more ambitious than the May program. As noted above, they overperformed relative to the revised program by 0.5 percent of GDP. Based on the revised CP and on the 2005 budget, the Ecofin Council concluded on January that Cyprus has taken effective action to correct its fiscal imbalances, and no other steps are necessary under the excessive deficit procedures. Even more, recognizing the existence of downside risks to growth and their potential fiscal impact, the authorities are ready to consider additional measures if the CP may fall short to deliver the envisaged fiscal adjustment, and indicated that they would be prepared to consider most of the measures proposed by staff.

**To consolidate policy credibility over the medium term, the authorities are willing to consider a medium-term fiscal framework.** As a preparatory step, they have already limited the practice of approving many supplementary budgets to revise upward the spending ceilings during the year, and requested a fiscal ROSC for 2005.

### ***Monetary policy***

**The Central Bank of Cyprus (CBC) will continue to maintain a cautious stance of monetary policy.** There are a few reasons that would, at this stage, make a relaxation inappropriate. First, a vigilant monetary policy serves better the authorities' plans to participate in ERM2 as early as possible in the course of 2005. Secondly, although credit growth slowed from 8 percent in 2002 to 5 percent in 2003, as compared to an annual average of 13 percent during 1999-2001, it rebounded to 6.5 percent in 2004 and is expected to continue increasing slightly in 2005. Thirdly, inflationary pressures have crept up fueled by higher oil prices, and uncertainty regarding oil prices still persists. The authorities' policy is to keep the monetary stance consistent with other policies. Some monetary policy easing might become possible as the implementation of the fiscal consolidation program progresses and changes in oil prices will have tamed.

**The financial sector is sound, with banks being rated beyond the investing grade.** Enhanced disclosure rules and listing requirements have been introduced to strengthen the securities market in the wake of the stock market crash of 2000. Progress has been made in strengthening the insurance sector by bringing specific legislation in line with EU requirements in 2003. The same year, capital adequacy requirements and minimum reserve requirements on foreign currency have been raised. The CBC also issued a circular in late 2003 to tighten collateral requirements for real estate lending. Moreover, to have a more realistic view on the magnitude of nonperforming loans (NPL), the authorities have gradually reduced the time threshold for declaring an overdue loan to be nonperforming from 12 percent in 2003 to 3 percent in 2005. This, together with still weak recovery rules kept NPL

ratios high, but prudential oversight continues to be strong. Although the CBC and private banks agreed that supervision of financial institutions should be consolidated in one institution, the cooperative and credit societies, which hold a quarter of the financial system's deposit base, disagree. The offshore sector's reputation has improved, as ensured by staff, and the authorities plan to request a FSAP after MFD will have updated its 2001 OFC assessment in early 2005.

### ***ERM2 and Cyprus's competitiveness***

**Cyprus's long employed exchange rate regime mirroring ERM2 provides a good basis for joining ERM2 in the first part of 2005 and for adopting the euro as soon as possible.** The exchange rate movements have stayed for years within a de facto narrow band around the central parity, which means that ERM2 is, effectively, already there. By setting a near-term target for ERM2, the authorities aim at benefiting from the existing favorable political economy setting for reforms, and also at giving strong support for politically difficult fiscal measures already envisaged in the CP.

**The authorities view the actual exchange rate parity as appropriate and it should not be changed for competitiveness purposes.** As rightly stressed by staff, the convergence effect has explained most of the pound appreciation over the last decade. It is also worth mentioning that real appreciation has taken place in part due to the rise of inflation owing to the increase in the VAT rate by 5 percent since 2002 and in the rise of other EU harmonization-induced excise taxes. Even with a lower growth differential and a higher inflation differential versus the euro zone in 2002-03, other competitiveness indicators do not suggest that the exchange rate is out of line with fundamentals. Moreover, as stressed by the authorities and agreed by staff, given the openness of the Cypriot economy, any gain in competitiveness from a change in the pound's parity would be eroded by the pass-through effect. The authorities will protect competitiveness by implementing the envisaged fiscal adjustments and the needed measures in area of structural reforms.

### ***Structural reforms***

**Although privatization of the remaining public enterprises was not on the agenda, structural reforms have progressed.** The authorities were focused on complying with the EU's *acquis communautaire*, and services and utilities markets have opened up. Looking forward, in view of heightened competition from other carriers, the authorities are considering options to restructure the airline, including by disposing one of its subsidiaries. While the authorities do not see the immediate need to modernize corporate governance of public enterprises through corporatization, fostering competition and promoting efficiency remain among their objectives in area of public enterprise reform.

**The authorities consider that the automatic backward-looking wage indexation (COLA) system had worked well, but acknowledge the tendency of real wage growth to outstrip productivity gains, and will limit increases beyond the COLA in the public sector.** The authorities also note that the staff assesses the COLA system as a structural rigidity, but they believe that the system has benefits in terms of harmonious labor relations and is not a source of inflationary pressures.

*The reunification of Cyprus*

**The Cyprus authorities do not share the assessment of the staff conveyed in the last sentence of Box 3 (page 17) of the draft report that the Annan Plan was economically and financially viable.** They point out that the assessment of the viability of the Annan Plan was not a task of the staff during the 2004 Article IV Consultation with Cyprus and therefore the assessment was not discussed with the Cypriot authorities. Accordingly, the staff views do not represent a recent assessment of the viability of the Annan Plan.

**The staff has been informed of the Cyprus authorities' areas of concern regarding the Annan Plan and detailed papers on this subject have been sent to the staff.** Looking forward, the authorities are committed to continued cooperation in finding a solution towards an acceptable and viable reunification plan.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 05/39  
FOR IMMEDIATE RELEASE  
March 22, 2005

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2004 Article IV Consultation with Cyprus**

On February 18, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cyprus.<sup>1</sup>

### **Background**

The Cypriot economy has seen substantial changes since the last IMF Article IV consultation in 2002. Chief among these is accession to the European Union, the full impact of which is only gradually making itself felt. In a sense, Cyprus ceased to be an island on May 1, 2004. While these changes pose significant challenges for the authorities and for the private sector, they also offer substantial opportunities to enhance economic growth in Cyprus.

Economic growth has begun to rebound following a more modest performance in 2002-03, recovering in real terms to about 3½ percent in 2004 mainly driven by an increase in domestic demand. Real per capita income has continued to rise, now reaching above 80 percent of the average EU 25 income level when adjusted for purchasing power, unemployment remains low by European standards, and inflation has been kept at bay, although rising energy prices have exercised some upward pressures in 2004. Looking ahead, growth is estimated at close to 4 percent in 2005 reflecting an improved external environment. Over the medium term, growth prospects are subject to a significant degree of uncertainty given oil price volatility and a lack of clarity on reunification, as well as the ultimate impact of EU accession.

---

<sup>1</sup> 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.

Following a significant fiscal slippage in 2003, with the general government deficit rising to 6.3 percent of GDP amid expenditure overruns, the authorities have recently adopted an ambitious and detailed Convergence Program aimed at consolidating the fiscal accounts and bringing the deficit and debt levels down to levels compatible with the Maastricht criteria. The authorities have also stated their readiness to take additional measures in case the program does not yield the expected impact. The general government deficit is now targeted at 4.8 percent of GDP in 2004 and at 2.9 percent in 2005; meanwhile, public debt is expected to peak at 72 percent of GDP in 2004 before starting to decline, reaching close to 60 percent of GDP by 2009.

Substantial progress with structural reforms has been achieved in a number of areas, mainly in response to efforts to conform with the *acquis communautaire*. In particular, indirect taxation has been aligned more closely with EU standards, direct taxes have been lowered, the capital account has been liberalized, and financial sector legislation has been strengthened in line with EU directives.

The fiscal consolidation envisaged in the Convergence Program will enable the authorities to achieve their strategy of adopting the euro as soon as possible, including by joining the ERMII in the first half of 2005. The current parity is deemed appropriate. Further fiscal consolidation and deeper structural reforms, in particular labor market reforms, would be appropriate ways to prevent further erosion of competitiveness.

### **Executive Board Assessment**

Directors welcomed the Cypriot authorities' long record of good policy performance, which has led to low inflation, near full employment and, in 2004, a rebound in growth. They observed that accession to the EU has prompted many important structural reforms, helping to lay the foundation for sustained economic growth into the future. Directors noted the authorities' plans to join the ERMII in 2005 and adopt the euro thereafter, and cautioned that this will require determined and sustained fiscal adjustment and structural reform. In this regard, they welcomed the authorities' ambitious and updated Convergence Program and urged its full implementation. They commended the authorities' efforts to build national support for the Program.

Directors noted the significant fiscal slippage in 2002-03, and stressed that fiscal adjustment is now the key economic priority for Cyprus. They welcomed the appreciable progress made in this regard during 2004, and considered the 2005 overall deficit target of 3 percent of GDP to be achievable with continued scrupulous implementation of the Convergence Program measures. Directors welcomed the better-than-expected revenue yield of some measures, but stressed that key expenditure containment measures—including raising the retirement age in the public sector and limiting public sector wage increases—remain necessary. They also encouraged the authorities to follow up, if needed, on their stated readiness to take further measures to ensure the fiscal targets are achieved.

Directors noted that mounting demographic pressures reinforce the need for fiscal restraint and a reduction of the public debt over the medium term. In that light, Directors welcomed plans to target primary fiscal surpluses beginning in 2005, in part through caps on current and capital spending. Of particular importance will be reforms to the health care and pensions systems and the freeze on new government positions. Directors urged the

authorities to adopt an explicit medium-term fiscal framework, which would bolster policy formulation and credibility. Such a framework should also eliminate the need for supplementary budgets during the year. In this context, they welcomed the authorities' recent request for a fiscal Reports on the Observance of Standards and Codes assessment.

Directors supported the central bank's cautious monetary policy stance, stressing the need for vigilance in the face of possible inflationary pressures in the run-up to euro adoption. They agreed that the current exchange rate parity remains appropriate. However, a number of Directors urged reform of the wage-setting mechanism. While acknowledging that automatic, backward-looking wage indexation has contributed to harmonious labour relations in Cyprus, these Directors also noted that it has increased the pass-through of inflationary shocks, limited the ability of employers to provide performance-based merit pay increases, and reduced external competitiveness.

Directors stressed the importance of a strong structural reform effort to enhance competitiveness. They welcomed the reforms in electricity distribution, air transport and water management, and encouraged the authorities to modernize corporate governance in the public enterprises and consider eventual privatization of these enterprises where appropriate.

Directors welcomed the strengthening of financial sector regulations in recent years with a view to aligning them to EU norms. At the same time, they called for vigilance over the financial system's growing exposure to the real estate market and its interaction with the offshore sector. Directors also stressed the importance of effective supervision of the cooperative sector, and encouraged consolidation of their supervision under one institution. Directors looked forward to the Offshore Financial Center assessment update later this year, and encouraged the authorities to seek an evaluation under the IMF's Financial Sector Assessment Program.

Directors hoped that an agreement could be reached that would allow Fund staff to provide technical assistance, in the IMF's areas of expertise, to the Turkish Cypriot community in northern Cyprus.

Cyprus's macroeconomic statistics remain adequate for IMF surveillance purposes, but Directors noted that further improvements would be facilitated by the process of subscription to the Special Data Dissemination Standard.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

## Cyprus: Selected Economic Indicators

	2001	2002	2003	2004 1/
<b>Real economy</b>				
GDP (change in percent)	4.1	2.1	1.9	3.5
Domestic Demand (change in constant prices)	3.2	4.7	2.3	6.1
CPI (period average; change in percent)	2.0	2.8	4.1	2.5
Unemployment rate (in percent)	2.9	3.2	3.5	3.4
Gross domestic saving (in percent of GDP)	19.3	19.6	17.1	17.2
Gross domestic investment (in percent of GDP)	16.5	18.7	17.9	18.3
<b>Public finances</b> (general government, in percent of GDP)				
Overall balance	-2.3	-4.5	-6.3	-4.8
Primary balance 2/	1.1	-1.3	-2.8	-0.1
Gross debt (Maastricht definition)	61.9	65.2	69.8	72.3
<b>Money and credit</b> (end of year, percentage change)				
Reserve money	7.5	22.7	4.8	6.6
Broad money	13.3	10.3	4.0	8.4
Domestic credit	14.9	9.5	5.9	7.2
<b>Interest rates</b> (year average)				
Deposit rates 3/	6.0	4.8	3.8	4.2
Lending rates 4/	7.5	7.2	6.9	7.9
<b>Balance of payments</b> (in percent of GDP)				
Trade balance	-27.2	-27.2	-23.8	-24.6
Current account	-3.3	-4.5	-3.4	-4.3
<b>Fund position</b> (as of end-November, 2004)				
Fund holding of currency (in percent of quota)		65.72		
Holdings of SDRs (in percent of allocation)		12.91		
Quota (in millions of SDRs)		139.60		
<b>Exchange rate</b>				
Exchange rate regime		Cyprus pound		
Present rate (January 18 , 2005)		US\$2.24 per Cyprus pound		
Real effective exchange rate 5/	101.8	104.2	110.2	113.2

Sources: Cypriot Authorities; IMF, *International Financial Statistics*; and IMF staff estimates.

1/ IMF staff projections, unless otherwise indicated.

2/ Defined as non-interest revenue minus non-interest expenditure.

3/ 1-year fixed deposits over C£5,000. For 2004, data as of October.

4/ Enterprises secured loan rate. For 2004, data as of October.

5/ Based on CPI, 2000=100. For 2004, data as of October.