Cyprus: Second Post-Program Monitoring Discussions-Press Release; Staff Report and Statement by the Executive Director for Cyprus

INTERNATIONAL MONETARY FUND

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CYPRUS

June 2018

SECOND POST-PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

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

- A **Press Release** summarizing the views of the of the Executive Board as expressed during its June 4, 2018, consideration of the staff report that concluded the Second Post-Program Monitoring discussions with Cyprus.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 4, 2018, following discussions that ended on March 30, 2018, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 22, 2018.
- A **Statement by the Executive Director** for Cyprus.

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

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June 7, 2018

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IMF Executive Board Concludes Second Post-Program Monitoring Discussions with Cyprus, Extends Post-Program Monitoring

On June 4, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Second Post-Program Monitoring Discussions[1] with Cyprus and supported extending post-program monitoring through July 31, 2019.

Cyprus's economic recovery has strengthened. GDP growth has reached 3.9 percent in 2017, with upbeat activity concentrated in construction, tourism and professional services. The unemployment rate has continued to decline at a sustained pace, while moderate price and wage rises have supported competitiveness, helping to contain the increase in the current account deficit, despite higher imports. Improved economic conditions have supported robust fiscal revenue collection, contributing to a sizable primary surplus and a decline in the public debt ratio. Despite the vigorous upswing, non-performing loans still weigh on banks' profitability and have prevented significant improvement in households' and corporations' financial health. Political and social acceptance of strategic default continue to undermine financial intermediation.

The current strong expansion is forecast to extend well into the future, with growth inching up to 4 percent this year and 4.2 percent in 2019. The brisk pace of economic activity is underpinned by ongoing and planned construction projects, and is only partly dented by decelerating private consumption, as households step up loan repayments over time. In the medium term, growth is projected to ease gradually towards 2.5 percent, as construction projects reach completion. Investment, mainly in the tourism sector, is expected to raise potential growth somewhat. Sustained fiscal primary surpluses of around 4–4.5 percent of GDP during 2018–23, combined with buoyant nominal GDP growth, would help lower the public debt ratio to 72 percent of GDP by 2023, after a 12-percentage point increase in early 2018 from restructuring of the Cyprus

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

Cooperative Bank. Banks' weak asset quality and insufficient diversification of economic activity are sources of downside risks to this outlook.

Executive Board Assessment[2]

Executive Directors welcomed the economy's strengthening recovery, which has been accompanied by a sustained decline in the unemployment rate, a sizeable primary fiscal surplus, and a reduction in the public debt ratio. Directors observed, however, that despite the economy's strong upswing, banks' non-performing loans and private sector debt remain high, reflecting continued weak payment discipline. They urged the authorities to strengthen efforts to address these legacy problems.

Directors noted that Cyprus's capacity to repay the Fund is expected to be adequate under staff's baseline scenario, but is subject to significant downside risks. They agreed that sustained strong economic growth and accompanying fiscal primary surpluses would be crucial to achieve a projected rapid decline in the public debt-to-GDP ratio and allow continued access to financial markets on favorable terms. Strong and continued efforts to implement ambitious macroeconomic policies and structural reforms would further reinforce Cyprus's capacity to repay. In this context, Directors welcomed the authorities' willingness to continue post-program engagement with the Fund.

Directors stressed the urgency of reducing non-performing loans in a decisive and durable manner. They highlighted the need to ensure that banks remain adequately capitalized and provisioned and that loans transferred to the special purpose vehicle are restructured swiftly. They recommended amending the current framework for insolvency and foreclosure to improve payment discipline. Directors emphasized that any scheme aimed at encouraging vulnerable borrowers to begin servicing their loans should be subject to tight eligibility criteria to avoid moral hazard and contain fiscal costs.

Directors welcomed the rapid improvement in the fiscal position. They highlighted the need to avoid procyclicality and supported capping fiscal spending increases at the medium-term output growth rate. They also recommended instituting a durable mechanism to control the public-sector wage bill and keeping in check the fiscal risks arising from the planned introduction of the National Health System. These efforts would help safeguard the downward path of debt and create space to absorb contingent fiscal shocks.

Directors urged the authorities to restart macro-critical structural reforms to help diversify the economy. To attract capital into innovative sectors, they recommended focusing efforts on

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

strengthening the enforcement of commercial claims and the efficiency of the courts, as well as pursuing privatization. They also suggested avoiding an excessive concentration of economic activity in construction. Directors highlighted the importance of full compliance with AML/CFT standards and strengthening the anti-corruption framework.

Directors agreed to extend post-program monitoring through July 31, 2019.

Cyprus: Selected Economic Indicators, 2015–2019

	2015	2016	2017	Projections 2018	Projections 2019
Output/Demand					
Real GDP	2.0	3.4	3.9	4.0	4.2
Domestic demand	2.9	5.2	8.3	1.5	6.5
Consumption	1.6	2.6	3.9	3.5	2.7
Private consumption	2.6	3.3	4.2	3.6	3.0
Public consumption	-2.6	-0.4	2.7	2.7	1.4
Gross capital formation	11.6	19.8	29.8	-6.0	23.0
Foreign balance 1/	-0.9	-1.7	-4.5	2.3	-2.6
Exports of goods and services	5.8	4.0	3.4	-1.3	4.9
Imports of goods and services	7.4	6.8	10.1	-4.5	8.7
Potential GDP growth	1.0	1.4	1.8	2.2	2.4
Output gap (percent of potential GDP)	-6.4	-4.6	-2.6	-1.0	0.6
Prices					
HICP (period average, percent)	-1.5	-1.2	0.7	0.2	1.0
HICP (end of period, percent)	-0.5	0.1	-0.4	1.5	1.4
Employment					
Unemployment rate (percent)	14.9	13.0	11.0	9.5	8.0
Employment growth (percent)	-1.3	2.5	3.1	2.7	2.5
Public Finance					
General government balance	-0.2	0.4	1.8	2.1	2.1
Revenue	39.0	38.6	39.7	39.3	39.2
Expenditure	39.2	38.2	37.9	37.2	37.1
Primary Fiscal Balance	2.7	3.1	4.4	4.5	4.5
General government debt	107.5	106.6	97.5	106.1	97.8
Balance of Payments					
Current account balance	-1.5	-4.9	-6.7	-5.1	-7.2
Trade Balance (goods and services)	0.8	-0.8	-2.0	-1.5	-3.6
Nominal GDP (billions of euros)	17.7	18.2	19.2	20.1	21.3

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

INTERNATIONAL MONETARY FUND

CYPRUS

SECOND POST-PROGRAM MONITORING DISCUSSIONS

May 22, 2018

EXECUTIVE SUMMARY

The economic recovery has gathered further momentum. Strong GDP growth has supported employment. While the current account deficit has widened reflecting the high import content of demand, persistent price and wage moderation have sustained competitiveness. Improving cyclical conditions contributed to a sizable primary fiscal surplus and a decline in the public debt ratio.

However, the economy is still burdened with legacies from the crisis. Despite accelerating growth, private sector debt continues to be very high reflecting the slow pace of deleveraging. Banks' asset quality remains poor, weighing adversely on profitability. To support the position of the Cyprus Cooperative Bank and deal with NPLs more broadly across the banking system, the government has taken actions aimed at encouraging consolidation and reinforcing banks' balance sheets.

Capacity to repay the Fund is expected to be adequate under the baseline scenario, but is subject to significant downside risks. Strong economic growth, sizeable fiscal primary surpluses, the large share of official loans in public debt and the back-loaded repayment schedule of those loans are expected to support market access on favourable terms. However, repayment capacity could weaken if direct and contingent fiscal liabilities from NPLs are realized, growth falls abruptly or a boom-bust cycle re-emerges, or weak payment discipline continues.

To strengthen capacity to repay against adverse shocks, ambitious macroeconomic policies and structural reforms are needed:

- **Restructuring NPLs in a decisive and durable manner** by adhering to prudent capital and provisioning requirements and avoiding merely warehousing loans;

- **Restoring a responsible payment culture** by amending the foreclosure framework and ensuring that strategic default is no longer politically or socially acceptable;

- **Avoiding procyclical fiscal policy** by setting a ceiling for nominal spending that increases in line with medium-term output growth;

- **Restarting a comprehensive structural reform agenda** targeting more diversified and sustainable growth and reducing reliance on construction activity.

Approved By
Philip Gerson (EUR) and Kevin Fletcher (SPR)

Discussions took place in Nicosia during March 19–30, 2018. The staff team comprised R. van Elkan (head), S. Choi, H. Takizawa (all EUR), F. Narita (SPR), G. Mitchell Casselle (MCM) and V. Guzzo and M. Heracleous (IMF resident representative office in Nicosia). T. Chen and D. Noren (both EUR) supported the mission from headquarters. J. de Lint (office of the Executive Director) joined some of the meetings.

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ANNEXES

BACKGROUND[1]

1. **The IMF's Executive Board extended post-program monitoring (PPM) through July 2018.** PPM was initiated on March 18, 2016, following the termination of Cyprus's Extended Arrangement under the Extended Fund Facility (EFF). In August 2017, PPM was extended in view of the need for continued close monitoring of Cyprus's capacity to repay and progress toward external viability. The mission for the second PPM discussions in March 2018 coincided with the Fourth Post-Program Surveillance (PPS) mission of the European Commission (EC), European Central Bank (ECB) and European Stability Mechanism (ESM). The last Article IV consultation was concluded on December 13, 2017.

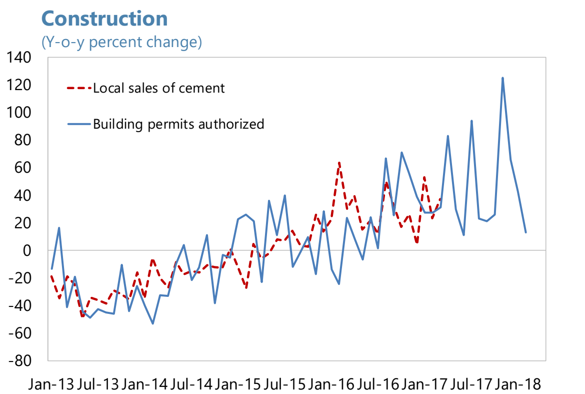
2. **In the first PPM discussions, the Fund welcomed the improved macroeconomic conditions that had strengthened capacity to repay, but saw risks from legacy stock imbalances.** GDP growth had accelerated, unemployment was declining, and the fiscal position was in small surplus. Emergency bank liquidity assistance had been fully repaid and bank deposits were rising again. The sovereign maintained steady access to capital markets on increasingly favorable terms and achieved a series of credit rating upgrades. However, public and private sector debt remained extremely high with a large volume of non-performing loans (NPLs), leaving the economy vulnerable to potential adverse shocks.

RECENT DEVELOPMENTS AND GROWTH PROSPECTS

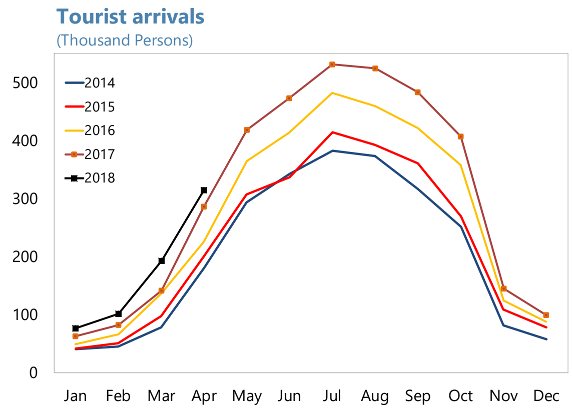
3. **The economic recovery has continued to gain momentum.** GDP grew by 3.9 percent in 2017, half a percentage point faster than a year earlier. This brought output to just 0.8 percentage points below its pre-crisis peak in real terms, while the negative output gap narrowed to 2.1 percent by end-2017. Growth is increasingly driven by strong momentum in the construction and real estate sectors, supported by a range of incentives,[2] including a Citizenship-by-Investment (CbI) program that has attracted foreign investment primarily in real estate. The tourism sector has also been strong, with expanded hotel capacity and quality upgrading, combined with improved air connectivity, underpinning double-digit increases in arrivals. Construction of residential properties and other projects has buoyed gross capital formation. Private consumption proved resilient, fueled by stronger employment, the expiration of temporary solidarity contributions introduced at the time of the crisis and—less encouragingly—strategic non-servicing of debt by many borrowers.

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

[2] Incentives include the abolition of the immovable property tax, tax breaks on capital gains and VAT, the relaxation of zoning and building coefficients as well as discounts on property transfer fees.

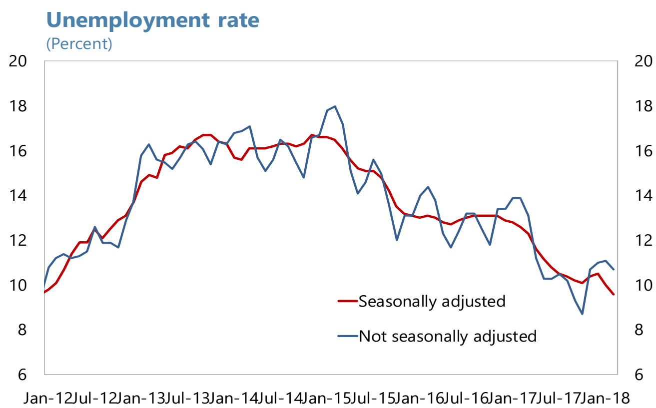


Sources: Statistical Service of the Republic of Cyprus; and IMF staff calculations.



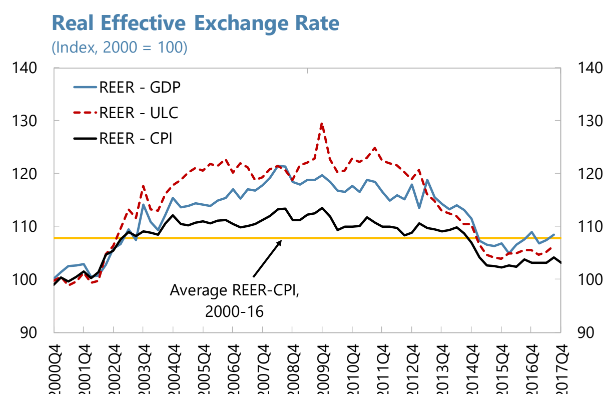
Source: Statistical Service of the Republic of Cyprus.

4. Price and wage moderation has persisted even as labor market conditions continue to improve. In December 2017, consumer price inflation dipped back into deflation territory and inflation stayed negative throughout Q1:2018, mainly driven by falling food prices and steady euro appreciation which outweighed the impact of rising energy prices. Core inflation was also slightly negative. The unemployment rate continued to decline, reaching 9.1 percent in March 2018 from 12.3 percent a year earlier, but remaining well above its pre-crisis level of around 4 percent, partly because recent construction activity is more capital intensive than in the past, thereby creating fewer employment opportunities.



Source: Eurostat.

5. The current account balance has deteriorated on strong domestic demand. The real effective exchange rate has remained broadly stable at post-crisis low levels, and improved cost competitiveness boosted exports of tourism and business services. Demand for imports has also risen on strong domestic demand, particularly for import-intensive construction investment. While the headline current account deficit widened by nearly 2 percentage points to 6.7 percent of GDP in 2017, the deficit adjusted for special purpose



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

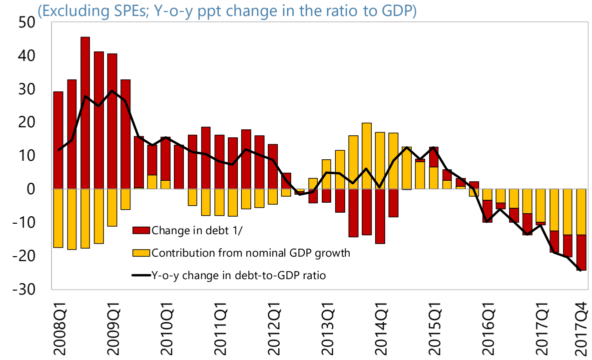
entities was a more modest 1.5 percent of GDP.[3] Net private financial inflows decelerated to 19 percent of GDP in 2017 from 34 percent of GDP the previous year. Cyprus's TARGET2 balance had increased to nearly 40 percent of GDP at end-2017.

6. Interest rates have remained close to historical lows, reflecting Cyprus's strong macroeconomic performance and accommodative monetary conditions in the euro area. Despite being ineligible for ECB operations,[4] yields on Cypriot government bonds have declined to low levels (the yield on a 7-year residual maturity bond was 2.23 percent at end-April). In addition, the sovereign has continued to receive favorable decisions by the major rating agencies.[5] Interest rates on banks' loans and deposits have extended their downward trend, contributing to easier financial conditions for the private sector.

7. Private sector debt remains among the highest in the euro area. The private gross debt-to-GDP ratio declined by 24 percentage points from a year earlier, to241 percent (132 percent for non-financial corporates[6] and 109 percent for households) in Q4:2017, driven largely by denominator effects from the rapid increase in nominal GDP. However, nominal deleveraging remains slow, and reductions that have taken place have occurred mainly through debt-to-asset and equity swaps as well as loan write-offs with commensurate use of provisions.

Total Debt Owed by Resident Non-Financial Private Sector

(Excluding SPEs; Y-o-y ppt change in the ratio to GDP)



Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Includes net repayment and write-offs.

[3] Treating special purpose entities (SPE)—companies registered in Cyprus, but with little physical presence in the country—as nonresidents, the underlying current account deficit was 1.5 percent of GDP in 2017, widening from 0.2 percent from a year earlier.

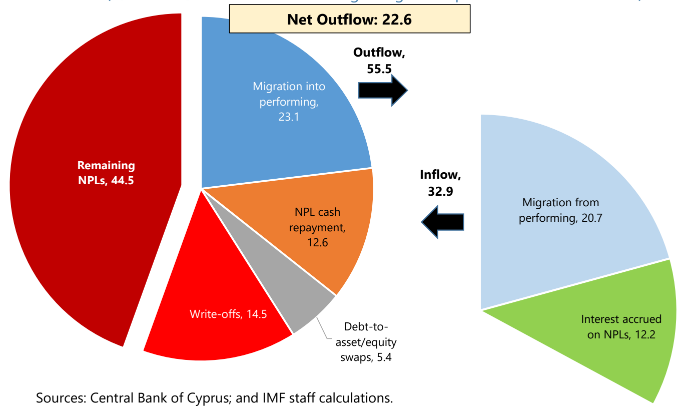
[4] This reflects the country's below-investment grade sovereign rating while being outside an ESM program.

[5] Moody's upgraded the Republic of Cyprus to Ba3 in July 2017, while S&P reaffirmed its BB+ rating (one notch below investment grade) and raised the outlook from stable to positive in September 2017. Fitch upgraded the rating also to BB+ with a positive outlook in April 2018.

[6] Excludes debt of non-financial SPEs. Including these entities, private sector gross debt would be 342 percent of GDP.

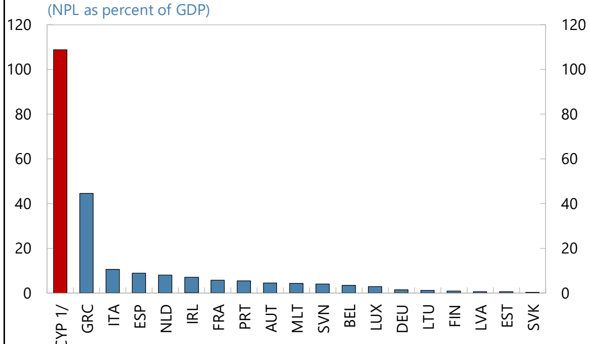
8. Banks have ample liquidity, but asset quality remains poor. System-wide deposits edged down in early 2018 after several years of increase. Nonetheless, with few opportunities for viable new lending given the high private sector indebtedness, banks have accumulated a large amount of liquid assets (79 percent of GDP at end-2017). As a result, the loan-to-deposit ratio fell to 72 percent (from nearly 83 percent three years earlier). Despite the improved debt-service capacity brought by the sustained recovery in output and employment, NPLs decreased only marginally and remained extremely high through end-2017. Following a step increase in January 2018 (due to a shift to IFRS9 accounting standards, which requires recognition of accrued interest on NPLs as part of NPLs), NPLs stood at 117 percent of GDP and 44 percent of total exposures. The first sale of NPLs (equivalent to 0.7 percent of GDP) by a bank to an asset management company is about to be completed. The banking sector again incurred large losses in 2017 on the need to build additional provisions and declining net interest income, compounded by limited progress on cutting operating expenses. As of 2017, capital ratios exceeded regulatory requirements and the provisioning coverage ratio stood at 47 percent, broadly in line with the EU average. The ECB will perform stress tests on all Cypriot systemic banks by November 2018.

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



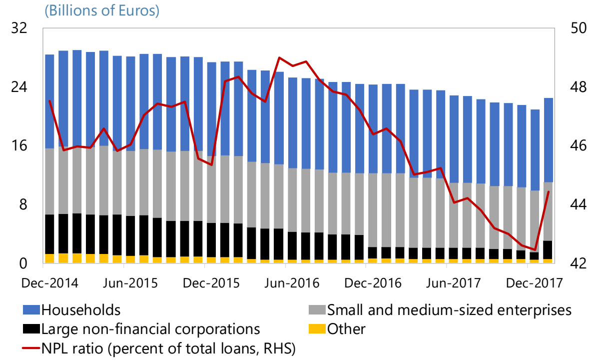
Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Data cover fixed-term loans owned by locally active banks. Two banks, RCB and Astro, are excluded.

NPL-to-GDP Ratio in Euro Area Countries, 2017Q3
(NPL as percent of GDP)



Sources: Central Bank of Cyprus, EBA, WEO, and IMF staff calculations.
1/ 2017Q4 data.

Non-Performing Loans
(Billions of Euros)



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

9. The government is enacting a set of policy measures aimed at dealing with NPLs. To increase the efficiency and effectiveness of loan collection and collateral enforcement, and thereby reduce moral hazard and discourage strategic default, the government has prepared amendments to the foreclosure framework. In addition, amendments to the corporate and personal insolvency

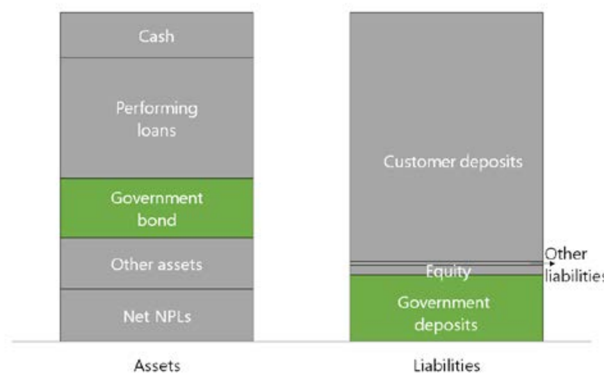
framework are being contemplated and some consideration is being given to a credit enhancement scheme for distressed residential real-estate loans.[7]

10. The asset quality of the Cyprus Cooperative Bank (CCB) is particularly weak and the government acted to shore up its balance sheet. In anticipation of a potential capital shortfall, and as part of a plan to dilute the public sector's current ownership, a search for private investors interested in acquiring all or part of the CCB has been initiated. To strengthen the asset quality and funding structure of the CCB in preparation for its sale, in early-April, the government placed in the bank a bond with a face value of €2.35 billion (12 percent of GDP) and €150 million in cash, together with a corresponding deposit (Box 1).

Box 1. Strategy for the CCB

The state-owned CCB, the second largest domestic bank, is currently searching for private investors. The asset quality of the CCB is particularly weak. The bank is heavily exposed to residential mortgages, has made little progress in tackling its NPLs, which are close to 58 percent of total loans, and has provisions covering only 47 percent of NPLs. Targeting a coverage ratio of 65 percent would require about €800 million in additional provisions, resulting in a sizable capital shortfall.

CCB Balance Sheet After Government Placement



Sources: Central Bank of Cyprus and IMF staff estimates.

The CCB initiated a search for private investors in March interested in acquiring the entire bank or part of its assets and liabilities. Expressions of interest were received from several potential acquirers. To strengthen the asset quality and funding structure of the CCB in preparation for its sale, in early-April, the government undertook a balance sheet operation. On the asset side, the government placed in the CCB a combination of a €2.35 billion (12 percent of GDP) bond and €150 million in cash. On the liability side, this was matched with a deposit of €2.5 billion, collateralized by nonperforming loans and other specified assets.

One possible outcome is for an investor to acquire assets excluding NPLs, as well as all customer deposits, leaving behind in a run-off vehicle the NPLs net of provisions together with the government deposits, which are larger in size. On May 14, two investors submitted bids for the acquisition of the CCB's good assets. These bids are currently under review.

11. Real estate prices show signs of a turnaround, but in the context of a segmented market. Banks' limited reliance on foreclosure of residential NPLs has contained downward pressure on transaction prices. Indices based on assessed values, rather than sales prices, suggest residential property prices began to increase in 2017, after being broadly stable during the previous two years.

[7] To provide incentives for reaching sustainable agreements and servicing of the restructured loan throughout its remaining life, vulnerable borrowers eligible under the scheme would—provided certain conditions are met—receive a stream of government co-payments on their loan-servicing obligations.

However, demand is strong for luxury properties, buoyed by the CbI scheme, where prices are inflated by the implicit value of citizenship.[8]

12. Fiscal performance has improved markedly in recent years, and is set to continue to do so under current plans. Overall and primary surpluses increased by 1.4 and 1.3 percentage points in 2017 to reach 1.8 and 4.4 percent of GDP, respectively. The favorable outturn reflects strong revenue collection brought by the robust recovery—especially in construction—and several one-off sources,[9] despite loosening measures amounting to 1½ percentage points of GDP implemented during 2015–17, and backloaded to 2017.[10] Gross public debt declined to 97.5 percent of GDP at end-2017. The strong fiscal performance has continued in Q1:2018, with the primary surplus at 2.1 percent of projected annual GDP, compared with 1.5 percent of GDP in the same quarter a year earlier. The authorities' 2018–21 Stability Program seeks to maintain high fiscal surpluses, and projects a further slight widening of the primary surplus to 4.5 percent of GDP this year and 4.6–4.7 percent of GDP subsequently.[11] In their Stability Program, the combination of projected large primary balances and robust growth is forecast to lead to a sharp decline in the gross public debt-to-GDP ratio by some 10 percentage points to 88 percent by 2021, including the recent CCB debt operation.

13. Since the presidential elections earlier this year, the government has focused on preparing a strategy to reduce NPLs. Incumbent President Nicos Anastasiades was re-elected in February 2018. Managing the challenges in the banking sector has been a priority for the new government. Talks to reunify the island remain suspended.

Forecast

14. The current phase of strong growth is forecast to persist and moderate only in the medium term. In staff's baseline scenario, GDP growth is projected to remain robust at 4 percent and 4¼ percent this year and next, respectively, before easing toward 2½ percent over the medium term. The negative output gap is expected to close by the end of this year and turn positive in future years, despite the high level of unemployment, which is largely structural due to job mismatch and erosion of skills due to long-term inactivity. This forecast reflects buoyant construction investment, in turn driven by a pipeline of large, mainly foreign-funded projects, even though private

[8] Most investment through the CbI scheme has targeted the real estate sector. The scheme requires individual investments of at least €2 million, in addition to the purchase of a residence valued at least €500,000. Eligible investment allowed under the scheme includes real estate, land development, infrastructure projects, participation in Cypriot companies and investment in Alternative Investment Funds.

[9] One-off revenue includes proceeds from the sale of gas exploration rights (spread over 2017–19 on an accrual basis), additional value-added tax revenue from increased transactions of properties, boosted by temporary eligibility for exemptions from all future capital gains tax, and collection of tax arrears.

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

[11] Cyprus Ministry of Finance, "Stability Programme, 2018–2021," April 2018.

consumption growth should slow somewhat as households step up servicing of loans. Potential growth is forecast to rise somewhat on increased capacity in the tourism sector brought by ongoing construction projects. The high import-content of domestic demand, particularly for construction, is expected to offset the impact of strong tourism exports, keeping the current account deficit at around 7 percent of GDP.

Authorities' Views

15. Strong growth is set to continue, supporting further declines in unemployment, robust fiscal performance and lower NPLs. Growth is projected to remain around 4 percent during 2018–19 and decelerate only marginally thereafter, underpinned by rising disposable incomes and foreign capital inflows that will drive private consumption and investment. While the traditional sectors of tourism, professional services and construction will remain the main growth drivers, economic expansion is expected to be broad-based with shipping, energy and higher education also contributing and generating employment. After several years of depressed conditions, construction activity has bottomed out, but despite rapid expansion, remains well below its pre-crisis peak. While strong domestic demand has re-widened the current account deficit, further build-up of imbalances is projected to be contained because the construction projects will expand capacity to generate tourism exports.

CAPACITY TO REPAY

16. Scheduled repayments to the Fund commence in October 2020. Taking advantage of the low cost of market financing and rising cash balances, Cyprus made an early repurchase to the Fund in July 2017 to reduce its interest expenditures.[12] Repayments to the Fund are scheduled to run through January 2026. Obligations to the Fund are expected to peak at €165 million (0.7 percent of GDP) in 2021 and not to exceed 12 percent of total public debt service costs in any single year.

17. Cyprus actively managed its debt profile in 2017. The fiscal authorities issued an €850 million Eurobond on favorable terms (7-year bond at an average yield of 2.8 percent) in June 2017 and redeemed soon-to-mature debt that, together with the partial early repurchase to the Fund, helped reduce a hump in the repayment profile during 2019–20. In November 2017, the government repaid a €615 million loan from the Central Bank of Cyprus.

A. Repayment Capacity Under the Baseline Scenario

18. Capacity to repay the Fund under staff's baseline scenario is expected to be adequate. This assessment is underpinned by the significant strengthening of fiscal performance and improved market conditions since the first PPM. Moreover, it is predicated on the full and successful implementation of the authorities' strategy for the financial sector, as outlined in ¶9, 10 and Box 1. Toward this end, liability management operations aimed at replacing privately-placed bonds with

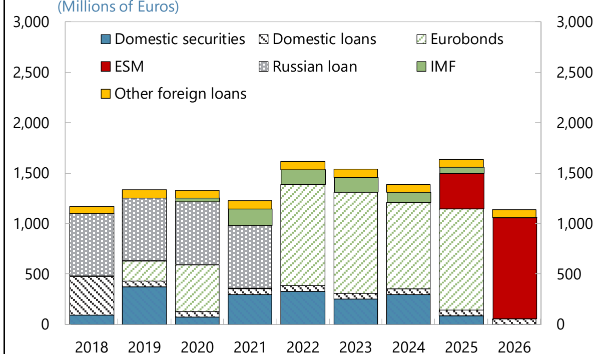
[12] The repurchase was SDR222 million, corresponding to the amount of EFF credit in excess of 187.5 percent of quota that was subject to a 200 basis points level-based surcharge.

internationally-syndicated debt should proceed in a gradual manner so as to support continued smooth market access.

19. Large primary surpluses and strong economic growth under the baseline scenario are expected to lower gross public debt to near 70 percent of GDP by 2023. The gross public debt ratio stood at 97.5 percent of GDP at end 2017, with debt net of cash-on-hand equaling 94 percent of GDP. The recent placement at the CCB of €2.35 billion in long-term domestic bonds added 12 percentage points of GDP to gross debt in April 2018.[13] Nonetheless, sustained large primary surpluses of 4–4½ percent of GDP forecast for 2018–23 and projected brisk nominal GDP growth of 4¾–6 percent of GDP would reduce the debt ratio by about 25 percentage points during this period, leaving it at 72 percent of GDP (68 percent on a net basis) in 2023.

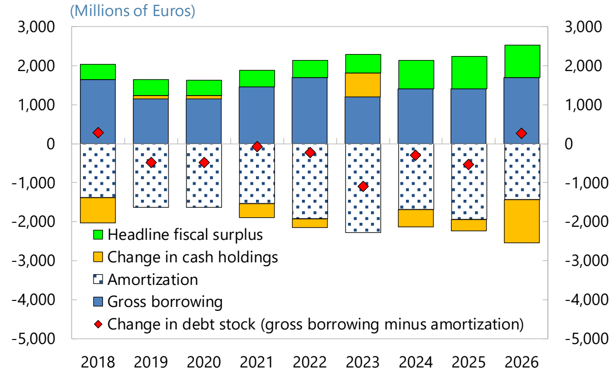
20. The profile of gross public financing needs (GPFN) is expected to be stable. The amortization schedule for medium- and long-term debt is relatively smooth, ranging between €1.2–1.8 billion, while the average maturity of marketable securities stands at five years. GPFN are expected to remain below 10 percent of GDP through 2023. Given Cyprus's plan to maintain a cash buffer no smaller than 9-month-ahead GPFN, and assuming liability-management operations occur gradually, gross medium-term borrowing in the securities market would be within a moderate €1.5–2 billion per year through 2023 (Table 3). However, beyond this horizon, additional financing needs will likely rise as repayments to the ESM commence in 2025 and rise to €1 billion per year from 2026.

Amortization of Existing MLT Debt
(Millions of Euros)



Source: Public Debt Management Office.

Sources and Uses of Funds
(Millions of Euros)

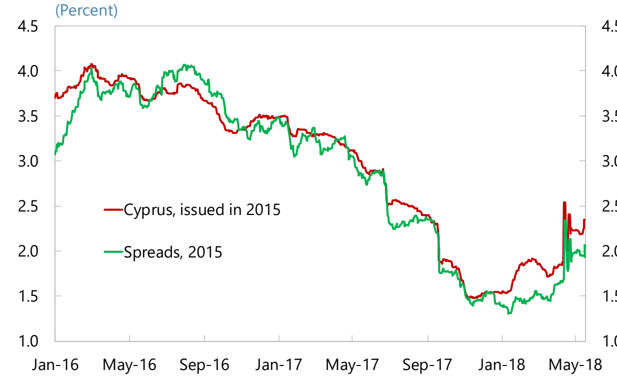


Source: IMF staff projections.

[13] The government bond represents the maximum fiscal cost associated with the CCB's existing NPLs. Staff's projections assume that net debt has increased by the same amount. Future value recovery from NPLs in the run-off vehicle would reduce net debt. Depending on the specific modalities of the transaction, acquisition of the CCB—as well as staff redundancies—may have significant additional fiscal implications.

21. Strong macroeconomic and fiscal performance would help contain borrowing costs, although spreads could also be affected if risks to the outlook (Section B) are realized. Yields on Cyprus's Eurobonds continued to decline through Q4:2017, and spreads over German government bonds had narrowed to historically low levels. However, following the balance sheet operation in the CCB, spreads initially jumped by about 100 basis points (bp), but then moderated somewhat, although as of mid-May, they remained about 70 bp higher than at end-2017, at around 200 bp. Continued tightening of global financial market conditions during the forecast period is assumed to widen spreads to 300 bp. Nonetheless, sustained primary surpluses and a downward path for debt over the medium term are expected to allow the sovereign to maintain comfortable market access.

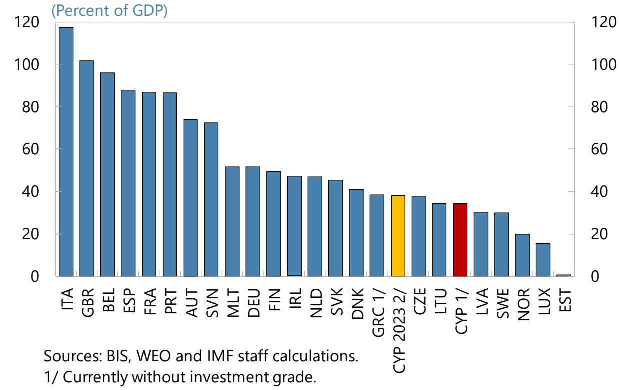
7-Year Government Bond Yields and Spreads
(Percent)



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

22. The large share of loans from official creditors will help contain total interest expenses. Repayment of loans from the ESM, which account for the bulk of official loans, commences in 2025. These loans carry low interest rates. Therefore, despite replacing earlier-maturing debt—including a bilateral loan from Russia maturing in 2018–21—and some privately-placed debt with market- borrowing, total interest costs should remain low. Moreover, the stock of market-based borrowing relative to GDP is expected to increase only modestly owing to strong growth in nominal GDP.

General Government Debt in Marketable Securities, 2017Q3
(Percent of GDP)



Sources: BIS, WEO and IMF staff calculations.
1/ Currently without investment grade.
2/ Includes full conversion of privately-placed debt.

Authorities' Views

23. Cyprus's capacity to repay is strong, underpinned by prudent fiscal policy and debt management practices in combination with robust economic growth. Projected large primary fiscal surpluses and strong GDP growth will anchor a rapid decline in the gross public debt-to-GDP ratio. The current cash balance is sufficient to cover medium- and long-term debt redemptions and interest payments through the remainder of 2018. Thereafter, annual debt issuance in the Eurobond market and sizable primary surpluses will ensure that future cash balances cover at least nine months of financing needs on a rolling basis. To increase the depth and liquidity of the market for Cypriot government bonds, consideration may be given to replacing domestically-issued debt with debt issued on the international market.

B. Risks to Repayment Capacity

24. Cyprus's repayment capacity to the Fund is subject to significant risk. The public debt sustainability analysis (public DSA, Annex I) indicates that repayment capacity is generally resilient to standardized shocks. However, capacity could be significantly weakened by the realization of country-specific risks (Annex II):

- ***Operational risks from the banking sector strategy.*** The current more-resolute approach to addressing NPLs is warranted, but could inadvertently intensify financial stability risks if investor and creditor confidence is eroded, resulting in additional fiscal costs. In such a scenario, the government's ability to access debt markets may be affected, with adverse effects on repayment capacity.

- ***Risks from an abrupt growth slowdown or a renewed boom-bust cycle.*** Current strong GDP growth is dependent on construction activity and tourism, and could be sensitive to a scaling back of the CbI scheme, a much sharper-than-expected tightening of global financial conditions, or a reduction of tourism demand owing to regional geopolitical developments. In addition, a shock in the banking sector could spill over to the rest of the economy through various channels. An alternative scenario where real GDP growth is halved, the primary fiscal surplus is reduced by three percentage points, sovereign bond spreads widen by 75 basis points, and inflation decelerates modestly (all relative to the baseline) would result in a public debt ratio of 96 percent of GDP in 2023 (24 percentage points higher than in the baseline). In the absence of such shocks, growth could remain strong for longer if the current momentum in construction activity continues. However, this could lead to excessive supply of luxury properties, eventually resulting in a new boom-bust cycle.

- ***Risks from weak payment discipline.*** Continued weak payment discipline over the medium to long term would have significant adverse effects on economic growth through subdued provision of new credit and, more broadly, by eroding trust in private contracts. An adverse scenario (shown in the public DSA) based on the realization of a contingent fiscal liability of 50 percent of GDP could be accompanied by a spike (in the DSA scenario, of 1,250 basis points) in borrowing costs for the sovereign and private sector for one year. While other euro area countries saw only modest, short-lived increases in spreads following the announcement of their recent bank interventions (Box 2), the effect in Cyprus could be larger and more persistent because fiscal support could be considerably higher in view of the much-larger scale of NPLs as a share of GDP. A spike in borrowing costs of this magnitude would compress output and depress inflation. Public debt would rise to 155 percent of GDP by 2020 and decline only gradually to 148 percent of GDP by 2023. Temporary loss of access to debt markets would also be possible.

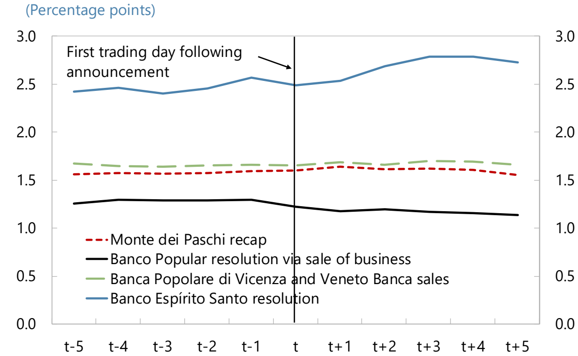
- ***Risks from the public sector***. Sustained spending pressure could lead to the gradual erosion of the primary surplus, and might arise from the new National Health Service (to be rolled out

in 2019), faster growth in the public-sector wage bill, or pending claims for compensation against measures taken in 2012–13 in response to the banking crisis.

Box 2. Bank Interventions and Sovereign Bond Spreads

Spillovers to sovereign bond spreads have been muted following recent bank interventions in Europe. Portugal's spreads narrowed somewhat when an announcement was made on August 3, 2014, that a systemic bank's senior debt (not held by related parties) along with deposits and assets not related to other parts of the group would be transferred to a new bridge bank, with the transaction financed by the government at the total fiscal cost of 2.7 percent of GDP, although spreads widened in subsequent days. Spreads were barely affected following the announcement of a precautionary recapitalization of the third-largest Italian bank (December 23, 2016) or liquidation and sale of parts of two mid-sized regional Italian banks to a well-capitalized domestic bank (June 25, 2017). Both cases dealt with lingering risks, though at the expense of the government contributing fiscal resources (0.3 and 0.3 percent of GDP, respectively, excluding guarantees). When a systemic Spanish bank was sold to another systemic bank (June 7, 2017), without recourse to fiscal resources, sovereign spreads declined.

Bank Intervention and Sovereign Bond Spreads
(Percentage points)



Sources: Bloomberg Finance L.P.; and Fund staff calculation.

Authorities' Views

25. While risks remain in some areas, mitigating factors are also in place. Legacy NPLs are the main risk. However, the recent increase in gross public debt to facilitate the future restructuring of the CCB was a one-off operation, and any additional fiscal costs will be modest. At the time of the balance sheet operation, borrowing costs were affected, but only modestly and for a short period. Measures to strengthen the legal framework and incentivize viable debt restructurings could dampen private consumption but would also mitigate risks to the sovereign arising from NPLs. Continued large fiscal primary surpluses and cash buffers will provide insurance in the event of volatility in the sovereign bond market. Economic growth is broad-based and there are no indications of an emerging boom-bust cycle as fiscal spending is not deficit financed and construction activity is mainly funded from FDI. Furthermore, construction projects advance only in-step with available financing and several of these projects will raise potential growth. While external risks are likely to remain contained, any potential effects would materialize mainly through weaker tourism demand from key markets.

POLICIES TO REDUCE REPAYMENT RISKS

To mitigate risks to capacity to repay, high private debt and NPLs should be reduced, payment discipline should be restored, fiscal spending should be capped by medium-term growth and a structural reform agenda targeting more diversified and sustainable growth should be implemented.

A. Financial Sector Policy

26. The authorities' proposed NPL strategy appropriately focuses on achieving a decisive and durable improvement in loan quality, both on and off banks' balance sheets. Several concrete measures are needed to support the strategy and increase the chances of success. Banks should remain adequately capitalized and provisioned. Close adherence to loan classification and provisioning requirements as well as credit standards for new lending should be maintained. Banks should also be discouraged from relying excessively on debt-to-asset and debt-to-equity swaps to avoid building-up illiquid portfolios of uncertain value. To minimize upfront and contingent fiscal costs, loans left behind in a run-off entity, as envisaged for the NPLs of the CCB, should not be merely warehoused. Accordingly, the run-off entity should have a governance structure that insulates it from political interference, a mandate to cure the transferred NPL portfolio, explicit operational targets and a budget adequate to conduct upfront restructuring and subsequent servicing of the loans.[14]

27. Contract enforcement is among the bedrocks of a market economy and a reliable payment culture should be restored to support financial intermediation. More effective enforcement would also ensure a higher rate of recovery for the state in the CCB's run-off vehicle. Priority should be given to targeted amendments of the foreclosure law, aimed at four key objectives: (i) clarifying the modalities for applying the new foreclosure rules and procedures to legacy cases; (ii) adopting more flexible procedures for notifying borrowers of foreclosure proceedings; (iii) clarifying what information needs to be provided regarding the collateral and ensuring potential buyers have access; and (iv) streamlining procedures for selling collateral, including through e-auctions. The legal framework for bank liquidation should also be amended to empower the CBC to appoint a liquidator. However, to be successful, legal amendments must be accompanied by a further strengthening of related institutions and professionals (including the insolvency service, insolvency practitioners, and the courts). Reforming the country's payment culture, such that strategic default is no longer seen as politically or socially acceptable, is essential.

28. While there is some merit in a scheme that encourages vulnerable borrowers to begin servicing their loans (see para. 9), it should abide by strict safeguards if implemented. Properly designed and implemented, such a scheme could strengthen the viability of borrowers and provide strong incentives to conclude restructuring agreements and comply with them throughout their

[14] An appropriate governance structure would encompass two key elements: (i) a framework agreement on corporate governance matters (including a fit-and-proper board of directors, separate budget and staffing, externally-audited financial reports) and a high-level loan restructuring strategy between the state and the run-off entity; and (ii) a loan service agreement (including operational targets) between the run-off entity and the third-party debt servicer.

lifetime. However, to minimize moral hazard, reduce the likelihood that strategic defaulters would be eligible and contain the total fiscal cost of the subsidies, several principles should be followed: (i) eligibility criteria should be targeted to less-well-off borrowers and, to discourage strategic default by currently-performing borrowers, should adopt a back-dated test date; (ii) individual means-testing, including a borrower's real and financial assets, should be applied with penalties for incomplete or inaccurate disclosure; (iii) a cash subsidy should be paid only if the borrower is fully-current on payments after the loan has been restructured; and (iv) the size of the subsidy should be calibrated to the individual borrower's repayment capacity. In addition, loans of eligible borrowers should remain on the balance sheets of banks (or in the run-off vehicle, in the case of the CCB) as an in-house approach, combined with expertise and more-remote borrower relations that come with third-party debt servicing companies. This approach is most likely to generate viable loan restructurings and ensure continued future loan performance. The alternative of transferring NPLs to a separate vehicle may lower incentives to restructure the loans, increase operational risk and raise unintended moral hazard, while it would be unlikely to lead to an upfront de-recognition of the NPLs as banks would maintain financial links with—and hence exposure to—the risks in the NPL vehicle.

29. Establishing a publicly-owned centralized Asset Management Company (AMC) is not advisable as the risks would likely outweigh the benefits in the case of Cyprus. An AMC would entail significant fiscal risk if the market value of NPLs is considerably-below the book value net of provisions. In addition, AMCs are not well-suited for dealing with large numbers of relatively small-value loans. Moreover, a public AMC may be subject to political interference and warehousing of loans, rather than seeking to recover value from the portfolio (Box 3).

Authorities' Views

30. Recent actions undertaken in the banking sector will generate significant improvements in asset quality and system viability. Measures taken to encourage consolidation and strengthen banks' balance sheets will reduce systemic risk and allow banks to focus on their core objective of providing credit on sound underwriting principles. The amount of NPLs in the banking sector will be significantly reduced. Reforms in the legal framework governing foreclosures and the insolvency framework, coupled with the full operation of third-party loan servicing companies, are expected to result in a significant acceleration in the pace of debt restructuring, both within and outside of banks, and increase the repayment rate on loans. In addition, collateral enforcement will be enhanced thereby leading to the preservation of banks' capital. Within a limited fiscal envelope and under conservative eligibility criteria, consideration may be given to a targeted subsidy scheme that incentivizes debt servicing by distressed mortgage borrowers. While local bank funding of construction of large luxury properties remains very limited, any spillovers from price developments in the high-value segment to other market segments will be continuously monitored, and if needed, appropriate measures from a national perspective will be taken.

Box 3. Challenges in Setting Up a Centralized Asset Management Company (AMC)

Centralized publicly-owned AMCs have been used in some cases to manage the legacy nonperforming assets left after a financial crisis. However, publicly-owned AMCs may lead to significant fiscal risk, warehousing of loans and political interference. Moreover, several country-specific issues should be considered when assessing the case for an AMC in Cyprus.

The advantages of centralized AMCs for managing large volumes of NPLs include the following:[1/] (i) helping to facilitate the orderly resolution of a problem bank, thereby shoring-up financial stability; (ii) catalyzing the development of a secondary market for distressed debt; (iii) freeing-up bank management from dealing with NPL portfolios and allowing them to re-focus on new business and long-term growth strategies, thus supporting profitability; and (iv) centralizing scarce human resources and expertise, benefiting from economies of scale and facilitating creditor coordination.

However, centralized publicly-owned AMCs have several challenges: (i) the gap between book value and market price of the NPLs may be very wide; (ii) implications for the country's fiscal outlook in terms of both direct and contingent liabilities may be large; (iii) a banking system's loan portfolio may not be conducive to centralized restructuring, with residential mortgage collateral typically posing the greatest challenge for social and political reasons; (iv) the governance structure may inadequately protect the AMC from political interference; and (v) limitations in the existing legal framework that could, in turn, be reflected in the transfer price of the assets. In addition, the underlying data should be of high quality, including well-documented and consistent information on collateral, prior to transferring NPLs to an AMC in order to facilitate NPL workouts.

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1/ Similar issues are discussed in the European Commission's "AMC Blueprint", March 2018.

B. Fiscal Policy

31. The authorities have maintained a generally-prudent fiscal policy, and current plans aim to maintain high primary surpluses, although policy would turn somewhat procyclical. Recent fiscal performance has benefited from strong GDP growth, with revenue outpacing spending. Consistent with the authorities' forecasts, staff expects the primary surplus to remain unchanged at about 4½ percent of GDP during 2018–19. Thereafter, the primary surplus is projected to decline by a cumulative ½ percentage point by 2023 on some reduction in nontax revenue (transfers of EU funds) and a decline in one-off tax revenues (tax arrears). However, with output expected to exceed potential, keeping the growth of spending in line with that of tax revenue would lead to an unwarranted structural loosening.

32. To avoid procyclicality and protect the downward path of debt, fiscal spending growth should be capped by medium-term GDP growth. Setting an annual ceiling for nominal spending that increases in line with medium-term output growth (with downward adjustment to compensate for any future cuts to tax rates or narrowing of tax bases) would avoid procyclical policy. It would also help rebuild fiscal space following the recent materialization of liabilities related to the banking sector and allow for productive public investment. To achieve these goals, a more-durable mechanism to keep the public-sector wage bill in check should be instituted. Costs related to the planned introduction of the NHS should be closely monitored and adequate spending safeguards should be introduced.

Authorities' Views

33. **The authorities are committed to maintaining a prudent fiscal stance to help reduce the high level of public debt and support balanced growth.** Reducing taxes and consolidating public expenditure were successful in generating a rapid economic recovery and have boosted the primary surplus in recent years. This strategy remains unchanged, and fiscal plans for 2018–21 envisage maintaining a low tax burden while capping expenditure increases at the medium-term GDP growth rate. This should generate sizeable primary surpluses on the order of 4½–4¾ percent of GDP per year, similar to the 2017 outturn. Restrained wage and salary increases will be supported by the existing collective agreement with public-sector unions and the legislated hiring freeze, although exemptions are permitted to address critical shortages, and a portion of the growing number of vacancies will be filled. Windfall revenue, including from growth overperformance, will be saved to bring forward the reduction in public debt. The effects of the forthcoming National Health Service on fiscal sustainability and competitiveness of the broader economy are being reviewed to identify the potential need for any policy adjustments.

C. Structural Reforms

34. **Broad-based support for macro-critical structural reforms has faded since the EFF-supported program expired.** While privatization of the commercial operations of the Limassol port was completed, the rest of the privatization agenda has largely stalled. The public administration reform has also been derailed, except for amending rules regarding mobility between the Public Service and State-Owned Organizations (SOEs) as well as among the various SOEs. With both the length of time required to resolve a commercial claim through the courts and the per-capita number of pending civil and commercial cases among the highest in the EU, there is broad agreement that the court system and legal enforcement are in urgent need of improvement, although no tangible progress has been made.

35. **A comprehensive reform agenda should be enacted promptly to improve prospects for more-diversified and sustainable growth.** The effectiveness of commercial claims enforcement and the efficiency of the courts should be strengthened to improve the country's payment culture and its attractiveness as an investment destination. Following a favorable ECB opinion, the long-delayed central bank governance reform should also be enacted promptly. Privatizations should be restarted to allow greater competition and attract capital into innovative sectors, helping to reduce the current concentration of growth in a few sectors of the economy and create job opportunities for high-skilled workers. Eligibility requirements of the CbI scheme should be decoupled from real estate to avoid excessive concentration of economic activity in this sector, over-supply of luxury properties and the risk of a future sharp price correction. Moreover, if signs emerge that the construction sector is becoming reliant on domestic credit, then bank lending standards should be tightened and banks' countercyclical buffer should be raised. Effective compliance with AML/CFT standards by all sectors covered by the AML/CFT system should be ensured to maintain the integrity of the scheme and mitigate risks to correspondent banking. The upcoming MONEYVAL assessment provides an opportunity to demonstrate that all requirements have been implemented.

Authorities' Views

36. **Reform efforts are expected to regain momentum.** The presidential elections and the parliamentary recess have significantly slowed the pace of reform. However, a long pipeline of bills is either already before parliament or will be submitted in the coming months. The cabinet has approved a draft bill providing the legal basis for the transposition of CyTA into a private sector company enabling the participation of strategic investors, with the government remaining the majority shareholder. Other privatizations that are expected to be launched during the next 12 months include the national lottery, the port of Larnaca, the Cyprus Stock Exchange and several real estate assets. The set of bills aimed at reforming the public administration is being amended with a view to re-submission to parliament. Reform of the judicial system aimed at improving its efficiency and claims enforcement is a priority for 2018, and a project management team will be established and tasked with implementing the recommendations delivered by a functional review of the court system. Developments in the construction sector and property market will continue to be closely monitored.

STAFF APPRAISAL

37. **Cyprus's recovery has gathered further momentum, but the economy is still confronted with legacies from the crisis.** GDP growth near 4 percent has contributed to higher employment. The current account deficit has widened given the high import content of demand, but persistent price and wage moderation have sustained competitiveness so far. Improving cyclical conditions have also been reflected in a sizable primary fiscal surplus and a decline of the public debt ratio. Despite these achievements and encouraging signs of lower corporate and household leverage relative to GDP, private sector debt continues to be very high and banks' asset quality remains poor, weighing adversely on the profitability of the financial sector.

38. **In the baseline, the recovery is forecast to continue, showing signs of moderation only in the medium term.** The large pipeline of construction projects and only a gradual return to better payment compliance by overleveraged households and businesses is set to sustain above potential growth and a wide current account deficit for an extended period. The pace of growth is projected to slow gradually as construction projects reach completion. The labor market is expected to improve further, although limited opportunities for high-skilled workers may slow the pace at which unemployment declines.

39. **Capacity to repay the Fund under staff's baseline scenario is expected to be adequate, but it is subject to significant downside risk.** Adequate repayment capacity is underpinned by sustained strong economic growth with accompanying benefits for fiscal primary surpluses, which anchor the projected rapid decline in the public debt-to-GDP ratio and expected continued access to financial markets on favourable terms. Successful transformation of the CCB is also assumed, together with gradual liability-management operations. The large share of official loans in public debt and their back-loaded repayment schedule also support repayment capacity. However, major downside risks could materialize from direct and contingent fiscal liabilities due to NPLs, a sharp fall

in GDP growth or a renewed boom-bust cycle, and continued weak payment discipline. In this context, sovereign-bank linkages remain an important channel for the transmission of risks. To reinforce capacity to repay against adverse shocks, ambitious macroeconomic policies and structural reforms are warranted.

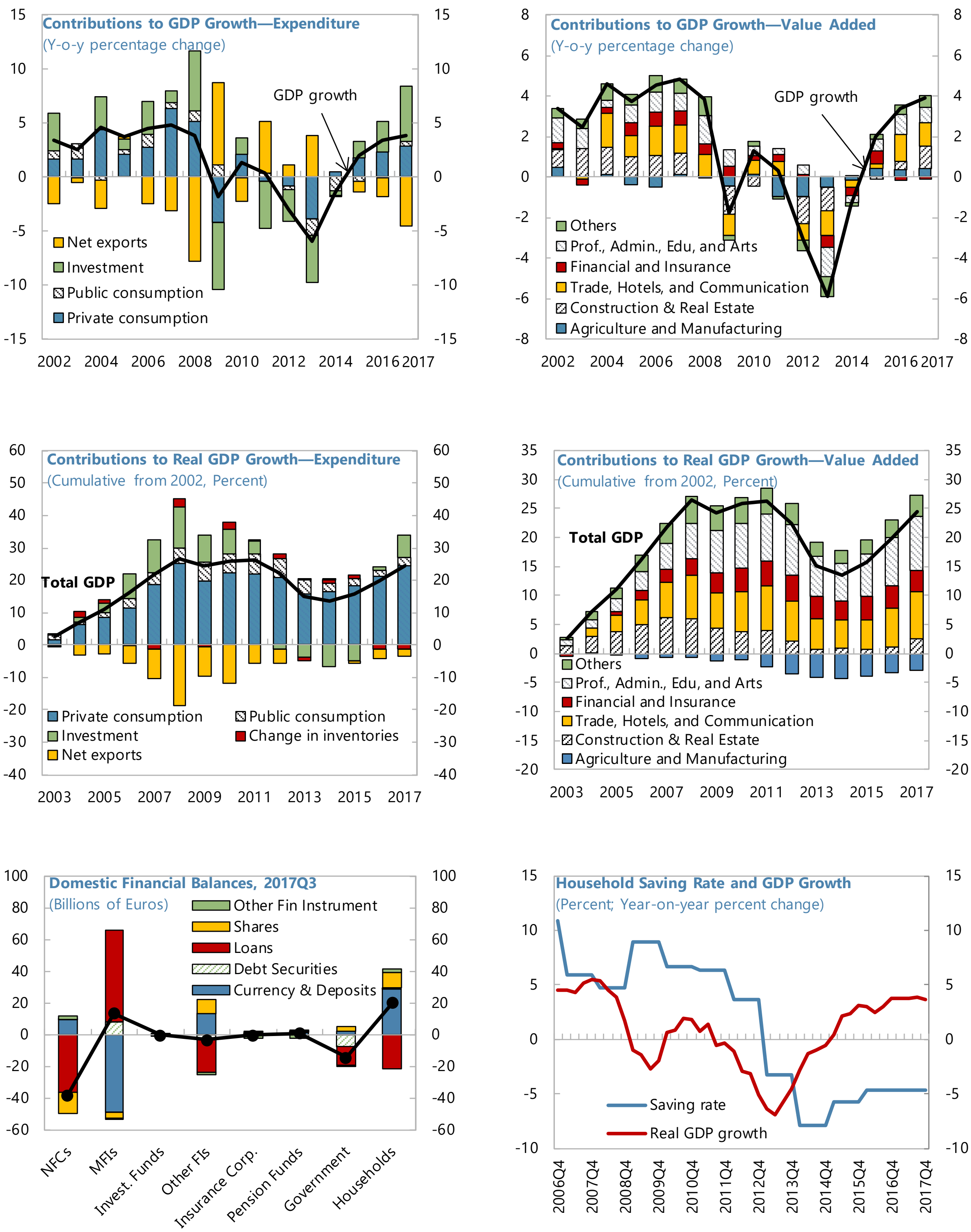
40. NPLs should be restructured in a decisive and timely manner. Banks should remain well capitalized and provisioned, while the soon-to-be created run-off entity should have a governance structure that protects it from political interference and allows for swift restructuring of loans. Amendments to the current framework for insolvency and foreclosure are needed to improve payment discipline and screen out strategic defaulters. Any scheme supporting vulnerable borrowers' payment behavior should be subject to tight eligibility criteria and within a limited fiscal envelope.

41. To counter the risk of procyclical policies, growth of fiscal spending should be capped by the medium-term rate of economic growth. A durable mechanism to control the public-sector wage bill should be instituted and fiscal risks from the planned introduction of the NHS should be kept in check. This policy would help safeguard the downward path of debt and create space to absorb possible contingent fiscal shocks.

42. The current cyclical rebound provides the opportunity to restart macro-critical structural reforms targeting a more diversified economy. The focus should be on strengthening the enforcement of commercial claims and efficiency of the courts, restarting the privatization agenda and restructuring oversized and uncompetitive sectors to modernize the economy and attract investment into innovative sectors. Incentives supporting the construction sector should be withdrawn.

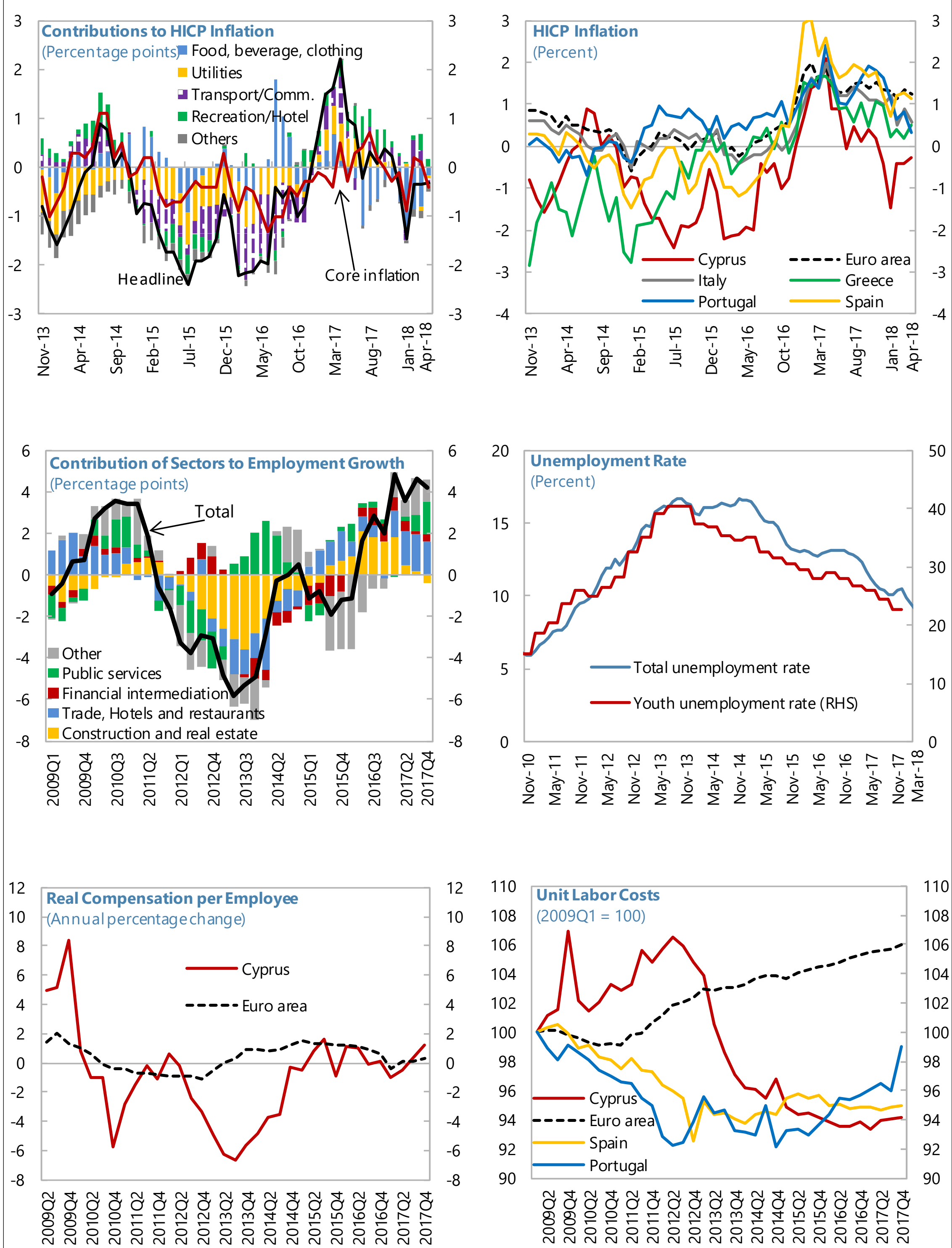
43. Continued close monitoring of Cyprus's repayment capacity under PPM is warranted during the next 12 months. Progress toward external viability continues to be subject to significant risk. In particular, realization of contingent liabilities arising from banks' large NPLs could adversely affect the sovereign's market access. The Cypriot authorities have expressed their willingness to continue to remain engaged with the Fund under PPM until 2020.

Figure 1. Cyprus: Macroeconomic Performance



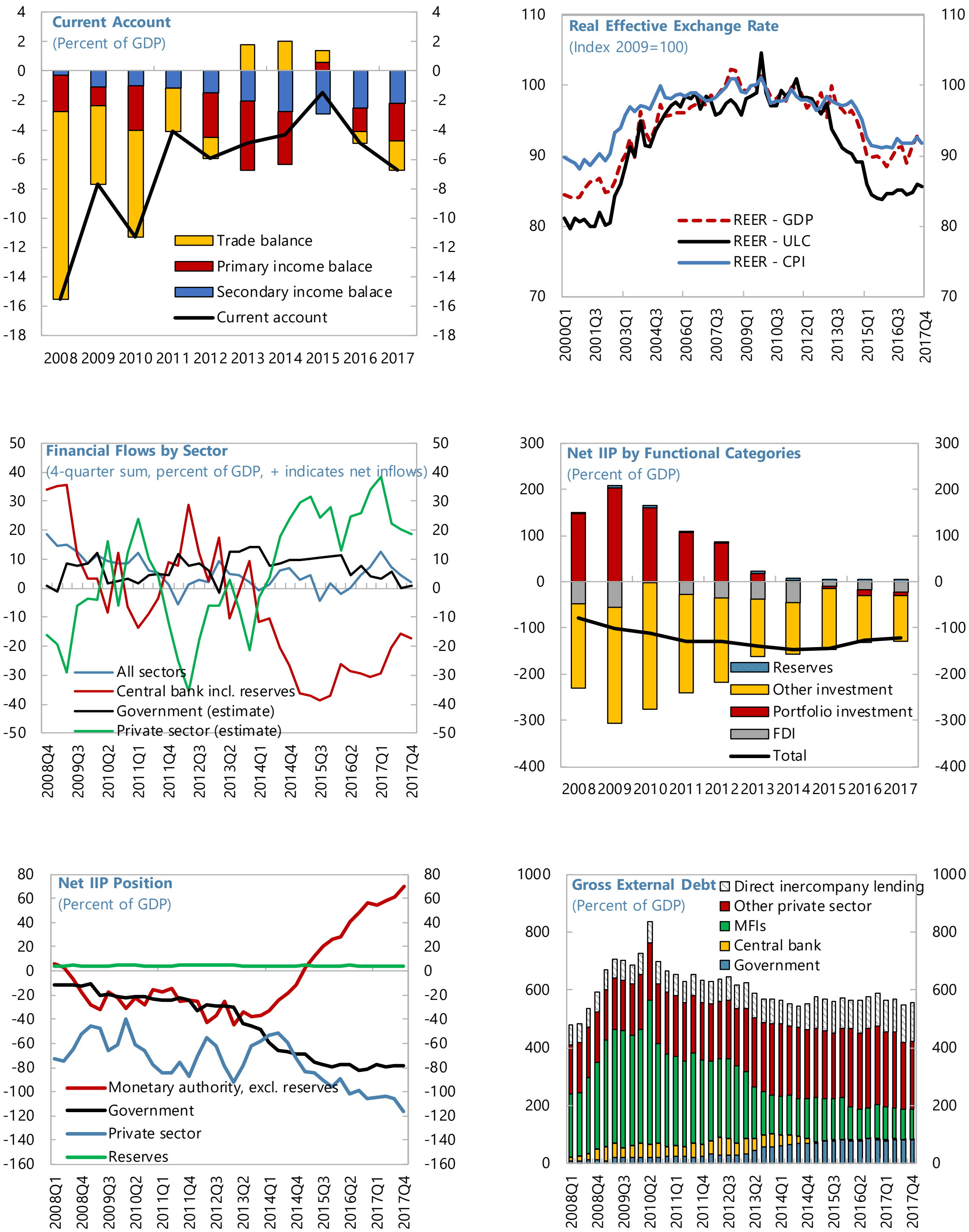
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 2. Cyprus: Inflation and Labor Market



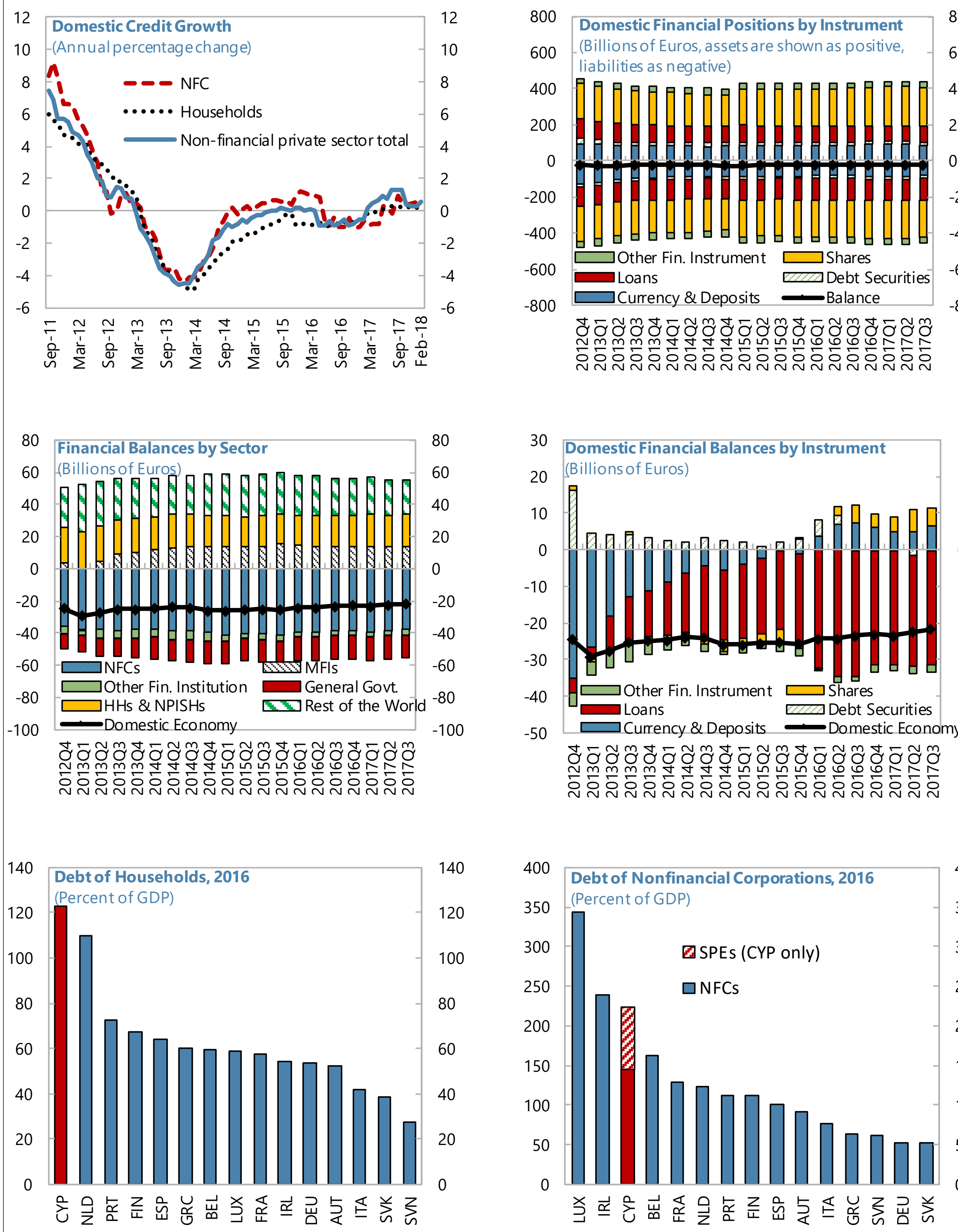
Sources: Cystat; ECB; Eurostat; and IMF staff calculations.

Figure 3. Cyprus: External Indicators



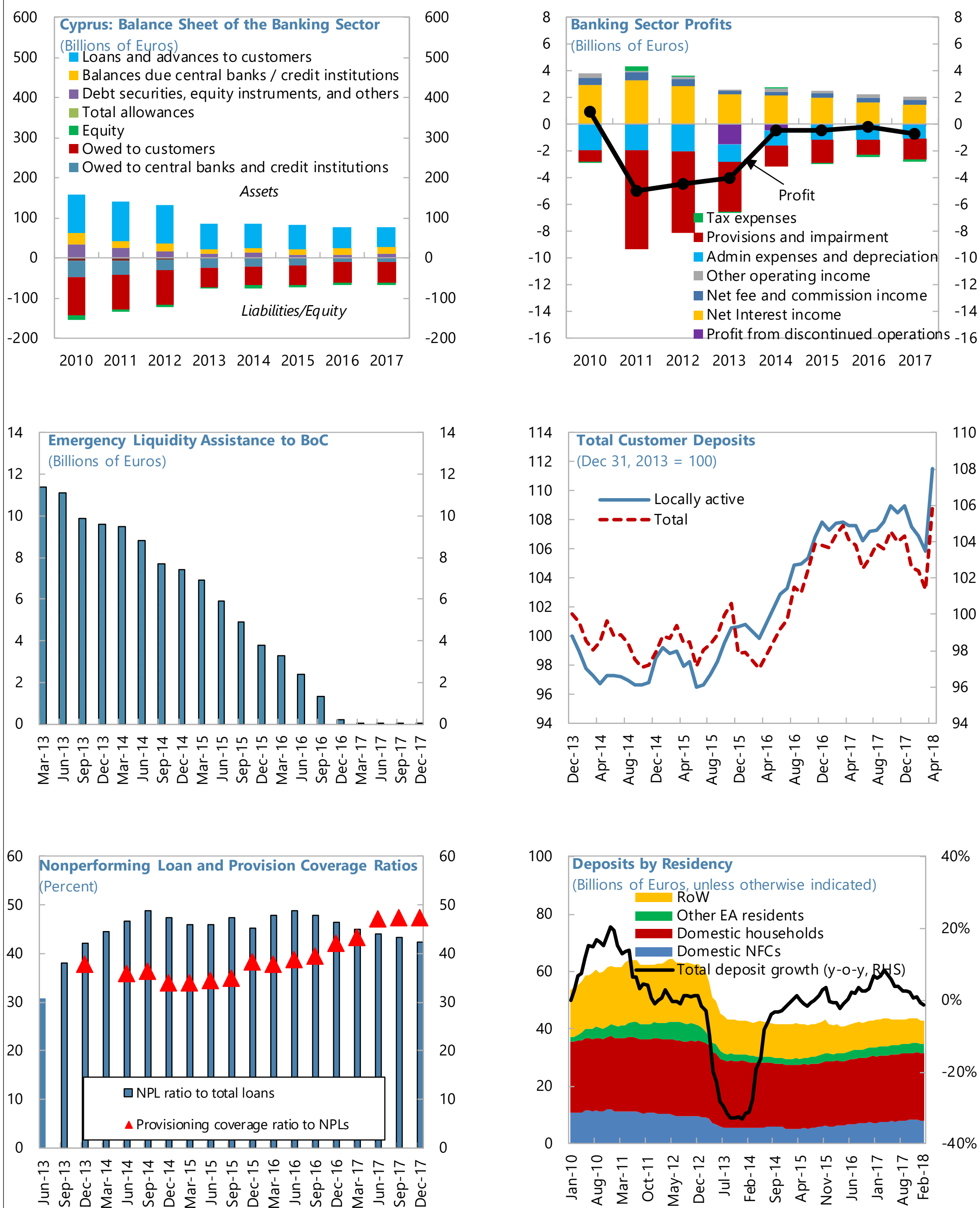
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Credit and Balance Sheets



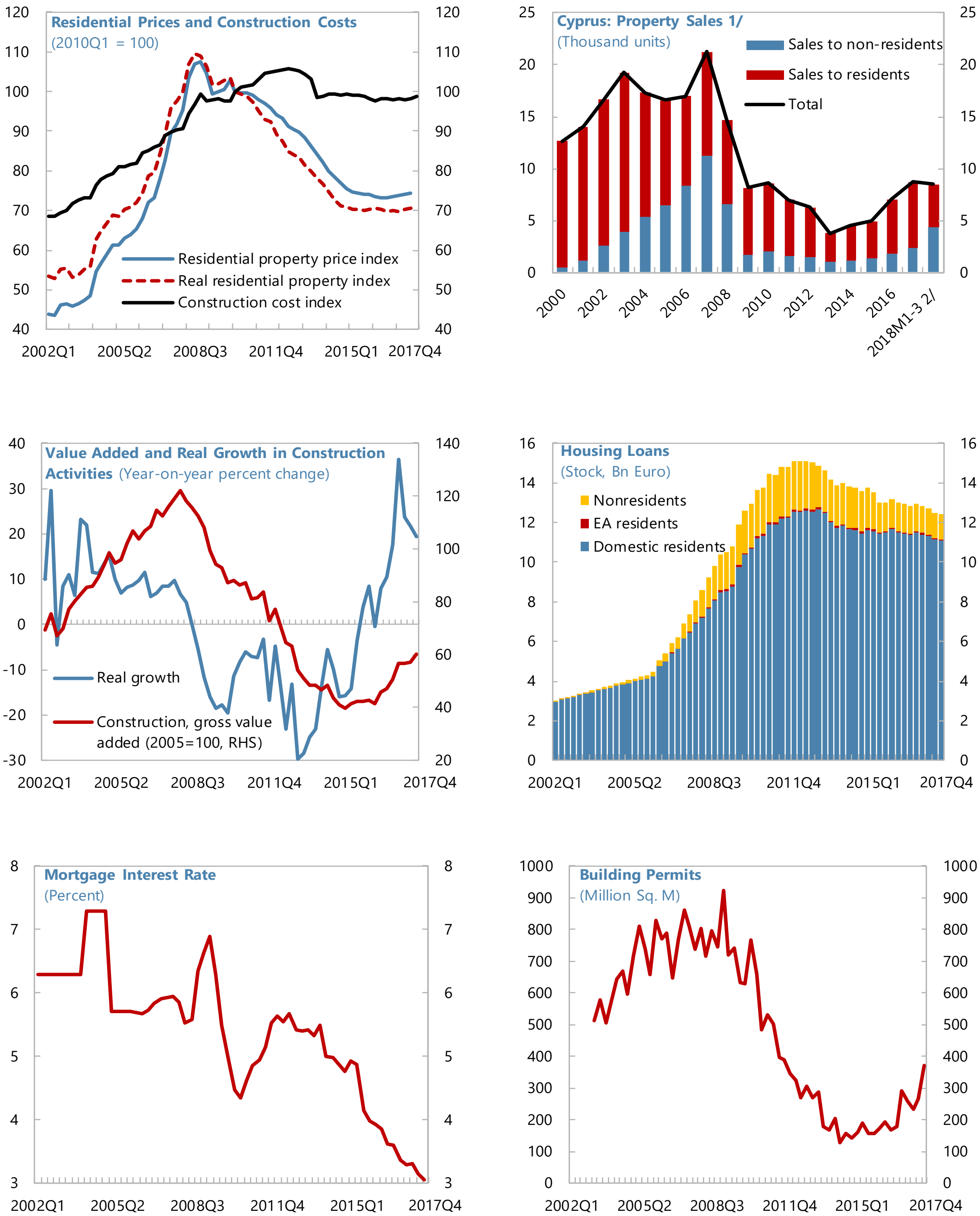
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 5. Cyprus: Banking Sector



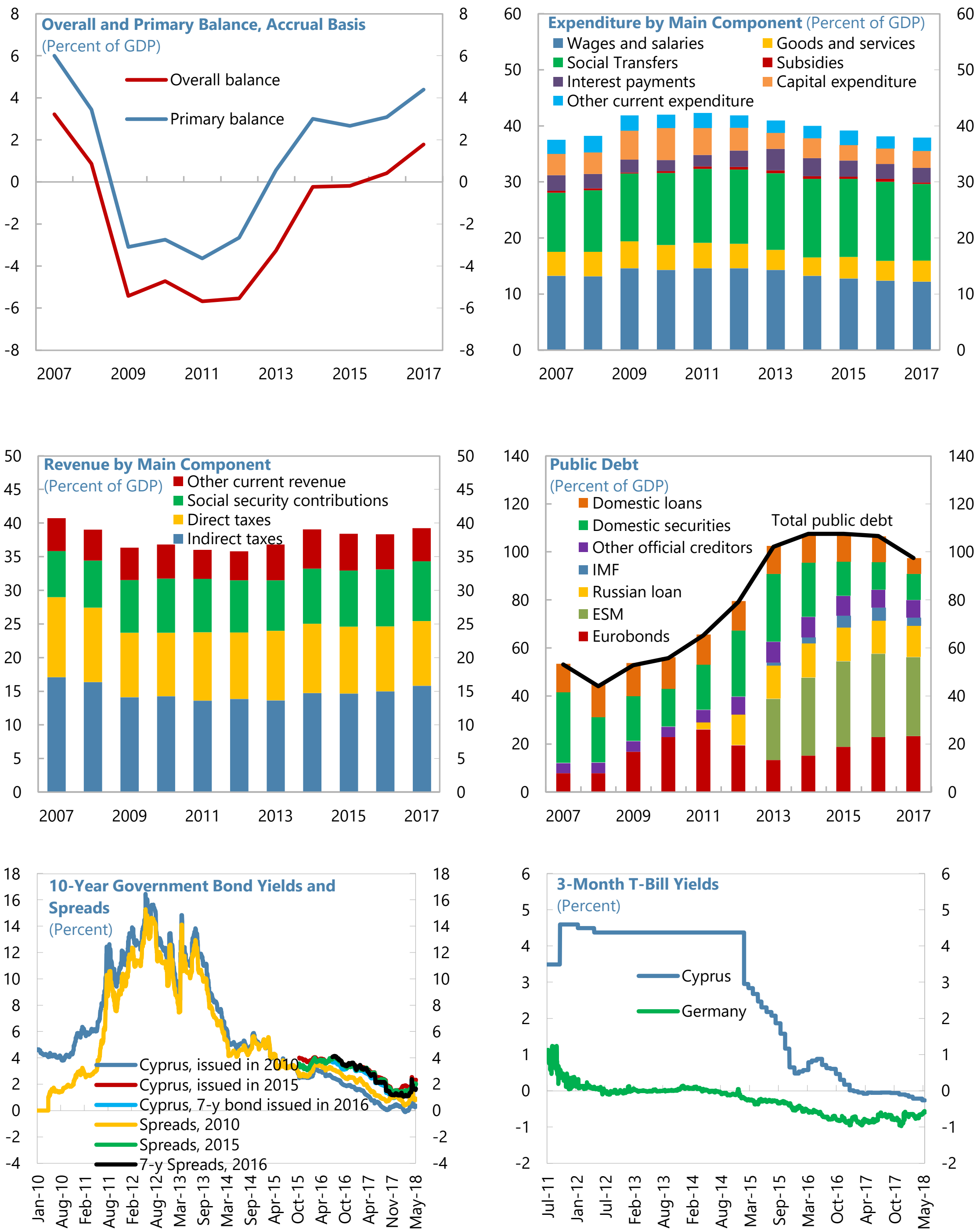
Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff calculations.
Notes: At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Housing Market



Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.
1/ Post-2018 and pre-2018 data on sales to no-residents are not directly comparable as the methodology to compile data has changed.
2/ Annualized.

Figure 7. Cyprus: Fiscal Developments



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

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

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Real Economy			(Percent change, unless otherwise indicated)						
Real GDP	2.0	3.4	3.9	4.0	4.2	3.4	2.8	2.5	2.4
Domestic demand	2.9	5.2	8.3	1.5	6.5	4.0	3.1	2.5	2.3
Consumption	1.6	2.6	3.9	3.5	2.7	2.5	2.3	2.2	2.2
Private consumption	2.6	3.3	4.2	3.6	3.0	2.8	2.6	2.5	2.5
Public consumption	-2.6	-0.4	2.7	2.7	1.4	1.2	1.1	1.0	1.0
Gross capital formation 1/	11.6	19.8	29.8	-6.0	23.0	9.5	5.5	3.3	2.7
Foreign balance 2/	-0.9	-1.7	-4.5	2.3	-2.6	-0.8	-0.4	-0.1	-0.1
Exports of goods and services	5.8	4.0	3.4	-1.3	4.9	3.5	3.1	3.1	3.1
Imports of goods and services 1/	7.4	6.8	10.1	-4.5	8.7	4.4	3.4	3.0	2.9
Potential GDP growth	1.0	1.4	1.8	2.2	2.4	2.6	2.7	2.7	2.7
Output gap (percent of potential GDP)	-6.4	-4.6	-2.6	-1.0	0.6	1.3	1.5	1.3	1.0
HICP (period average)	-1.5	-1.2	0.7	0.2	1.0	2.2	1.9	2.0	2.0
HICP (end of period)	-0.5	0.1	-0.4	1.5	1.4	1.8	1.9	2.0	2.0
Unemployment rate (percent)	14.9	13.0	11.0	9.5	8.0	7.0	6.5	6.2	6.1
Employment growth (percent)	-1.3	2.5	3.1	2.7	2.5	2.0	1.5	1.2	1.0
Labor force	-2.6	0.3	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Public Finance			(Percent of GDP, unless otherwise indicated)						
General government balance	-0.2	0.4	1.8	2.1	2.1	1.7	1.8	1.8	1.8
Revenue	39.0	38.6	39.7	39.3	39.2	38.7	38.5	38.5	38.4
Expenditure	39.2	38.2	37.9	37.2	37.1	36.9	36.7	36.7	36.7
Primary Fiscal Balance	2.7	3.1	4.4	4.5	4.5	4.1	4.1	4.1	4.0
General government debt	107.5	106.6	97.5	106.1	97.8	89.9	84.9	79.8	71.7
Balance of Payments									
Current account balance	-1.5	-4.9	-6.7	-5.1	-7.2	-7.3	-7.1	-6.8	-6.6
Trade Balance (goods and services)	0.8	-0.8	-2.0	-1.5	-3.6	-3.5	-3.2	-2.7	-2.1
Exports of goods and services	64.5	64.7	64.6	59.4	59.4	58.7	58.5	58.3	58.2
Imports of goods and services	63.7	65.5	66.5	60.9	63.0	62.2	61.7	61.0	60.3
Goods balance	-16.7	-21.2	-23.5	-20.0	-20.5	-20.5	-20.4	-20.2	-20.0
Services balance	17.5	20.4	21.6	18.4	16.9	17.0	17.2	17.5	17.8
Primary income, net	0.6	-1.6	-2.5	-1.6	-1.7	-1.8	-1.9	-2.1	-2.4
Secondary income, net	-2.9	-2.5	-2.2	-2.0	-1.9	-2.0	-2.0	-2.0	-2.1
Capital account, net	0.3	0.2	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Financial account, net	-1.6	-7.4	-2.1	-4.6	-6.7	-6.8	-6.8	-6.5	-6.2
Direct investment	47.4	-7.8	-23.1	-5.5	-6.2	-6.1	-6.0	-5.8	-5.6
Portfolio investment	-11.6	-19.0	1.2	-3.0	1.1	2.4	-1.0	-0.1	1.9
Other investment and financial derivatives	-37.4	19.4	19.9	3.9	-1.6	-3.2	0.2	-0.6	-2.4
Reserves (+ accumulation)	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 3/	5.7	0.7	-1.4	0.0	0.0	-0.2	-0.7	-0.6	-0.6
Errors and omissions	-0.4	-2.7	4.1	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	11.5	12.5	14.4	13.1	14.2	15.3	15.8	16.1	16.3
Government	2.6	3.2	4.8	5.1	5.1	4.7	4.8	4.8	4.8
Non-government	8.9	9.3	9.6	8.0	9.1	10.5	11.0	11.4	11.5
Gross capital formation	13.0	17.4	21.1	18.2	21.5	22.5	22.9	22.9	22.9
Government	2.8	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Private	10.2	14.6	18.1	15.2	18.4	19.5	19.9	19.9	19.8
Foreign saving	-1.5	-4.9	-6.7	-5.1	-7.2	-7.3	-7.1	-6.8	-6.6
Memorandum Item:									
Nominal GDP (billions of euros)	17.7	18.2	19.2	20.1	21.3	22.7	23.9	25.2	26.5
External debt	572.7	588.9	565.7	552.7	534.1	514.1	500.6	487.5	473.7

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

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

2/ Contribution to real GDP growth.

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

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

(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Revenue	39.0	38.6	39.7	39.3	39.2	38.7	38.5	38.5	38.4
Current revenue	38.4	38.3	39.3	39.1	39.0	38.5	38.3	38.3	38.2
Tax revenue	24.6	24.6	25.4	25.3	25.2	25.0	25.0	25.0	25.0
Indirect taxes	14.7	15.0	15.8	15.8	15.7	15.6	15.6	15.6	15.6
Direct taxes	9.9	9.6	9.6	9.5	9.5	9.4	9.4	9.4	9.4
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	8.4	8.5	8.9	8.8	9.1	9.1	9.1	9.1	9.1
Other current revenue	5.5	5.2	5.0	5.0	4.7	4.3	4.2	4.2	4.1
Capital revenue	0.6	0.2	0.5	0.2	0.2	0.2	0.2	0.2	0.2
Expenditure	39.2	38.2	37.9	37.2	37.1	36.9	36.7	36.7	36.7
Current expenditure	36.4	35.4	34.9	34.2	34.1	33.9	33.7	33.7	33.6
Wages and salaries	12.8	12.4	12.2	12.0	11.9	11.8	11.8	11.8	11.8
Goods and services	3.9	3.5	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Social Transfers	13.9	14.1	13.6	13.3	13.1	13.0	12.8	12.8	12.8
Subsidies	0.4	0.5	0.3	0.3	0.5	0.6	0.6	0.6	0.6
Interest payments	2.9	2.7	2.6	2.4	2.5	2.4	2.3	2.3	2.3
Other current expenditure	2.6	2.2	2.4	2.4	2.4	2.5	2.5	2.5	2.5
Capital expenditure 2/	2.8	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Overall balance 3/	-0.2	0.4	1.8	2.1	2.1	1.7	1.8	1.8	1.8
Statistical discrepancy	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-0.5	0.4	1.8	2.1	2.1	1.7	1.8	1.8	1.8
Net financial transactions	-0.5	0.4	1.8	2.1	2.1	1.7	1.8	1.8	1.8
Net acquisition of financial assets	-0.1	-5.3	-3.7	15.1	-0.2	-0.4	1.5	0.9	-2.3
Currency and deposits 4/	-0.2	-5.3	-3.7	15.1	-0.2	-0.4	1.5	0.9	-2.3
Securities other than shares 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	0.3	-5.7	-5.6	13.0	-2.3	-2.1	-0.3	-0.9	-4.1
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-4.7	-5.2	0.3	17.7	0.6	0.7	2.9	-0.3	-3.6
Loans	5.1	-0.5	-5.9	-4.6	-2.9	-2.9	-3.3	-0.5	-0.5
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Output Gap	-6.4	-4.6	-2.6	-1.0	0.6	1.3	1.5	1.3	1.0
Primary balance (ESA2010) 3/	2.7	3.1	4.4	4.5	4.5	4.1	4.1	4.1	4.0
Cyclically adjusted primary balance 3/	5.2	4.9	5.2	4.8	4.4	3.8	3.8	3.8	3.8
Structural primary balance 3/	6.3	4.6	4.8	4.4	4.0	3.8	3.8	3.8	3.9
Structural overall balance 3/	3.4	1.9	2.2	2.0	1.5	1.5	1.5	1.5	1.6
Public debt	107.5	106.6	97.5	106.1	97.8	89.9	84.9	79.8	71.7
Public debt net of cash holding	103.7	101.1	94.0	99.5	92.0	84.8	78.6	72.9	67.5

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

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

3/ Fiscal account 2015 excludes recapitalization of the cooperative sector of €0.175 billion.

4/ The cash drawdown used to recapitalize the cooperative sector in 2015 is excluded from these lines consistent with the exclusion of the recapitalization operations of the cooperative sector in the overall and primary balance.

Table 3. Cyprus: General Government Gross Financing Requirements and Sources of Financing, 2018–23

(Millions of euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023
			Projections			
Gross borrowing needs	993	1,229	1,243	1,092	1,479	1,820
Overall deficit	-415	-444	-390	-436	-441	-472
Primary surplus	-896	-970	-924	-980	-1,022	-1,071
Interest payments	481	526	534	544	581	599
Amortization	1,375	1,640	1,633	1,528	1,920	2,292
Medium- and long-term	1,175	1,340	1,296	1,064	1,470	1,842
Foreign	697	907	1,160	706	1,081	1,081
Eurobonds	0	199	458	0	1,000	1,000
Russia	625	625	625	625	0	0
Other	72	83	77	81	81	81
Domestic	478	434	136	358	389	761
Short-term	200	300	300	300	300	300
EU and IMF	0	0	37	165	150	150
Stock-flow adjustment 1/	33	33	0	0	0	0
Gross financing sources	993	1,229	1,243	1,092	1,479	1,820
Privatization receipts	0	0	0	0	0	0
Market access	1,650	1,150	1,150	1,450	1,700	1,200
Medium- and long-term	1,350	850	850	1,150	1,400	900
Foreign	900	650	650	950	1,150	650
Domestic 2/	450	200	200	200	250	250
Short-term	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0
Use of deposits 3/	-657	79	93	-358	-221	620
Net placement	2,625	-490	-483	-78	-220	-1,242
Medium and Long Term Debt	2,525	-490	-446	86	-70	-1,092
Domestic Securities 4/	2,705	-177	121	-100	-82	-454
Eurobonds	750	301	42	800	0	-500
Domestic Loans	-384	-57	-57	-57	-57	-57
Foreign Loans	-547	-558	-552	-556	69	-81
Short term (Net increase)	100	0	0	0	0	0
EU and IMF	0	0	-37	-165	-150	-150
Memorandum item:						
Cash holding (eop)	1,321	1,242	1,149	1,507	1,728	1,108
General government debt (eop)	21,358	20,867	20,385	20,306	20,086	18,994
General government debt (eop, percent of GDP)	106.1	97.8	89.9	84.9	79.8	71.7
General government net debt (eop, percent of GDP) 5/	99.5	92.0	84.8	78.6	72.9	67.5

1/ Adjustments for consistency between estimated cash basis fiscal balance and debt data.

2/ €2.35 billion domestic debt issued to enhance the CCB balance sheet is not included as the transaction did not involve cash.

3/ Minus (-) sign represents accumulation of deposits.

4/ Includes €2.35 billion domestic debt issued to the CCB.

5/ General government debt minus cash holding.

Table 4. Cyprus: Balance of Payments, 2013–23

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					Prel.			Projections			
					(Percent of GDP)						
Current Account Balance	-4.9	-4.3	-1.5	-4.9	-6.7	-5.1	-7.2	-7.3	-7.1	-6.8	-6.6
Trade Balance (Goods and Services)	1.8	2.0	0.8	-0.8	-2.0	-1.5	-3.6	-3.5	-3.2	-2.7	-2.1
Goods Balance	-16.2	-16.0	-16.7	-21.2	-23.5	-20.0	-20.5	-20.5	-20.4	-20.2	-20.0
Exports	15.0	15.9	16.2	14.2	12.9	8.1	7.7	7.4	7.2	7.0	6.8
Imports	31.2	31.9	33.0	35.5	36.4	28.0	28.1	27.9	27.6	27.2	26.8
Services Balance	18.0	18.0	17.5	20.4	21.6	18.4	16.9	17.0	17.2	17.5	17.8
Exports	43.7	46.1	48.3	50.5	51.7	51.4	51.7	51.4	51.3	51.3	51.4
Imports	25.7	28.1	30.8	30.0	30.1	32.9	34.8	34.4	34.1	33.8	33.6
Primary Income	-4.7	-3.6	0.6	-1.6	-2.5	-1.6	-1.7	-1.8	-1.9	-2.1	-2.4
Secondary Income	-2.1	-2.7	-2.9	-2.5	-2.2	-2.0	-1.9	-2.0	-2.0	-2.0	-2.1
Capital Account	1.4	0.8	0.3	0.2	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Financial Account (- financing)	-1.9	-7.1	-1.6	-7.4	-2.1	-4.6	-6.7	-6.8	-6.8	-6.5	-6.2
Direct Investment	-1.7	-7.9	47.4	-7.8	-23.1	-5.5	-6.2	-6.1	-6.0	-5.8	-5.6
Portfolio Investment	-70.0	-17.7	-11.6	-19.0	1.2	-3.0	1.1	2.4	-1.0	-0.1	1.9
Financial Derivatives	-0.3	1.6	-4.9	1.9	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Other Investment	70.2	16.8	-32.4	17.5	19.6	3.6	-1.8	-3.4	0.0	-0.8	-2.7
Reserves (+ accumulation)	-0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	1.6	-3.6	-0.4	-2.7	4.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Program Financing 1/	26.7	7.2	5.7	0.7	-1.4	0.0	0.0	-0.2	-0.7	-0.6	-0.6
Private Net Capital Flows 2/	21.6	-24.0	-27.9	-34.0	-18.6	…	…	…	…	…	…
o/w Portfolio Investment	-77.1	-15.9	-12.8	-22.4	-3.7	…	…	…	…	…	…
o/w Other Investment	100.6	-1.8	-57.6	-5.8	7.9	…	…	…	…	…	…
o/w MFIs	59.2	-1.5	-38.1	5.4	-0.2	…	…	…	…	…	…
o/w Non-MFIs	41.4	-0.3	-19.5	-11.1	8.1	…	…	…	…	…	…
Gross External Debt	569.1	554.4	572.7	588.9	565.7	552.7	534.1	514.1	500.6	487.5	473.7
o/w Short-term Debt	241.5	208.4	197.0	199.8	195.0	194.0	192.1	190.0	188.7	187.6	186.6

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

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

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

Table 5. Cyprus: External Financing Requirements and Sources, 2013–23
(Millions of euros)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
						Projections					
GROSS FINANCING REQUIREMENTS	**70,884**	**52,200**	**45,010**	**42,917**	**45,591**	**46,197**	**48,588**	**51,012**	**52,966**	**55,487**	**57,722**
Current account deficit ("-" = CA surplus)	896	761	259	889	1,291	1,036	1,544	1,644	1,708	1,718	1,735
Medium- and long-term debt amortization	9,880	7,628	8,065	7,073	7,627	7,697	7,992	8,355	8,017	8,496	8,598
Public sector	1,458	678	1,392	276	602	697	907	1,160	706	1,081	1,081
Banks	4,089	1,392	1,146	887	773	787	795	807	819	830	841
Other private	4,333	5,557	5,527	5,910	6,251	6,214	6,291	6,388	6,492	6,585	6,676
Short-term debt amortization	60,108	43,812	36,686	34,956	36,406	37,464	39,052	40,977	43,076	45,124	47,239
Public sector	7,653	7,504	2,874	222	272	209	144	108	81	61	46
Central Bank	7,650	7,504	2,874	201	254	191	144	108	81	61	46
General government and SOEs	3	0	0	20	18	18	0	0	0	0	0
Banks	35,384	19,265	19,593	22,493	17,997	18,707	19,471	20,266	21,095	21,959	22,858
Other private	17,071	17,042	14,219	12,241	18,137	18,548	19,438	20,602	21,899	23,104	24,335
EU and IMF	0	0	0	0	267	0	0	37	165	150	150
SOURCES OF FINANCING	**66,046**	**50,933**	**44,000**	**42,792**	**45,591**	**46,197**	**48,588**	**51,012**	**52,966**	**55,487**	**57,722**
Capital account (net)	255	147	49	37	104	105	116	93	84	90	98
Foreign direct investment (net)	304	1,397	-8,415	1,413	4,447	1,113	1,319	1,383	1,433	1,461	1,486
Cypriot investment abroad	-4,840	-1,789	15,752	938	4,890	2,810	2,976	3,128	3,283	3,449	3,620
Foreign investment in Cyprus	-4,536	-392	7,337	2,351	9,337	3,923	4,294	4,511	4,716	4,911	5,106
New borrowing and debt rollover	47,594	43,403	44,572	44,586	45,203	47,367	49,246	51,490	53,892	56,303	58,077
Medium and long-term borrowing	3,782	6,718	9,617	8,179	7,739	8,315	8,269	8,415	8,769	9,064	8,658
General government	26	910	2,062	125	850	900	650	650	950	1,150	650
Banks	-6,696	404	112	438	825	817	842	856	863	873	883
Other private	10,453	5,404	7,443	7,616	6,063	6,598	6,777	6,909	6,956	7,041	7,125
Short-term borrowing	43,812	36,686	34,956	36,406	37,464	39,052	40,977	43,076	45,124	47,239	49,419
Public sector	7,504	2,874	222	272	209	144	108	81	61	46	35
Central Bank	7,504	2,874	201	254	191	144	108	81	61	46	35
General government and SOEs	0	0	20	18	18	0	0	0	0	0	0
Banks	19,265	19,593	22,493	17,997	18,707	19,471	20,266	21,095	21,959	22,858	23,795
Other private	17,042	14,219	12,241	18,137	18,548	19,438	20,602	21,899	23,104	24,335	25,590
Other	17,893	5,985	7,793	-3,243	-4,163	-2,387	-2,092	-1,954	-2,443	-2,367	-1,939
Of which: Net errors and omissions	298	-637	-74	-500	790	0	0	0	0	0	0
FINANCING GAP	**4,838**	**1,267**	**1,010**	**125**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	4,585	1,100	600	0	0	0	0	0	0	0	0
IMF	253	167	410	125	0	0	0	0	0	0	0
ROLLOVER RATES											
General government 1/	2%	134%	150%	48%	140%	126%	72%	56%	135%	106%	60%
Central bank	98%	38%	7%	126%	75%	75%	75%	75%	75%	75%	75%
Private	66%	92%	104%	106%	102%	105%	105%	106%	105%	105%	105%
Banks	32%	97%	109%	79%	104%	104%	104%	104%	104%	104%	104%
Non-financial corporates	128%	87%	100%	142%	101%	105%	106%	107%	106%	106%	105%

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

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

Table 6. Cyprus: Monetary Indicators, 2010–17

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

	2010	2011	2012	2013	2014	2015	2016	2017
Aggregated Balance Sheet of Monetary Financial Institutions excluding the Central Bank of Cyprus								
Assets	135.0	131.4	128.1	90.3	91.1	91.0	86.5	80.5
Claims on Central Bank of Cyprus	2.3	2.9	3.9	2.7	4.2	7.2	9.0	11.8
Claims on Cypriot resident Other MFIs	5.6	5.0	4.6	3.3	4.1	4.5	5.6	0.3
Claims on Cypriot resident non MFIs	54.0	58.2	60.6	55.0	53.5	54.1	48.1	46.6
General government	4.5	5.3	6.5	5.4	4.5	3.4	3.3	3.9
Private sector excluding SPEs 1/	46.5	48.6	49.3	46.5	45.2	44.5	41.9	39.6
Households	22.5	23.5	23.9	22.3	21.9	21.5	20.8	19.8
Non-Financial Corporations	23.3	24.1	24.4	23.4	21.8	21.9	20.0	18.8
Non-Bank Financial Intermediaries	0.7	1.0	1.0	0.8	1.6	1.1	1.2	1.0
SPEs	3.0	4.4	4.8	3.1	3.7	6.2	2.9	3.2
Claims on non-residents	69.3	61.3	55.9	25.3	25.6	21.6	19.1	16.5
Other assets	3.8	3.9	3.2	3.9	3.8	3.6	4.7	5.2
Liabilities	135.0	131.6	128.1	90.3	91.1	91.0	86.6	74.2
Liabilities to the Central Bank of Cyprus	5.5	5.5	9.8	11.2	8.5	4.7	0.9	0.9
Liabilities to Cypriot resident Other MFI	5.5	4.9	4.5	3.1	3.6	4.2	5.1	0.3
Deposits of Cypriot resident non MFIs	45.4	43.7	43.3	33.0	32.3	32.9	36.6	37.8
General government	0.5	0.5	0.5	0.4	0.5	0.5	1.0	1.1
Private sector excluding SPEs	36.8	37.4	37.5	29.9	29.3	29.9	32.4	34.0
Households	25.4	26.0	26.4	23.3	22.3	22.4	23.1	23.6
Non-Financial Corporations	6.7	6.7	5.7	3.9	3.8	4.6	5.7	6.7
Non-Bank Financial Intermediaries	4.7	4.6	5.4	2.7	3.2	2.9	3.5	3.6
SPEs	8.1	5.8	5.3	2.6	2.5	2.4	3.2	2.8
Deposits of non-residents	60.6	56.5	51.3	24.5	24.1	25.5	20.9	19.5
Debt securities	2.4	2.6	1.7	0.5	0.4	0.7	0.3	0.6
Capital and reserves	12.8	11.3	15.1	16.4	20.8	21.7	21.5	13.6
Other liabilities	2.8	7.1	2.4	1.6	1.5	1.3	1.4	1.4
Money and Credit								
Net foreign assets	4.0	-1.4	-1.0	-5.5	0.2	0.6	8.2	9.4
Monetary Financial Institutions	6.3	2.2	3.0	0.3	1.3	-4.6	-2.1	-3.5
Central Bank of Cyprus	-2.3	-3.7	-4.0	-5.8	-1.1	5.2	10.2	12.9
Net domestic assets	51.7	53.9	56.4	52.0	49.6	48.2	44.8	42.7
General government sector credit, net	5.2	5.3	7.2	5.5	4.3	3.6	2.9	3.1
Private sector credit excluding SPEs	46.5	48.6	49.3	46.5	45.3	44.5	41.9	39.6
SPEs credit	3.0	4.4	4.8	3.1	3.7	6.2	2.9	3.2
Other items,net	-12.3	-11.8	-15.6	-15.1	-19.4	-19.9	-17.8	-15.9
Cypriot Resident Broad money (M2)	46.6	45.0	44.6	34.5	34.1	35.0	38.1	39.4
Cypriot Resident Narrow money (M1)	10.6	11.1	11.5	10.4	11.4	12.8	15.1	16.6
				(Percent of GDP)				
General Government sector credit, net	27.1	26.6	36.7	30.4	24.4	20.5	15.9	16.2
Private sector credit excluding SPEs	241.0	246.6	252.8	256.4	257.1	250.9	231.4	209.9
SPEs credit	15.7	22.1	24.5	17.0	21.0	34.7	16.1	16.8
Cypriot Resident Broad money (M2)	241.2	228.0	229.0	190.0	193.6	197.0	210.1	208.6
Cypriot Resident Narrow money (M1)	55.2	56.4	58.9	57.3	65.0	72.4	83.3	87.8
				(Annual percentage change)				
General Government sector credit, net	-1.6	0.4	36.2	-22.9	-22.2	-15.1	-20.9	5.9
Private sector credit excluding SPEs	8.8	4.6	1.3	-5.6	-2.7	-1.7	-5.8	-5.5
Gross Household and non-financial corporations credit excluding SPEs	8.5	4.2	1.2	-5.3	-4.5	-0.6	-6.0	-5.2
SPEs credit	2.3	44.0	9.9	-35.6	19.9	66.8	-52.7	8.6
Cypriot Resident Broad money (M2)	10.4	-3.4	-0.8	-22.8	-1.1	2.5	9.0	3.4
Cypriot Resident Narrow money (M1)	2.3	4.4	3.2	-9.4	10.0	12.3	17.6	9.7
Memorandum items:								
Credit to deposits Ratio, Cypriot residents (in percent)	108.9	120.9	124.5	151.9	153.6	155.8	123.8	114.0
Deposits from Cypriot Private Sector excluding SPEs (y-o-y percent change)	6.5	1.7	0.3	-20.2	-2.0	2.1	8.2	4.8
SPEs Deposits (y-o-y percent change)	33.8	-28.3	-9.4	-50.3	-5.3	-1.8	31.3	-13.0

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

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

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

(Percent, unless otherwise specified)

	2010	2011	2012	2013	2014	2015	2016	2017
Capital Adequacy								
Regulatory capital ratio	12.3	8.6	7.3	13.5	15.3	16.6	16.8	16.3
Tier I capital ratio	10.9	7.4	6.3	12.3	14.6	16.0	16.4	15.4
Asset Quality								
Non-performing loans (NPLs) to total gross loans 2/	13.3	17.3	27.1	44.4	47.5	45.3	46.4	42.5
Non-performing loans (NPLs) to total gross loans (local operations) 3/	14.2	16.3	22.6	44.4	47.8	45.8	47.2	43.7
Provisions to NPLs	...	...	...	...	33.9	38.3	42.3	47.3
Restructured loans classified as NPLs to total NPLs	...	...	...	28.0	33.9	40.1	40.8	40.9
Earnings and Profitability								
Return on assets 4/	...	-3.7	-5.4	-14.7	-0.1	0.6	1.4	-4.3
Return on equity 4/	...	-54.5	-83.5	-100.5	-4.6	2.4	19.8	-34.6
Net interest income to gross income ratio	75.9	82.3	78.9	86.2	78.4	81.2	75.3	70.8
Net fees and commissions income to gross income ratio	13.5	13.9	16.0	13.4	11.6	13.8	14.6	16.5
Net interest margin	2.0	2.4	2.3	2.4	2.9	2.8	2.6	2.3
Liquidity								
Cash, trading and available-for-sale assets to total assets ratio	10.7	9.7	8.6	7.0	14.4	19.8	22.9	27.9
Others								
Total loans and advances to total assets ratio	71.5	76.1	82.9	83.6	73.4	73.6	69.1	64.1
Total deposits (other than from credit institutions) to total assets ratio	62.1	64.3	71.7	63.8	63.0	65.1	74.9	75.7

Sources: Central Bank of Cyprus.

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

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

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

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

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

(Millions of SDRs)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Disbursement	222.8	148.5	321.8	99.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service	1.6	3.8	7.5	13.1	236.2	11.0	11.5	42.8	148.4	133.5	131.0	91.7	53.1	9.0
Repurchase	0.0	0.0	0.0	0.0	222.4	0.0	0.0	31.3	138.2	125.8	125.8	88.7	51.6	8.3
Charges	1.6	3.8	7.5	13.1	13.8	11.0	11.5	11.5	10.2	7.7	5.2	3.0	1.5	0.8
Total debt service, in percent of														
Quota	1.0	2.4	4.8	4.3	77.7	3.6	3.8	14.1	48.8	43.9	43.1	30.2	17.5	3.0
GDP	0.0	0.0	0.1	0.1	1.5	0.1	0.1	0.2	0.7	0.6	0.6	0.4	0.2	0.0
Exports of goods and services	0.0	0.0	0.1	0.1	2.3	0.1	0.1	0.4	1.3	1.1	1.0	0.7	0.4	0.1
Outstanding stock	222.8	371.3	693.0	792.0	569.6	569.6	569.6	538.3	400.1	274.3	148.5	59.8	8.3	0.0
In percent of quota	140.8	234.7	438.1	260.7	187.5	187.5	187.5	177.2	131.7	90.3	48.9	19.7	2.7	0.0
In percent of GDP	1.4	2.5	5.0	5.5	3.5	3.4	3.2	2.8	2.0	1.3	0.7	0.3	0.0	0.0
In percent of exports of goods and services	2.3	4.1	7.7	8.6	5.5	5.7	5.4	4.8	3.4	2.2	1.1	0.4	0.1	0.0

Source: IMF staff estimates.

1/ Effective february 2016, the new Quota of SDR 303.8 million is applied.

Annex I. Public Sector Debt Sustainability Analysis

The Public DSA framework for Market-Access Countries indicates that in the baseline, public debt is on a rapid downward path after a one-off increase in 2018 and gross financing needs are manageable. However, risks to debt sustainability remain high and debt reduction could be temporarily halted by an adverse short-term growth shock and significantly delayed by a combination of sustained stagnation, a modest primary deficit and persistent deflation. If a large contingent liability were to materialize, public debt would rise to and remain at a very high level, particularly if market dislocation persists.

Baseline Scenario

1. **The debt issuance aimed at shoring up the balance sheet of the CCB has temporarily reversed the rapid downward path of Cyprus's public debt.** Rapidly-rising cash balances arising from the increasing primary surplus and strong growth enabled the government to make an early repurchase to the Fund in July 2017 and repay part of the debt owed to the CBC in November 2017. As a result, public debt declined sharply to 97.5 percent of GDP at end-2017 from 106.6 percent of GDP a year earlier. However, to strengthen the balance sheet and funding structure of the CCB, the government placed €2.35 billion domestic bonds at the CCB in April 2018. This transaction contributes to the projected increase in public debt to about 106 percent of GDP at end-2018.

2. **However, from 2019, public debt is projected to resume a rapid decline.** Projected high primary surpluses and robust economic growth will support a durable decline in public debt to 72 percent of GDP by 2023.

3. **Despite the ongoing sale transaction of the CCB, gross public financing needs (GPFN) are expected to be manageable.** GPFN will remain less than half the benchmark for advanced economies (20 percent of GDP) over the projection horizon. The debt issuance to the CCB was implemented through a private off-market placement of long-term non-cash domestic bonds. Moreover, taking advantage of strong market access, the authorities undertook transactions to eliminate a prior repayment hump in 2019–20. Specifically, in June 2017, the authorities issued €850 million in Eurobonds and bought back bonds scheduled to mature in 2019. They also made early repurchase to the Fund and repaid part of the debt owed to the CBC. Looking forward, the authorities plan to issue medium- or long-term Eurobonds each year to maintain a cash buffer sufficient to cover gross financing needs on a 9-month forward rolling basis.

Risk Assessment

4. **High NPLs poses a risk to the sustainability of public debt.** Fiscal costs and public debt might increase further as the sale of the CCB to private investors are finalized. Furthermore, in addition to the NPLs at the CCB, broader risk from NPLs at other systemic banks could spill over to the government's balance sheet.

5. **Cyprus's current high level of public debt also leaves it vulnerable to macro-fiscal shocks.** Under the baseline, Cyprus's public debt ratio is projected to remain above the benchmark

for advanced economies (85 percent of GDP) until 2021. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 100 percent until 2023 with a probability of 13 percent (fan chart in Annex Figure 1).[1]

6. **GPFN will remain contained even under a range of shocks.** In the event of short-duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would be contained below 15 percent of GDP through 2023, still below the 20 percent benchmark.

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

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

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

- The sovereign bond spread relative to German bonds—an indicator of market perception of sovereign risk—was around 160 basis points on average in the past three months, below the lower risk-assessment benchmark. However, Cyprus's bonds remain at least one notch below investment grade even after a series of upgrades by major rating agencies during 2015–17.

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

Realism of Baseline Assumptions

8. **GDP growth and fiscal outturns have surpassed staff's forecasts in recent years, in contrast to previous excessive optimism.** Recent GDP growth and the fiscal balance have been stronger than expected, due in part to robust external demand and private financial inflows that have substituted for new bank lending. This over-performance occurred despite the sizable structural fiscal consolidation during the program. In contrast, projection errors during 2012–13

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

[2] As of end-2017, the weighted average maturity of total debt is 7 years, while that of marketable debt is 4.9 years as of end-June 2017. The shares of debt that falls due within 1 year and 5 years are 5.7 percent and 35.4 percent, respectively.

indicate excessive optimism although these errors reflect difficult-to-foresee events (damage to the sole power plant in 2011 and the write-down of banks' holdings of Greek public debt in 2012).

Stress Tests and Alternative Scenarios

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

- **Growth shock.** A one standard deviation (3.3 percentage points) decrease in growth during 2019–20, accompanied by (i) a 35 and 72 basis points (bps) rise in interest rates in 2019 and 2020, respectively (corresponding to 25 bps rise per one percentage point reduction in primary balance), and (ii) a decrease in inflation by 0.25 percentage points per percentage point reduction in GDP growth, would raise public debt by 12 percentage points relative the baseline to 103 percent of GDP by 2020, before declining to 84 percent of GDP by 2023.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.6 percent of GDP during 2019–20, accompanied by 41 bps rise in interest rates (corresponding to 25 bps rise per one percentage point reduction in primary balance) or an increase in the real interest rate by 518 bps during 2019–23 would raise public debt marginally to around 74–75 percent of GDP by 2023.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 105 percent of GDP in 2020 before declining to 90 percent of GDP by 2023. Gross financing needs would peak at 11.7 percent of GDP in 2020—still below the 20 percent benchmark—before falling back.

10. Under an alternative scenario of realization of large contingent liabilities, public debt rises sharply and remains high. A one-off 50 percent of GDP increase in fiscal spending in 2019 is assumed to lead to a temporary spike in the borrowing costs for the sovereign by 1,250 basis points in 2019 and to be accompanied by compression of output and a decline of inflation in 2019–20.[3] Under this scenario, public debt would reach 155 percent of GDP in 2020 and would decline only gradually to 148 percent of GDP by 2023. However, such a spike in borrowing costs would likely preclude market access, with further detrimental implications for debt sustainability.

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

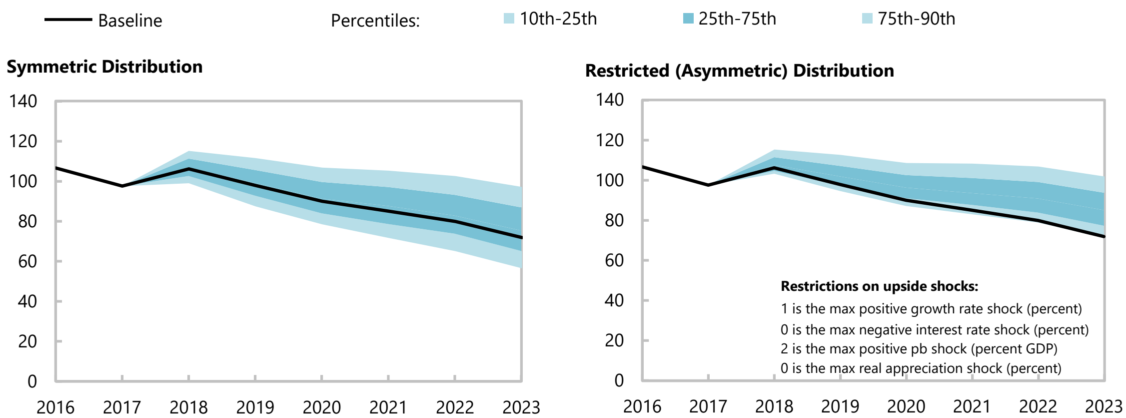
Cyprus: Public DSA Risk Assessment

Heat Map

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

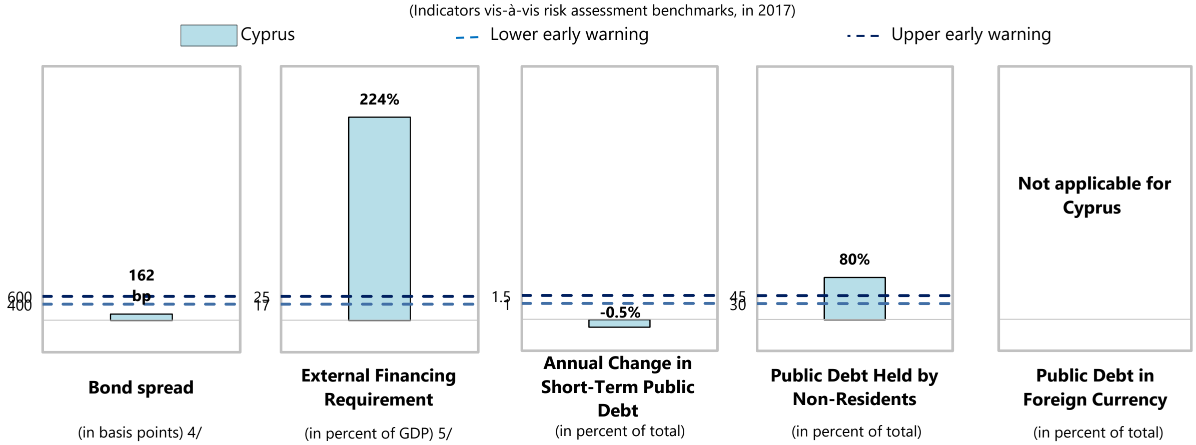
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

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



Source: IMF staff.

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

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

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

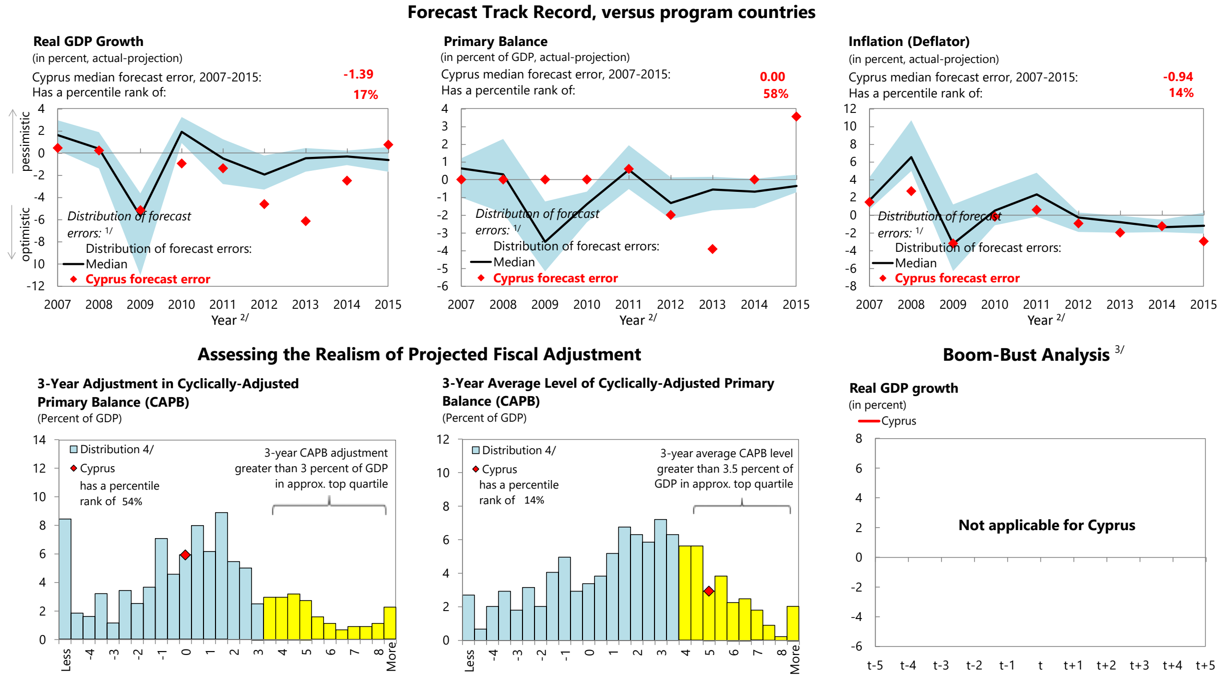
Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 30-Jan-18 through 30-Apr-18.

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

Cyprus: Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Cyprus, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

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

(in percent of GDP unless otherwise indicated)

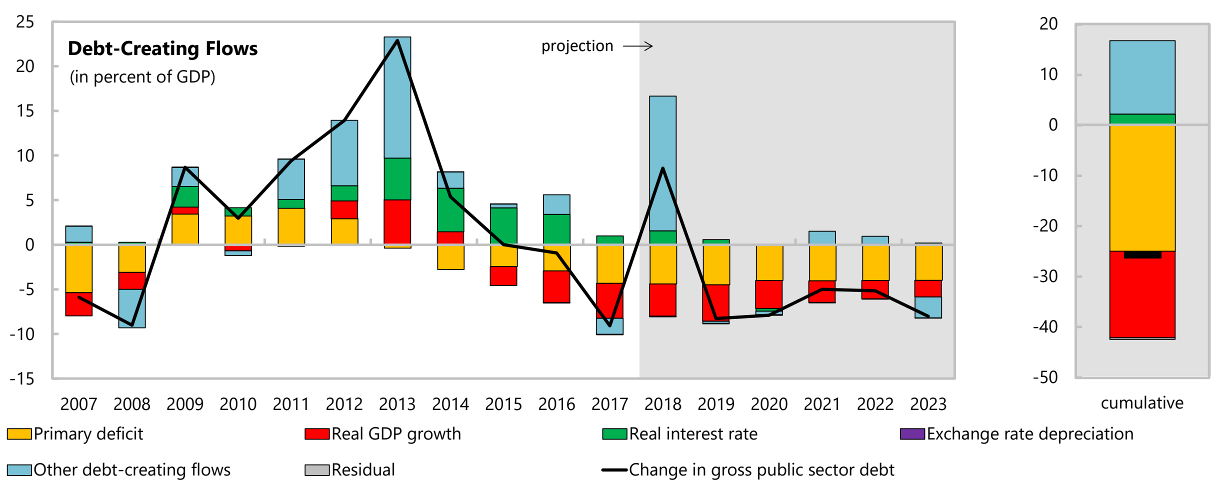
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2007-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	74.2	106.6	97.5	106.1	97.8	89.9	84.9	79.8	71.8
Public gross financing needs	13.5	8.9	10.0	4.8	5.6	5.5	4.6	5.9	6.9
Real GDP growth (in percent)	0.0	3.4	3.9	4.0	4.2	3.4	2.8	2.5	2.4
Inflation (GDP deflator, in percent)	1.2	-0.7	1.5	0.9	1.8	2.8	2.6	2.7	2.6
Nominal GDP growth (in percent)	1.3	2.7	5.5	4.8	6.0	6.3	5.5	5.3	5.1
Effective interest rate (in percent) [4]	4.2	2.6	2.6	2.6	2.5	2.6	2.7	2.9	3.0

As of April 30, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		199
5Y CDS (bp)		140
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB+	BB+
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	5.4	-0.9	-9.1	8.6	-8.3	-7.9	-5.0	-5.2	-8.0	-25.7	
Identified debt-creating flows	5.4	-0.9	-9.0	8.7	-8.2	-7.8	-4.9	-5.1	-8.0	-25.4	
Primary deficit	0.0	-2.9	-4.3	-4.4	-4.5	-4.0	-4.0	-4.0	-4.0	-25.0	-4.0
Primary (noninterest) revenue and grants	37.8	38.4	39.7	39.2	39.1	38.6	38.5	38.4	38.4	232.3	
Primary (noninterest) expenditure	37.7	35.5	35.3	34.8	34.7	34.6	34.4	34.4	34.4	207.3	
Automatic debt dynamics [5]	2.5	-0.1	-2.9	-2.1	-3.5	-3.4	-2.4	-2.0	-1.6	-15.0	
Interest rate/growth differential [6]	2.5	-0.1	-2.9	-2.1	-3.5	-3.4	-2.4	-2.0	-1.6	-15.0	
Of which: real interest rate	2.2	3.4	1.0	1.6	0.6	-0.3	0.0	0.1	0.2	2.2	
Of which: real GDP growth	0.2	-3.6	-3.9	-3.6	-4.1	-3.1	-2.4	-2.0	-1.8	-17.1	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	3.0	2.2	-1.8	15.1	-0.2	-0.4	1.5	0.9	-2.3	14.5	
Privatization/Drawdown of Deposits (+ r	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	3.0	2.2	-1.8	15.1	-0.2	-0.4	1.5	0.9	-2.3	14.5	
Residual, including asset changes [8]	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.3	

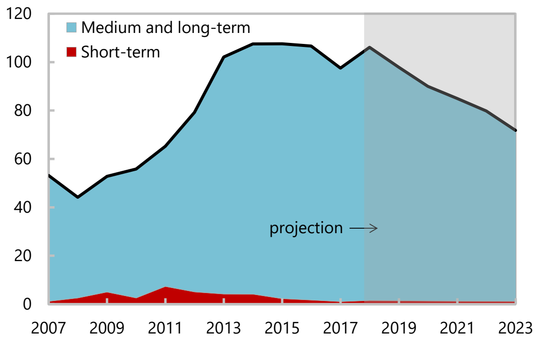


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ))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

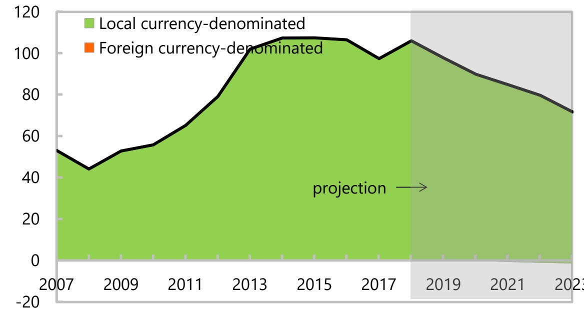
Cyprus: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



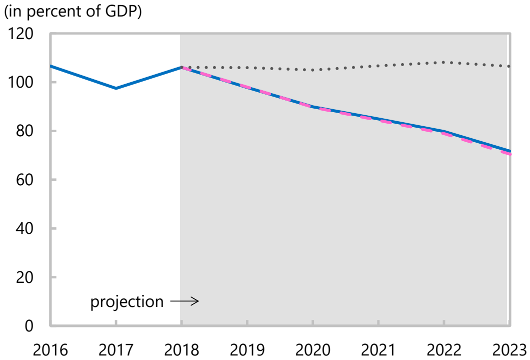
By Currency
(in percent of GDP)



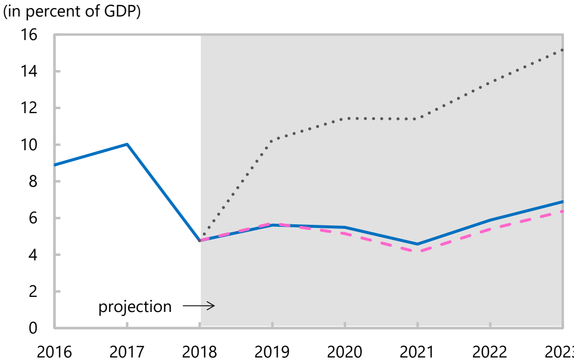
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

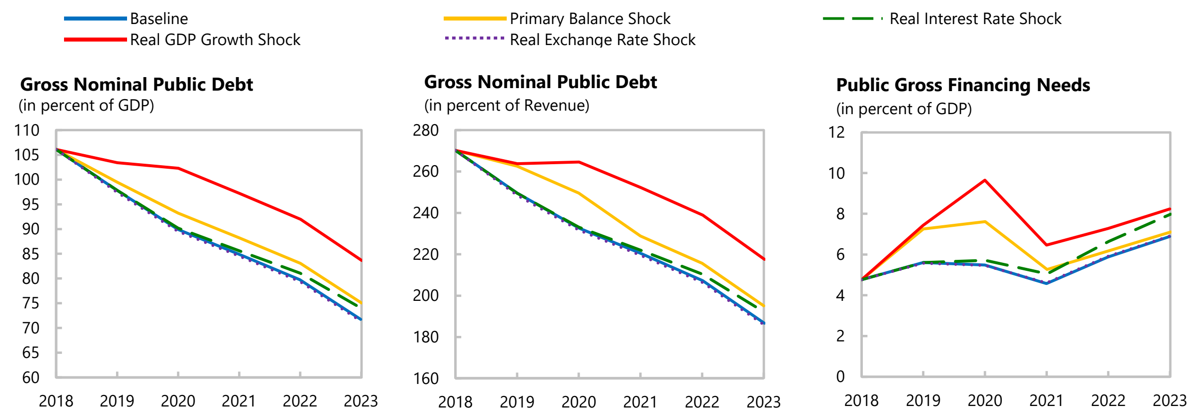
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	4.2	3.4	2.8	2.5	2.4
Inflation	0.9	1.8	2.8	2.6	2.7	2.6
Primary Balance	4.4	4.5	4.0	4.0	4.0	4.0
Effective interest rate	2.6	2.5	2.6	2.7	2.9	3.0
Constant Primary Balance Scenario						
Real GDP growth	4.0	4.2	3.4	2.8	2.5	2.4
Inflation	0.9	1.8	2.8	2.6	2.7	2.6
Primary Balance	4.4	4.4	4.4	4.4	4.4	4.4
Effective interest rate	2.6	2.5	2.6	2.7	2.9	3.0

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	0.3	0.3	0.3	0.3	0.3
Inflation	0.9	1.8	2.8	2.6	2.7	2.6
Primary Balance	4.4	0.2	0.2	0.2	0.2	0.2
Effective interest rate	2.6	2.5	2.8	3.2	3.7	4.1

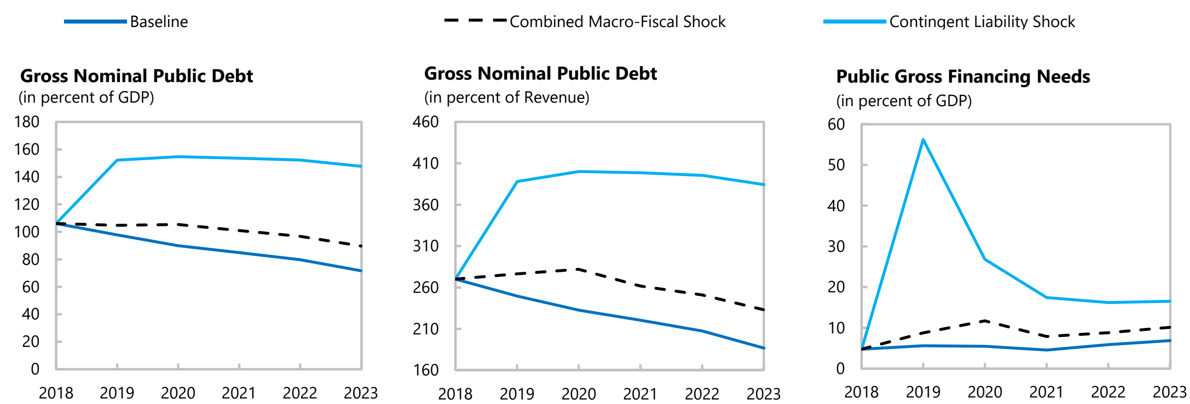
Source: IMF staff.

Cyprus: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	4.0	4.2	3.4	2.8	2.5	2.4
Inflation	0.9	1.8	2.8	2.6	2.7	2.6
Primary balance	4.4	2.8	2.4	4.0	4.0	4.0
Effective interest rate	2.6	2.5	2.6	2.8	3.0	3.1
Real Interest Rate Shock						
Real GDP growth	4.0	4.2	3.4	2.8	2.5	2.4
Inflation	0.9	1.8	2.8	2.6	2.7	2.6
Primary balance	4.4	4.5	4.0	4.0	4.0	4.0
Effective interest rate	2.6	2.5	2.8	3.2	3.7	4.2
Combined Shock						
Real GDP growth	4.0	0.8	0.1	2.8	2.5	2.4
Inflation	0.9	1.0	2.0	2.6	2.7	2.6
Primary balance	4.4	1.8	-0.2	4.0	4.0	4.0
Effective interest rate	2.6	2.5	3.0	3.5	4.1	4.7

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	4.0	0.8	0.1	2.8	2.5	2.4
Inflation	0.9	1.0	2.0	2.6	2.7	2.6
Primary balance	4.4	3.1	1.1	4.0	4.0	4.0
Effective interest rate	2.6	2.5	2.6	2.8	3.0	3.1
Real Exchange Rate Shock						
Real GDP growth	4.0	4.2	3.4	2.8	2.5	2.4
Inflation	0.9	2.2	2.8	2.6	2.7	2.6
Primary balance	4.4	4.5	4.0	4.0	4.0	4.0
Effective interest rate	2.6	2.5	2.6	2.7	2.9	3.0
Contingent Liability Shock						
Real GDP growth	4.0	0.8	0.1	2.8	2.5	2.4
Inflation	0.9	1.0	2.0	2.6	2.7	2.6
Primary balance	4.4	-45.5	4.0	4.0	4.0	4.0
Effective interest rate	2.6	2.6	6.8	6.4	6.5	6.6

Source: IMF staff.

Annex II. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Expected Impact of Risk on Repayment Capacity	Policy Response
Externally Sourced Risks		
Medium **Policy uncertainty:** Two-sided risks to U.S. growth with uncertainties about the positive short-term impact of the tax bill on growth and the extent of potential medium-term adjustment to offset its fiscal costs; uncertainty associated with negotiating post-Brexit arrangements and NAFTA and associated market fragmentation risks; and evolving political processes, including elections in several large economies, weigh on the whole on global growth	Medium The Cypriot economy is heavily dependent on foreign demand—especially from the UK and Russia—for tourism and business services. Weaker external demand would adversely affect long-term growth.	Seek to broaden sources of foreign demand beyond a narrow set of countries. Restart structural reforms to make the economy more flexible and dynamics in response to demand shocks.
Medium **Retreat from cross-border integration:** Fraying consensus about the benefits of globalization leads to protectionism and economic isolationism, resulting in reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	Medium The Cypriot economy is heavily dependent on foreign demand for tourism and business services. Weaker external demand would adversely affect long-term growth.	Restart structural reforms to make the economy more flexible and dynamics in response to demand shocks.
High **Tighter global financial conditions:** Against the backdrop of continued monetary policy normalization and increasingly stretched valuations across asset classes, an abrupt change in global risk appetite (e.g., due to higher-than-expected inflation in the U.S) could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	Medium Higher interest rates on Cypriot government borrowing would raise the cost of refinancing maturing official loans with market debt. Higher interest rates on private sector debt would raise debt service obligations, decreasing domestic demand and/or deteriorating loan quality.	Undertake additional fiscal consolidation to reduce borrowing needs. Incentivize private-sector borrowers to engage with banks by strengthening the legal and framework for insolvency and foreclosure.

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

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

Annex III. Financial Position in the Fund

(As of March 31, 2018)

Membership Status: Joined December 21, 1961; Article VIII

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

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	132.80	100.00
Holdings	49.56	37.32

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

Financial Arrangements:

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

Actual and Projected Payments to the Fund (SDR millions; Projected from 2018):

	Principal	**Charges/Interest**	**Total**
2015	0.00	7.52	7.52
2016	0.00	13.12	13.12
2017	222.38	13.78	236.16
2018	0.00	11.00	11.00
2019	0.00	11.50	11.50
2020	31.31	11.51	42.82
2021	138.19	10.18	148.37
2022	125.81	7.69	133.50
2023	125.81	5.19	131.00

Statement by Anthony De Lannoy, Executive Director for Cyprus, and Dries Cools, Advisor to the Executive Director
June 4, 2018

The authorities highly appreciated the Second Post-Program Monitoring (PPM) discussions after exiting the Extended Arrangement under the Extended Fund Facility (EFF) in 2016. The authorities had requested the continuation of PPM after the 2017 early repayment which had led to a reduction of the amount of credit outstanding below the threshold for PPM, and express their strong willingness to continue to be engaged with the Fund until 2020.

The repayment capacity of Cyprus is underpinned by solid growth and a prudent fiscal position. Except for the banking industry, where needed deleveraging is taking place, growth has been broad-based. Strong growth is not limited to the construction sector and the tourist industry, but is also observed in trade, professional services and manufacturing services. Growth is projected to remain firm at around 4 percent of GDP in 2018-2019, and the authorities expect cross-sectoral growth to continue. Planned infrastructure projects do not only cover tourism and residential investment, but also areas including energy, education and transport. The growth momentum is unlikely to be threatened by a boom-bust cycle, as construction activity is mainly financed from FDI, and fiscal spending is not deficit financed.

The authorities are committed to maintaining a prudent fiscal stance. Cyprus' primary surplus has been in positive territory for years and reached 4.5 percent of GDP in 2017. This shows that the authorities are focused on a sustained and gradual reduction of the general government debt to GDP ratio from 97.5 percent in 2017 to 72 percent in 2023, in full respect of the debt rule in the preventive arm of the European Stability and Growth Pact. The authorities' 2018–2021 fiscal plans provide for a cap on expenditures increase set at the medium-term GDP growth rate. The authorities also maintain a policy of wage and salary restraint. The authorities have reached a collective agreement with public sector unions, introducing a control mechanism limiting the overall growth in the wage bill in the public sector below the growth of nominal GDP. A Law has also been adopted to suspend the recruitment of new personnel in the public sector, with exceptions being subjected to a strict control mechanism.

The current economic outlook in conjunction with a prudent fiscal stance is a good starting point to set in motion financial and structural reforms. The authorities aim to further facilitate the reduction of NPLs, which have witnessed a decline in absolute terms since 2016. Ongoing reforms include the strengthening of the effectiveness of the legal framework related to the management of non-performing exposures and strategic defaulters. Beside these improvements to the Insolvency and Foreclosure frameworks, the authorities are also addressing the most challenging portfolio of NPLs (mortgage loans or

SME loans with primary residence of the borrower as collateral) through a targeted subsidy scheme that incentivizes debt servicing by distressed mortgage borrowers.

The authorities continue to strive towards advancing their structural reform agenda which spans over a range of policies. The authorities would like to point at the continued efforts deployed to increase the efficiency of the Judiciary and public and local administration. In addition, the authorities are addressing skills mismatches by improving the labor market relevance of the educational system and the quality of active labor market policies, particularly for young people. Finally, the authorities aim at relaunching their privatization plans in the coming 12 months, which include the state telecoms company, the state lottery, the port of Larnaca, the Cyprus Stock Exchange, and several real estate assets.

The authorities look forward to continuing fruitful discussions with the IMF on the occasion of the Article IV mission in September.