Cyprus: 2019 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Cyprus

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 19/362

CYPRUS

December 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Cyprus the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 27, 2019 consideration of the staff report that concluded the Article IV consultation with Cyprus.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 27, 2019, following discussions that ended on September 26, 2019, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 12, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Cyprus.

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

Selected Issues

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December 10, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with Cyprus

On November 27, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Cyprus.

Following a period of rapid recovery from the 2012–13 financial crisis, Cyprus's economic growth momentum is gradually slowing. Growth decelerated to 3.2 percent (year-over-year) in the first semester of 2019, from 4.0 percent in 2018, amidst a slowing global economy and Brexit-related uncertainty which has taken a toll on tourism receipts and service exports. The underlying current account deficit widened due to slower growth of trading partners. Fiscal performance was strong as the underlying general government primary surplus rose to 5.4 percent of GDP in 2018. Inflationary pressure remained low, and the unemployment rate continued to decline, reaching close to pre-crisis levels. While the banking sector has made significant improvements, challenges remain. Non-performing loans, at 30 percent of loans, remain among the highest in Europe. A large private sector debt overhang persists, given continued difficulties in debt workouts. Lagging productivity growth and political pressure to unwind key reforms also weigh on the outlook.

The near-term outlook remains robust despite increasing external headwinds. Real GDP growth is projected to moderate to around 3 percent in 2019–20, supported by construction and services sectors. Over the medium term, economic growth is projected to slow to its long-run potential rate of around 2½ percent, as the transitory effects of the investment boom dissipates. Private consumption is expected to remain resilient, however, on the back of tightening labor markets and the gradual credit recovery as banks' balance sheet improves. Public debt is projected to decline to 65 percent of GDP by 2024 on the back of continued high primary surplus. Risks to the outlook are predominantly on the downside arising from sharper-than-expected external shocks.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong economic recovery and declining unemployment rate, and commended the authorities for the good progress in addressing banking sector vulnerabilities and improving macroeconomic fundamentals. Directors pointed out that productivity growth has been weak, reflecting institutional bottlenecks and the slow pace of technology adoption, and that private sector indebtedness remains high amid ongoing challenges in debt workouts. Looking ahead, given the significant downside risks, Directors encouraged further steadfast efforts to address crisis legacies by continuing to reduce debt vulnerabilities, improve public spending efficiency, and raise economic growth potential and inclusiveness.

Directors emphasized the importance of steady NPL resolution and sustainable debt workouts. They highlighted the need for ensuring a well-functioning NPL resolution toolkit, including through implementation of a credible foreclosure framework, along with complementary reforms in the judiciary. Directors also stressed the need to continue strengthening the supervisory and regulatory framework of credit acquiring companies and to finalize the governance structure of state-owned Cyprus Asset Management Company. They underlined the importance of minimizing moral hazard risks inherent in the state-subsidy scheme for primary homeowners (Estia).

Directors saw a need for broader efforts to further strengthen banks' balance sheets and profitability. They advised that banks should continue to maintain adequate provisions and capital buffers. Directors agreed that to ease pressures on profitability, policies should encourage lower cost-to-income ratios through diversifying income sources, rationalizing operations, and implementing digitization solutions. Directors noted that macro-financial risks from the property market appear limited now but warrant close monitoring.

Directors welcomed Cyprus's strong fiscal performance, and stressed the need to continue to reduce debt sustainability risks and to enhance the efficiency of expenditures. Directors considered that expenditure growth, particularly that of the wage bill, should be contained to keep debt firmly on a downward path and to prevent crowding out of productive spending. They agreed that there is scope to improve the efficiency of education spending and increase investment in technological innovation and human capital buildup to reduce skills mismatches and achieve more inclusive growth, particularly among the youth. Managing incentives and costs of services as well as ensuring the competitiveness of the public health sector is key to control fiscal risks from the recently implemented National Health System.

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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.

Directors emphasized that structural reforms are key to raise medium-term growth potential. Given low labor productivity growth and challenges to investment and economic efficiency, they called for policies to support greater market diversification, competition, and technology adoption. Directors welcomed the authorities' strategy to improve STEM training and research and development innovation and to ease access to finance, as well as their national digital strategy. They recommended continued efforts to improve the efficiency of the judiciary and strengthen public sector governance. Directors agreed that mitigating existing inherent AML/CFT risks remains a critical priority.

Cyprus: Selected Economic Indicators, 2016–2020

	2016	2017	2018	Projections 2019	Projections 2020
Output/Demand					
Real GDP	6.7	4.4	4.1	3.1	2.9
Domestic demand	8.2	7.2	2.5	4.4	3.5
Consumption	3.4	4.0	3.3	3.5	3.0
Private consumption	4.4	4.5	3.3	3.6	3.2
Public consumption	-0.9	2.1	3.5	4.0	2.4
Gross capital formation	37.9	22.1	-0.9	7.8	5.9
Foreign balance 1/	-1.1	-2.7	1.5	-1.3	-0.7
Exports of goods and services	7.2	8.7	4.6	0.2	2.1
Imports of goods and services	9.0	12.8	2.4	1.9	3.0
Potential GDP growth	1.8	2.2	2.5	2.6	2.8
Output gap (percent of potential GDP)	-3.0	-1.0	0.6	1.0	1.1
Prices					
HICP (period average, percent)	-1.2	0.7	0.8	0.7	1.6
HICP (end of period, percent)	0.1	-0.3	1.1	1.2	1.3
Employment					
Unemployment rate (EU standard, percent)	13.0	11.1	8.4	7.0	6.0
Employment growth (percent)	1.4	4.6	5.6	2.5	2.0
Public Finance					
General government balance	0.1	1.7	-4.4	3.6	2.4
Revenue	37.7	38.6	39.2	41.4	43.7
Expenditure	37.6	36.9	43.6	37.8	41.3
Primary Fiscal Balance	2.8	4.2	-2.0	5.9	4.8
General government debt	103.4	93.9	100.6	94.8	87.9
Balance of Payments					
Current account balance	-4.2	-5.1	-4.4	-5.2	-4.8
Trade Balance (goods and services)	1.7	-0.4	0.8	-1.4	-1.3
Nominal GDP (billions of euros)	18.9	20.0	21.1	22.0	23.1
Memorandum Item:					
Underlying primary fiscal balance 2/	2.8	4.2	5.4	5.9	4.8

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

1/ Contribution to growth (percentage points).

2/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction and state-owned AMC of 7.4% of GDP.

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

November 12, 2019

KEY ISSUES

Macroeconomic context. Following a period of very rapid growth in the aftermath of the crisis, growth is gradually settling in at a more sustainable but still relatively robust pace despite the external slowdown. Output is projected to rise by around 3 percent in 2019–20, supported by construction and services sectors. Good progress has been made in addressing domestic and external stability risks arising from legacies of the financial crisis. Sales of non-performing loans (NPLs), amendments to the foreclosure and insolvency framework and resolution of a large systemic bank have helped strengthen bank balance sheets. Large fiscal surpluses have reduced risk premia to historical lows and reduced financing risks. Nonetheless, vulnerabilities remain: political pressure to unwind some of these reforms has recently escalated; NPLs in the banking system and debt levels are still high; bank profitability remains low; and difficulties in debt workouts and the resulting debt overhang weigh on productive investments. Productivity growth has also been weak, reflecting financial sector difficulties as well as a slower pace of technological diffusion and institutional inefficiencies.

Policy challenges. Reversal of reforms to the foreclosure framework would hinder ongoing NPL resolution efforts and create risks for financial stability. Realization of contingent liabilities from the still weak banking sector or increased fiscal spending pressures could undermine investor confidence, raising interest costs and depressing growth. Spillovers from negative external shocks, such as a disorderly Brexit, could also weaken growth momentum and adversely affect public debt sustainability. Over the medium term, the large private sector debt overhang and weak productivity growth create challenges to sustaining growth.

Policy priorities. Cyprus needs to build on recent gains by advancing reforms to secure macroeconomic stability, enhance efficiency and strengthen productivity and growth potential. More specifically, the authorities should (i) steadfastly implement the amended legal tools to lower NPLs and the debt overhang, and build bank capital buffers; (ii) reduce risks to debt sustainability and strengthen inclusive medium-term growth by maintaining strict spending discipline and improving the efficiency of public spending; and (iii) pursue institutional reforms, especially in the judiciary, anti-money laundering (AML) and public administration; strengthen technological investments; and enhance labor market linkages to enhance productivity growth. These policies are critical to reduce vulnerabilities and reinvigorate medium-term growth potential.

Approved By
Philip Gerson (EUR) and Nathan Porter (SPR)

Discussions took place in Nicosia from September 16 to 25, 2019. The mission team comprised Ms. Anita Tuladhar (head), Mr. Hajime Takizawa and Ms. Estelle Xue Liu (all EUR), Mmes. Ke Wang (SPR), Machiko Narita (MCM), and Amira Rasekh (LEG). Mr. Boyang Sun, Ms. Ritzy Dumo and Ms. Virginia Bezerra de Menezes (EUR) supported the mission from headquarters. Messrs. Anthony De Lannoy and Dries Cools (office of the Executive Director) joined some of the meetings.

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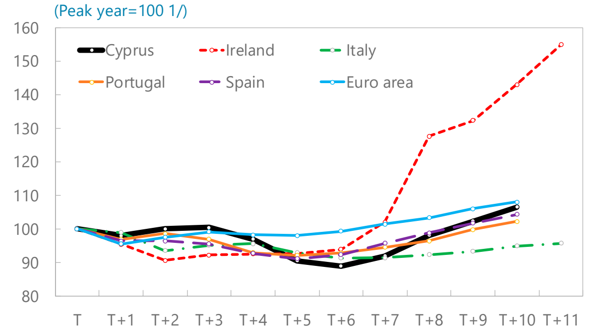
CONTEXT[1]

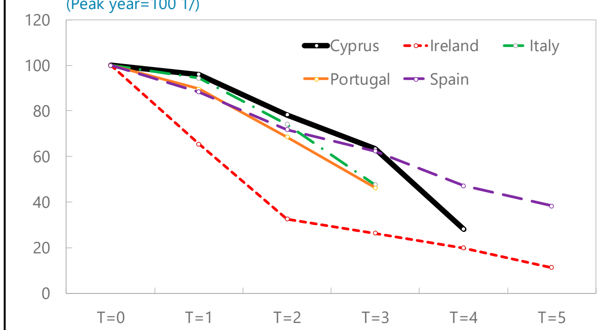
1. Following an uneven start, Cyprus's recovery compares favorably to those of other euro area economies affected by the financial crisis. Real GDP has now surpassed its pre-crisis peak, while the unemployment rate has declined significantly. Large NPL disposals and resolution of a systemic bank last year has helped strengthen bank balance sheets. While public debt jumped in the process, strict fiscal discipline and overall good progress with reforms have helped Cyprus regain its investment grade status and reduced risk premia to historical lows (Annex I).

Real GDP: Pre Crisis Peak to 2018
(Peak year=100 1/)



Sources: WEO; and IMF staff calculations.
1/ Peak years are 2007 for Italy and Ireland; 2008 for Cyprus, Euro area, Portugal and Spain.

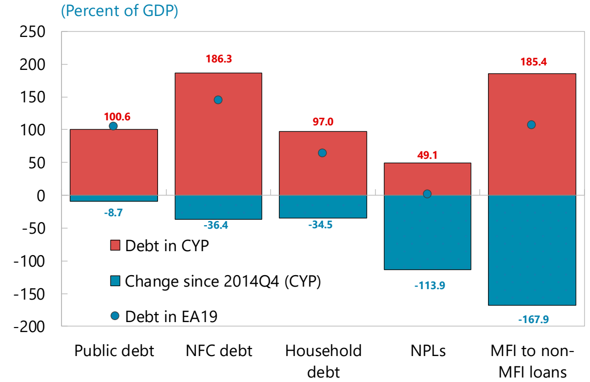
NPL to GDP: Post Crisis Peak to 2018
(Peak year=100 1/)



Sources: WEO; FSI; and IMF staff calculations.
1/ Peak years are 2014 for Cyprus, 2013 for Ireland, 2014 for Italy, 2015 for Portugal, and 2013 for Spain.

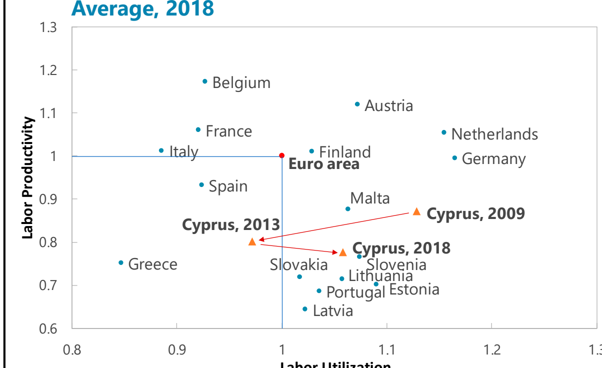
2. Nevertheless, challenges remain in sustaining this growth momentum. Despite recent progress, NPLs remain among the highest in Europe. While large stocks of distressed debt are now outside the banking system, a significant private sector debt overhang remains, given ongoing difficulties in debt workouts. While the growth recovery has been underpinned by increased labor absorption, productivity growth has been weak, undermining medium-term growth potential. Increasing political pressure to unwind key reforms in the financial and fiscal sectors is also weighing on the outlook.

Debt Indicators and NPLs, 2018Q4
(Percent of GDP)



Sources: Central Bank of Cyprus; Eurostat.

Convergence Indicators, Relative to Euro Area Average, 2018

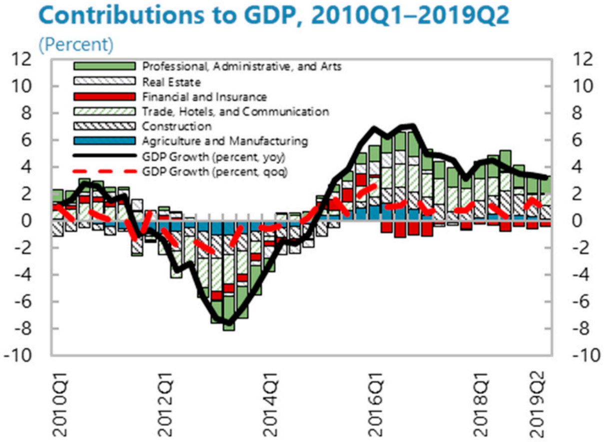


Sources: Eurostat; and IMF staff calculation.

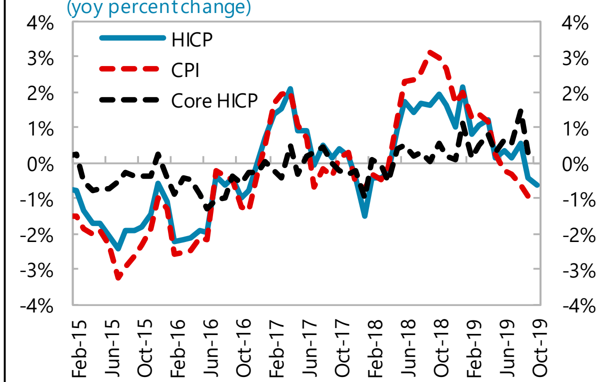
[1] This report does not cover areas of Cyprus not under the effective control of the Republic of Cyprus and assumes no change in the status quo.

RECENT DEVELOPMENTS

3. GDP growth is gradually slowing (Figure 1). Growth decelerated to 3.3 percent (yoy) in 2019:H1, from 4.1 percent in 2018, largely reflecting construction and services sector activity.[2] Domestic demand remains robust due to strong investment, driven by a pipeline of ongoing infrastructure projects and a transitory boost ahead of changes in the passport scheme.[3] Continued employment recovery has supported steady consumption growth. However, net exports are weakening with declining tourism receipts, partly due to Brexit effects.[4]



Source: Statistical Service of Cyprus.



Source: Statistical Service of Cyprus.
1/ Data on core HICP is up to September 2019.

4. Inflationary pressure remains low, although they are rising gradually in line with a robust labor market recovery (Figure 2). HICP inflation reached 0.7 percent (year to date, period average) in September 2019, compared with 0.5 percent over the same period last year. Average core inflation has steadily risen reaching 0.6 percent in September 2019. Nominal compensation per employee rose by 4.1 percent in 2019:Q2, mostly reflecting public sector wage increases. Spillovers to the private sector have been limited thus far helped by labor inflows, including from foreign workers. The unemployment rate declined to 6.5 percent in 2019:Q2 from 7.3 percent a year earlier but is still above pre-crisis levels.

5. The underlying current account deficit widened in 2018, led by an external slowdown (Figure 3). Although Cyprus maintains strong price competitiveness, as reflected in an REER and ULCs that are near post-crisis lows, its large exposure to the slowing EU and UK markets and financial regulatory changes have adversely affected exports of tourism, transport and financial services. Together with the continued strong demand-driven imports, the underlying current

[2] Cyprus's national accounts and external sector data were recently revised, as part of a five-year revision according to the Harmonized European Revision Policy (Annex II).

[3] Effective May 15, government introduced new measures tightening the Cyprus Investment Program (CIP) scheme that seeks to encourage investment in business innovation and to prevent overinvestment in the real estate sector.

[4] See *Annex V. Cyprus's Linkages with the UK and Exposure to Brexit in Cyprus: Third Post Program Monitoring Discussions*, IMF Country Report No. 19/151.

account deficit (adjusting for effects of special purpose entities, SPEs[5]) widened from 1.9 percent of GDP in 2017 to 3.4 percent last year and 4.8 percent in 2019:Q2 (on an annual basis). The Fund's EBA-lite Current Account model also suggests the external position is moderately weaker than implied by fundamentals and desirable policy settings (Annex III. External Sector Assessment and Annex IV and Selected Issues Paper (SIP). Export Competitiveness). [6]

Summary of EBA-Lite Results

	CA Norm (percent of GDP) (1)	Underlying CA (percent of GDP) (2)	CA Gap (percent of GDP) (2)–(1)	REER Gap (percent) (elasticity: -0.48)
CA	-0.9%	-3.4%	-2.3%	4.4%
ES	...	...	0.1%	-0.2%
REER	...			-1.5%

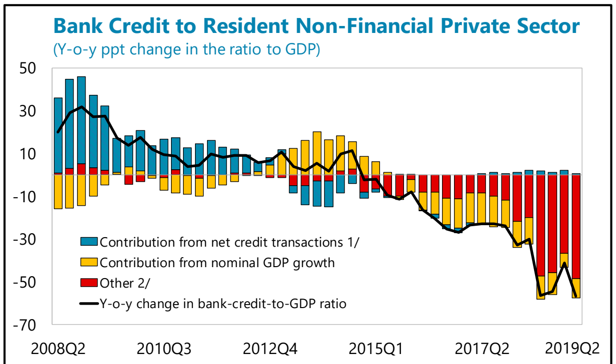
Source: IMF staff estimates.
Note: See Annex III for details. The assessment is based on the "Methodological Note on EBA-lite" https://www.imf.org/external/np/pp/eng/2016/020516.pdf).

6. **Net private financial inflows are gradually slowing (Figures 3 and 4).** While net Foreign Direct Investment (FDI) inflows remain robust in 2018, portfolio investment inflows and non-resident bank deposits have been declining amidst low interest rates, tighter AML compliance requirements and the continued bank deleveraging process. This decline in monetary and financial sector borrowing has helped partly offset the increased public debt. Direct intercompany borrowing remains high, partly reflecting SPE effects, although it has fallen from its peak at end-2017. Consequently, external debt (excluding SPEs) has been steadily declining (Annex V. Debt Sustainability Assessment) from 273 percent of GDP in 2018:Q1 to 260 percent in 2019:Q2. Net International Investment Position (NIIP) has been gradually declining, reaching -34 percent of GDP (excluding SPEs) at end-2019:Q2.

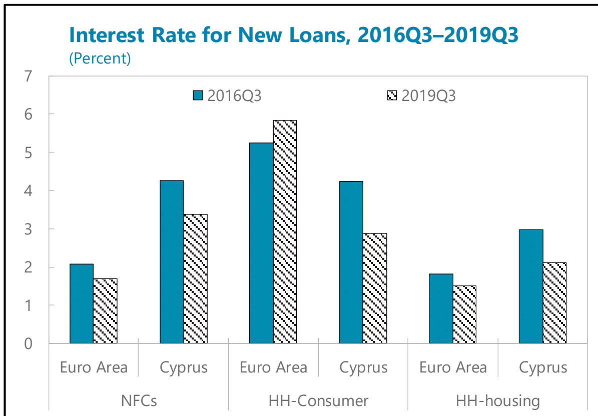
7. **Net credit growth remains subdued amidst continued bank deleveraging (Figure 4).** Net credit transactions, defined as pure new loans and interest accrued net of repayments, grew by 1.0 percent for domestic non-financial corporates (NFCs) and 0.3 percent for households over 12 months at end of September 2019. Accommodative monetary conditions have eased interest rates for new loans. Nevertheless, pure new credit growth continued to decelerate underscoring the weak demand arising from the continued debt overhang. Outstanding bank credit to the non-financial private sector declined by 57 percent of GDP over the year through 2019:Q2 mainly due to sale/transfer of NPLs.

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

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

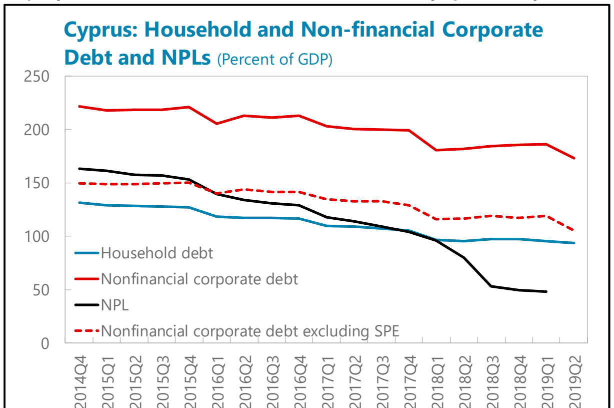


Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ "Net credit transactions" are pure new loans (excluding renegotiations) and interests accrued net of repayments (including debt-to-asset/equity swaps).
2/ Includes the contribution from write-offs, sales and transfer of loans.

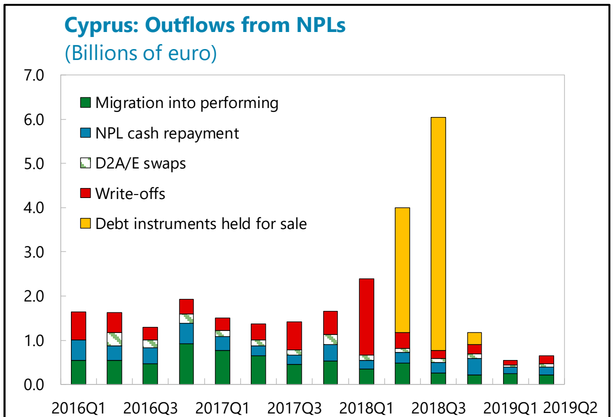


Sources: Central Bank of Cyprus and European Central Bank.

8. Compared with the pace of reduction of NPLs on banks' balance sheets, private sector deleveraging has been more limited. The transfer of two large NPL portfolios to credit acquiring companies (CACs), including a large one-off non-market transaction to the state-owned asset management company (CAMC), lowered the NPL ratio from 42½ percent of loans (104 percent of GDP) at end-2017 to 31 percent of loans (48 percent of GDP) at end-May 2019 (Annex VI). However, loan repayments, debt to asset swaps and loan write-offs have contributed to a decline of only 10½ pp in non-financial private sector debt over the past year till 2019:Q2. Sustainable debt restructuring has been challenging with greater reliance on balloon payments (for NFCs), interest reductions, waiver of arrears and maturity extensions instead of principal reductions.[7] Debt workouts are also pending as borrowers await the finalization the state subsidy scheme for restructuring and repayment of NPLs collateralized by primary homes (*Estia*).[8]



Source: European Central Bank.



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

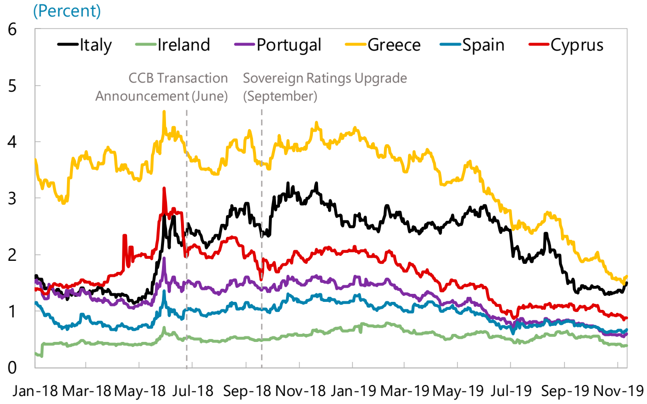
[7] Data covers fixed term loans only. The cure rate, i.e. share of restructured loans with no arrears, declined to 60 percent at 2019:Q2 from 64 percent a year earlier, despite sizable re-restructuring of loans.

[8] Under the scheme, the government will cover one-third of the eligible borrowers' total monthly installments at the end of each year, subject to the borrower continuing to pay their installments. Banks will also take a haircut up to the level of market price of underlying collateral. Applications for the subsidy program for restructuring started in September this year with a lower-than-expected take-up rate so far. Following evaluation of eligibility by the participating banks and final approval of viable restructuring by the state, payments are expected to begin by the end of the year. The authorities estimate that NPLs worth up to about €2 billion (10 percent of GDP) could benefit

(continued)

9. Fiscal performance remains strong. The general government primary surplus rose from 4.2 percent of GDP in 2017 to 5.4 percent of GDP in 2018 (excluding the one-off impact of the sale of the Cyprus Cooperative Bank and the state-owned Asset Management Company). In January-August this year, the general government overall balance recorded a surplus of 4.2 percent of GDP (est.), about ¾ percentage point higher than over the same period last year, which also reflected the temporary fiscal savings generated by the transition to the single-payer National Health Service (NHS). Revenues remained buoyant, despite a decline in fuel excises while expenditures were contained, partly reflecting delays in implementing the NPL subsidy scheme. Capitalizing on favorable market conditions, the authorities undertook a liability management operation and issued €1.75 billion of long-term (15- and 30-year) sovereign bonds in February and April to prefund an early repayment of a Russian loan this year.

10-Year Government Bond Spreads
(Percent)



Source: Bloomberg Finance L.P.

Fiscal Developments, January–Aug (Mill. Of Euros)

	2018	2019	percent change
Revenue	5,246	5,870	11.9
Current revenue	5,181	5,715	10.3
Tax revenue	3,383	3,562	5.3
Indirect taxes	2,115	2,176	2.9
Direct taxes	1,269	1,386	9.2
Social security contributions	1,212	1,572	29.7
Other current revenue	586	581	-0.7
Capital revenue	66	155	135.0
Expenditure	4,513	4,946	9.6
Current expenditure	4,283	4,805	12.2
Social Transfers	1,727	1,917	11.0
Capital expenditure	231	140	-39.2
Overall balance	733	924	
(In percent of GDP)	3.5	4.2	

Sources: CyStat; and MoF.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

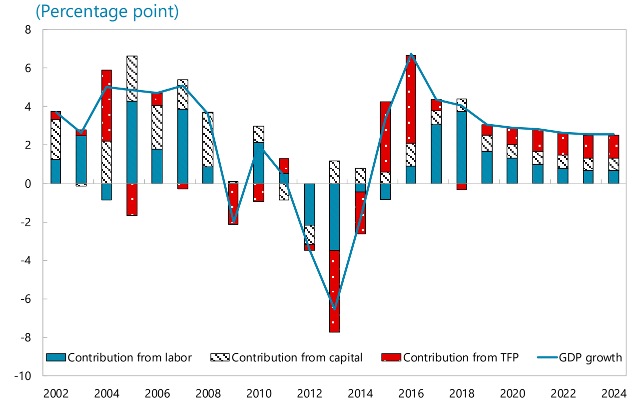
10. Growth is expected to moderate but stay robust in the near term. In the baseline scenario, real GDP growth is expected to reach around 3 percent in 2019–20, driven by foreign-financed investments in residential properties, education health and tourism infrastructure, and higher household disposable incomes. These will offset lower external demand from Brexit and the slowdown in the euro area. Inflation is projected to remain subdued this year, gradually rising due to higher energy prices and an emerging positive output gap. The current account deficit is expected to widen reflecting trading partners' slowing growth and the continued high level of construction-related imports.

from the scheme. For further details, see *Cyprus: Staff Report for 2018 Article IV Consultation,* IMF Country Report No. 18/337.

11. Over the medium term, growth is projected to slow to its potential of around 2½ percent, as the transitory effects of the investment boom, including from the recent tightening of the CIP scheme, gradually dissipate and faster NPL and debt workouts impact debt servicing and weigh on private consumption growth (Annex VII). The current account deficit would narrow on lower investment imports and a pickup in exports in line with the external demand recovery. The international investment position is expected to continue to improve gradually with decelerating FDI inflows and MFI deleveraging. Steady implementation of reforms that reduce the debt overhang, lower systemic financial risks and build up skilled human capital would help support consumption, investments and TFP growth over the longer term.

Contributions to GDP Growth (Projections from 2019)

(Percentage point)



Sources: Cystat; Eurostat; and IMF staff estimates.

12. Risks to the outlook are predominantly tilted to the downside (Annex VIII. Risk Assessment Matrix).

- On the *domestic* front, delays in NPL resolution due to backsliding on reforms could negatively affect the capital position of the banking system, as the need for higher provisioning would undermine profitability and in turn weigh on banks' ability to extend credit, adversely affecting growth. Realization of contingent liabilities from publicly supported schemes or difficulties in raising capital could weaken the fiscal position, exacerbating the risks to debt sustainability arising from the sovereign-bank nexus. The high level of external debt makes the economy vulnerable to interest rate and growth shocks. Increasing political pressure or court decisions to unwind crisis-era fiscal measures could reduce the primary surplus and slow the pace of debt reduction, eroding confidence, and increasing the sovereign risk premium and refinancing costs.

- On the *external* side, rising protectionist trade policies, a sharper-than-expected slowdown in euro area growth or a hard Brexit could affect transport and tourism revenues and FDI flows. Risks from financial distress in other markets could have spillover effects for Cyprus, which could raise interest rates and increase the stress on already highly-leveraged firms and households. A potential negative assessment on AML/CFT compliance risks could adversely affect confidence, deter investments and put pressure on correspondent banking relationships. On the upside, however, exploitation of offshore gas deposits and energy sector investments for regional connectivity could boost growth over the longer term.

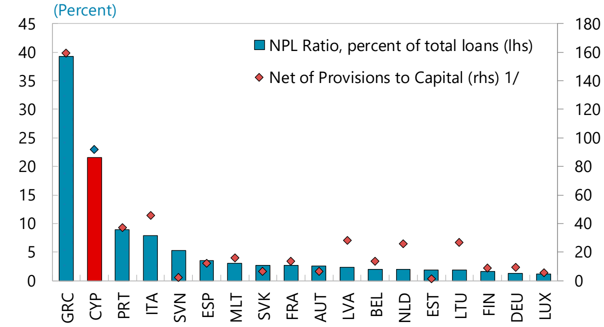
Authorities' Views

13. **The authorities broadly agreed with staff's assessment of the growth outlook.** Growth is expected to decelerate but will remain robust, as foreign-financed investment projects in diverse areas are not directly affected by the external downturn and will continue to support construction and professional services sectors. Current account deficits are expected to persist, albeit at the manageable levels, given continued strong domestic demand. The labor market is expected to move gradually towards full employment. Enhancing competitiveness and productivity through research and innovation will be increasingly crucial to raise medium-term growth potential.

14. **The authorities agreed with staff on the sources of risks but viewed their impact as more moderate.** While the authorities agreed that the euro area slowdown is a significant risk, they noted that the risk posed by Brexit has already been internalized and could be limited going forward. Furthermore, Brexit could benefit the economy over the medium-term with businesses relocating from U.K. to Cyprus. They continue to pursue efforts to strengthen AML/CFT compliance and expect to see that reflected in the forthcoming MONEYVAL report. On the domestic side, the authorities viewed the risk of realization of contingent liabilities from the financial sector as being more contained than considered by staff as the sector has already offloaded large NPL portfolios. On contingent liability risks from the fiscal sector, the authorities believe there is a political consensus to mitigate the adverse effect of any court-mandated unwinding of crisis-era wage cuts.

B. Financial Policies: Ensuring Financial Stability and Supporting Deleveraging

Non-Performing Loans, 2019Q2 or the latest
(Percent)



Sources: Central Bank of Cyprus; EBA; WEO; and IMF staff calculations.
1/ Latest data for Belgium, Cyprus, Finland, Greece, Ireland, Portugal, Slovakia and Slovenia is 2019Q1.
Latest data for France and Germany is 2018Q4, for Italy is 2018Q2.

15. **While the banking sector is more consolidated and asset quality has improved, profitability remains under pressure (Figure 5).** Lower provisioning needs helped banks turn a net profit last year. However, operating profits declined, reflecting Cypriot banks' low efficiency (Annex IX). Non-resident banking services are declining, while domestic competitive pressures are rising. The potential need for further provisioning as banks seek to lower NPL ratios to below 15 percent by 2021 amid some legal uncertainties[9], excess liquidity in a low interest rate environment with further monetary easing in the pipeline, and declining interest margins are adding to profitability pressures. Nonetheless, liquidity buffers remain sizable and bank capitalization is improving, also aided by a recent regulatory change allowing conversion of deferred tax assets into deferred tax credits.

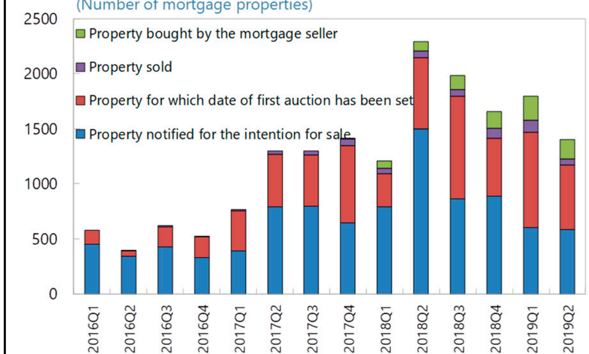
[9] New forward-looking provisioning rule under IFRS9, ECB's prudential provisioning guidance and expectations, EU Directive on bail-in-able debt requirements all imply higher provisioning and capital requirements.

16. Staff emphasized the need to continue efforts to strengthen bank profitability and capitalization. Banks should maintain adequate provisioning coverage and capital buffers to insulate against potential further losses from NPL workouts and sales of loans. Policies should also seek to raise private capital and encourage organic capital generation, including by diversifying revenue sources, rationalizing operational costs and undertaking digitization solutions. Increasing competitive pressures emanating from digitalization in the industry further underscores the need to redouble these efforts and strengthen supervisory capacity (Annex IX and SIP. Bank Digitalization). The potential buildup of risks from a shift towards negative interest rates for large depositors and cross selling of financial products should be closely monitored.

17. NPL resolution and sustainable debt workouts remain crucial for financial stability and growth. Key policy priorities include the following:

- **Foreclosure framework:** The 2018 amendments to the foreclosure and insolvency legislation, the sales of loans law, and the adoption of a law on securitization all enhanced the toolkit to address NPLs. Given Cyprus's lengthy foreclosure procedures, these amendments were critical to address strategic defaults and strengthen incentives for borrowers to enter negotiations for durable loan restructuring or personal insolvency.[10] Following the legal enactment, notifications on foreclosures and sale of properties gradually increased, including the repossession of foreclosed properties by banks. However, recent amendments to the foreclosure framework that allow borrowers to file court injunctions if the Financial Ombudsman deems that banks have not complied with the CBC restructuring code have created uncertainties by weakening prospects for collateral recovery and increasing the need for additional provisioning.[11] While strengthening of the supervisory oversight of durable restructuring will be crucial, responsibility for ensuring overall compliance of the CBC's restructuring code should remain with the bank supervisor. Progress with the introduction of electronic foreclosure auctions and complementary judicial reforms to reduce backlogs would also be key for strengthening collateral execution.

Processing of Foreclosures
(Number of mortgage properties)



Sources: Central Bank of Cyprus; and IMF staff calculations

- **Credit Acquiring Companies (CACs) and Cyprus Asset Management Company (CAMC):** With about 50 percent of GDP in NPLs now housed in CACs, continued strengthening of the

[10] See *Cyprus: Staff Report 2018 Article IV Consultation,* IMF Country Report No. 18/337 and *Reforming the Legal Framework to Support Private Debt Restructuring* in Selected Issues Papers, IMF Country Report No. 17/376.

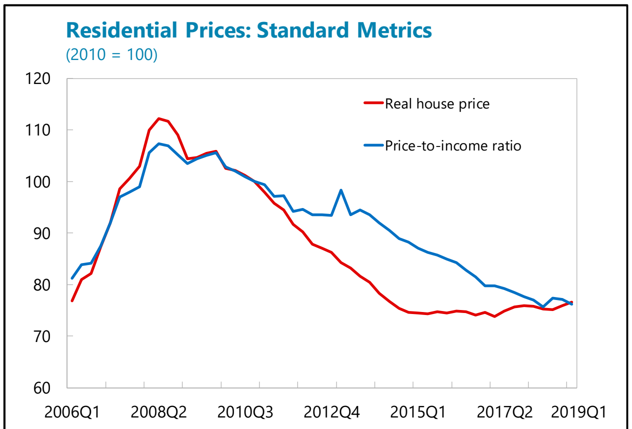
[11] These amendments were approved by Parliament in August but are currently under review by the Supreme Court. Until the ruling of the Supreme Court, the 2018 legislative framework remains in force.

oversight framework for CACs[12] and close data monitoring will be important (Annex VI). Performance of the state-owned CAMC has been picking up slowly, with just 7 percent of loans undergoing some workout solution over the first 9 months of operation. To speed up debt workout and maximize recovery, it is important to swiftly finalize the governance and operational structure, business strategic plan, and performance measurement framework, with an appropriate sunset clause, while balancing operational independence with public accountability and transparency.

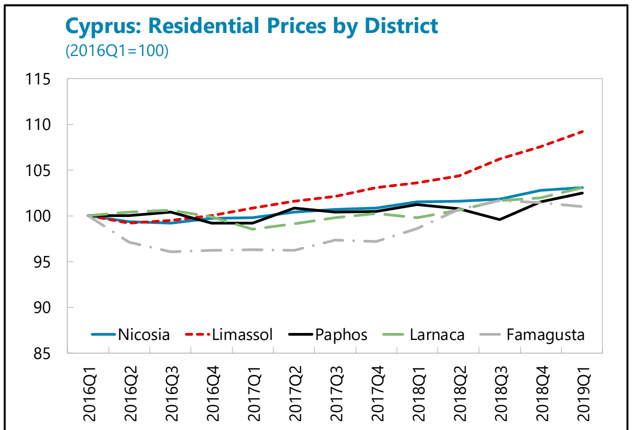
- **Viable corporate restructuring solutions:** Consideration should be given to enhancing the corporate restructuring options available to viable enterprises to overcome financial difficulties given the rather limited use of the examinership procedure thus far and the issues encountered in its implementation.

- ***Estia* and support for vulnerable primary homeowners:** With the state-subsidy scheme, *Estia*, at an early phase of implementation, staff underscored the need for close monitoring to prevent potential abuse and allow for timely reassessment of borrower eligibility. Any complementary schemes for vulnerable primary homeowners whose loans are deemed unviable under *Estia* should ensure further burden sharing. Any additional new scheme (e.g., a rent-to-buy scheme or an expanded housing subsidy) should be well-targeted. Prior to implementation, a full cost-benefit analysis should be undertaken considering the fiscal costs associated with rental subsidy, implementation costs, and moral hazard implications.

18. Property prices are rising gradually but unevenly across markets (Figure 6). Rising demand for housing and business offices is being met with increasing supply from new construction, as evidenced by the rising issuance of building permits, and release of repossessed collateral properties by banks. Real estate holdings by banks, CACs and investment funds have also



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



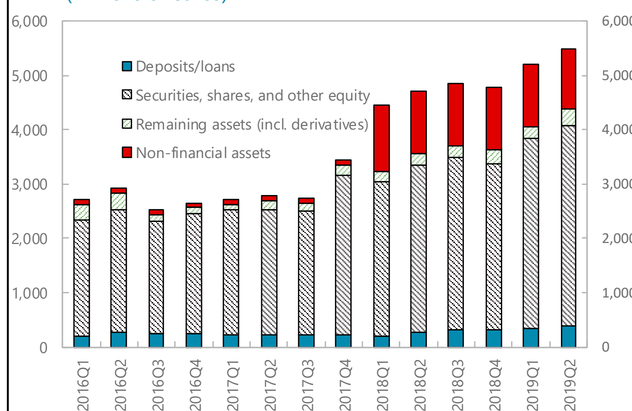
Source: Central Bank of Cyprus

[12] See *Annex VII. Regulatory Framework for the Sales of Non-Performing Loans in Cyprus*, IMF Country Report No. 18/337 and *Cyprus: Third Post Program Monitoring Discussions*, IMF Country Report No. 19/151.

increased.[13] Overall residential prices grew by 2.7 percent (yoy) in 2019:Q1 while sales transactions rose by nearly 6 percent during 2018.[14] The property market remains highly segmented, however, with higher price increases observed primarily in a growing luxury segment in some coastal areas (e.g., Limassol), fueled by the CIP-linked demand from non-residents, with limited spillovers to other segments so far. Rents have been rising rapidly—17 percent in 2018— mainly driven by the growing demand from foreign students and lagging supply of rental property investments, prompting the authorities to increase rental and housing subsidies and a range of incentives for developers to increase supplies of affordable housing and rental properties.

19. Macro-financial risks from the property market appear limited now but warrant close monitoring. While the sales of repossessed collateral properties by banks and CACs could potentially depress prices, downward pressures from such sales have not been evident in any market segments. However, it is important to continue monitoring sectoral and regional real estate market developments, considering the segmented nature of the market. Macroprudential measures tailored to the market segment should be undertaken if warranted, e.g. if the luxury sales become associated with rapid credit growth or high loan-to-value ratios. On the supervisory front, continued monitoring is needed on the large holdings of repossessed real estate by banks and CACs, to discourage and limit the risk of excessive holding of foreclosed properties. Also, the increased real estate holding by investment funds warrants close monitoring to mitigate risks related to liquidity mismatches.[15] Supervisory tools, in particular Pillar 2 requirements and explicit bank-specific objectives, should continue to be used to discourage excessive holding of foreclosed properties by banks.

Investment Funds - Assets Under Management
(Millions of euros)



Source: Central Bank of Cyprus.

[13] Banks holding of real estate remains large due to repossession of collateral properties through D2A swaps, and to a lesser extent, the foreclosure process. In 2018, real estate accounted for around 5 percent of consolidated assets of the two largest banks. On average, these properties were sold within two years and at higher values than their acquisition values during 2018–2019H1.

[14] More recent transactional data primarily based on developers' price quotes shows a faster increase of 8 percent (yoy) in 2019:Q2, This index however reflects price for newly constructed housing which are likely concentrated in the luxury segment.

[15] The non-banking sector comprising the insurance and investment funds sectors are relatively small but growing rapidly. Investment firms, while deemed to be systemically important, appear to have limited domestic interconnectedness.

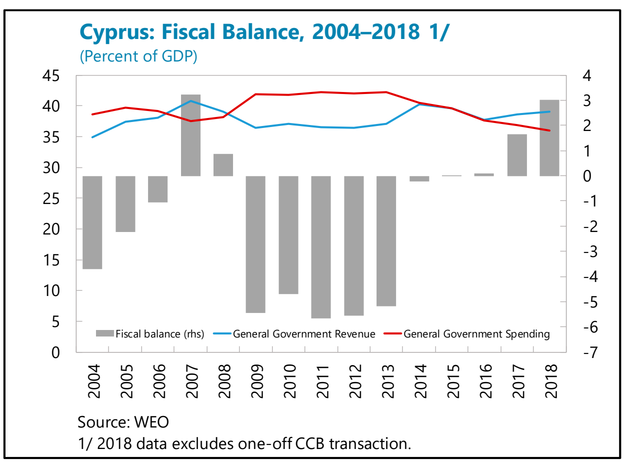
Authorities' Views

20. The authorities agreed efforts to facilitate NPL resolution need to be sustained. Efforts are ongoing to address concerns raised about the implementation of the Central Bank Code of Conduct without weakening the foreclosure framework as revised in 2018. Despite the uncertainties caused by the amendments to the foreclosure framework, banks have relatively comfortable capital positions and are expected to proceed with further sales of NPLs to remove the bulk of remaining NPLs. The authorities are proceeding with the *Estia* scheme and currently are not contemplating any further support other than those under the Estia scheme that will be assessed as non-viable. Debt-to-asset swaps will remain a useful tool for NPL resolution and the soon-to-be launched e-auction is expected to strengthen the effectiveness of the foreclosure framework. Beyond the legacy issue of NPLs, the authorities acknowledged the structural challenge of low profitability facing banks.

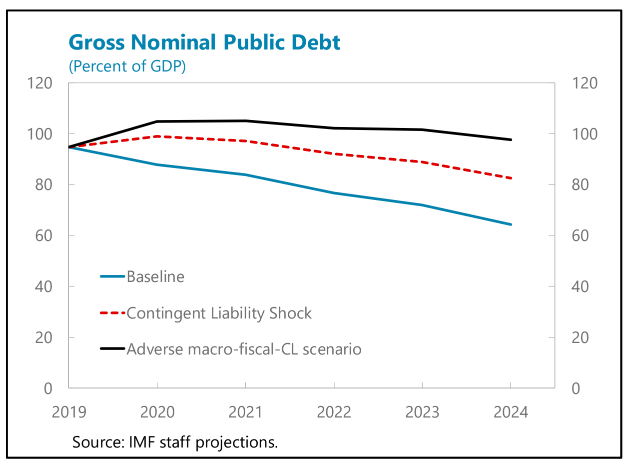
21. The authorities are stepping up the work to strengthen the supervision and regulation of CACs. The CBC is currently preparing a new regulatory and supervisory framework for CACs, recognizing that CACs hold a large and increasing volume of NPLs. The large holdings of repossessed real estate by banks and CACs are being monitored in the regular supervisory review process. Implications from the release of repossessed real estate on the property market, as well as their macro-financial risks, are covered by macroprudential oversight. The authorities emphasized that maximizing the recovery value should remain a key guiding principle in finalizing the governance and operational structure of the state-owned AMC, including its duration. The authorities agreed that reducing high private debt levels remains a priority, and faster progress with debt workouts can be expected going forward.

C. Fiscal Sector: Mitigating Risks to Debt Sustainability and Enhancing Efficiency

22. Cyprus is projected to maintain large fiscal surpluses that will allow it to lower debt rapidly, but risks remain (Figure 7). In 2019, the general government primary balance is projected to reach around 6 percent of GDP, which implies a slight weakening in structural terms to around



Source: WEO
1/ 2018 data excludes one-off CCB transaction.



Source: IMF staff projections.

4¼ percent of potential GDP next year.[16] Over the medium term, staff projects an overall surplus of 2¾ – 3½ percent of GDP. Under this baseline scenario, the public debt ratio is expected to decline by 31 percentage points of GDP over the next five years to 64 percent by 2024 (Annex V DSA). Key risks to the outlook arise from materialization of external growth shocks including from trade tensions and weaker-than-projected growth in the euro area, potential court-mandated increases in the wage bill[17], higher-than-expected transfers under the newly introduced National Health System (NHS), contingent liabilities from government guarantees to and pension deficits of public entities, and weak asset quality in the financial sector. Under an adverse scenario with lower-than-projected growth, some fiscal slippage and realization of financial contingent liabilities, public debt would exceed 98 percent of GDP through 2024.

Cyprus: Fiscal Targets, 2018–2024

	2018	2019	2020	2021	2022	2023	2024
		Projections					
		(Percent of GDP, unless otherwise noted)					
2020 Draft Budgetary Plan							
Total revenue	39.7	42.3	44.6	44.7	44.4	...	...
Total expenditure	44.5	38.4	42.0	42.2	42.1	...	...
Overall balance	-4.8	3.8	2.7	2.5	2.3	...	...
Primary balance	-2.3	6.2	5.1	...	...	...	...
Gross public debt	102.5	97.4	91.1	85.9	81.1	...	...
Staff projections							
Total revenue	39.2	41.4	43.7	44.2	44.0	43.9	44.4
Total expenditure	43.6	37.8	41.3	41.4	41.1	40.9	40.7
Overall balance	-4.4	3.6	2.4	2.8	2.8	3.0	3.7
Primary balance	-2.0	5.9	4.8	4.9	4.8	4.7	5.3
Gross public debt	100.6	94.8	87.9	83.7	76.6	71.9	64.2
		(Percent of potential GDP)					
Primary balance	5.5	6.0	4.8	5.0	4.9	4.8	5.3
Revenue 1/	39.3	41.8	44.2	44.7	44.4	44.3	44.7
Cyclically-adjusted tax revenue	33.6	36.1	38.9	39.5	39.4	39.4	39.9
Cyclical tax revenue	0.2	0.4	0.4	0.5	0.4	0.3	0.3
Other revenue 1/	5.5	5.3	4.8	4.7	4.6	4.6	4.6
Primary expenditure 1/	33.8	35.8	39.4	39.7	39.5	39.5	39.4
Cyclically-adjusted primary balance 1/	5.3	5.6	4.4	4.5	4.5	4.4	5.0
Structural primary balance 1/	4.7	4.5	4.1	4.3	4.4	4.4	5.0
Output gap	0.6	1.0	1.1	1.2	1.0	0.8	0.6

Source: Ministry of Finance; and IMF staff IMF staff projections.
1/ Excludes the fiscal impact of the sale of the Cyprus Cooperative Bank and state-owned AMC.

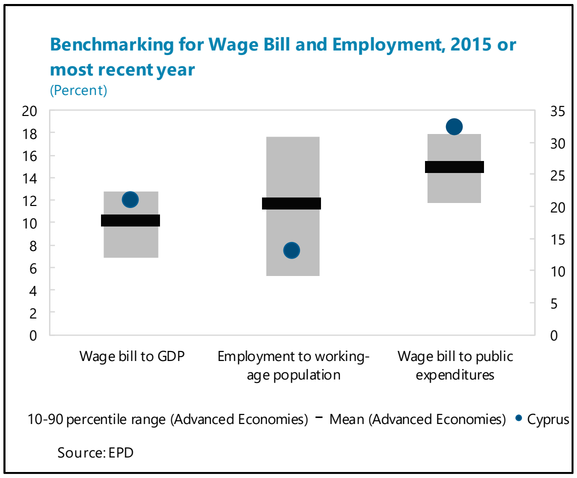
[16] Key measures include a cut of excise on fuel (0.3 percent of GDP), the subsidy scheme to mortgage borrowers (0.1 pp), reversal of wage cuts (0.2 pp), deficit of public hospitals (0.1 pp) and increase in SSC (-.5 pp). Fiscal data include the impact of NHS from 2019.

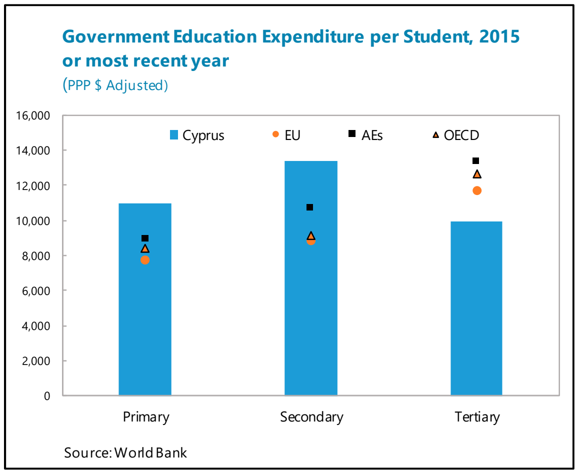
[17] In April, the authorities appealed the ruling that deemed the freeze of civil service wage increase and the reduction in civil service pay implemented during the crisis (of 1 percent of GDP annually), as unconstitutional. A decision by the Supreme Court is expected soon. In the event of an unfavorable ruling, a constitutional amendment is planned to nullify the adverse fiscal impact of the ruling.

23. Spending should continue to be firmly controlled to ensure a declining debt path, while the composition of expenditure should seek to enhance efficiency.[18] Limiting expenditure growth to nominal medium-term economic growth—which implies maintaining a primary surplus above 4 percent of GDP over the medium term—will be crucial to strengthen confidence, keep debt firmly on a durable downward path and support countercyclical policy. Public spending priorities could better support structural reform efforts to achieve faster and more inclusive medium-term growth (¶26).

- Growth in the *wage bill* should be maintained below nominal GDP growth. The wage bill remains high by international standards, reflecting the relatively high average wage rate. Further undoing crisis-era public wage cuts would reverse hard-won savings and crowd out more productive spending.

- Population aging with a declining share of school-aged children suggests there is scope to improve the efficiency of *education spending*. Furthermore, given relatively low public and private *R&D spending*, greater investment in technological innovation, including human capital buildup, would help support growth potential (¶28).





- Containing fiscal risks from the *NHS* will require a strict monitoring and regulatory framework for assessing health treatments and controlling cost of services. Ensuring the competitiveness of the public health sector and managing adequate incentives for provider payment mechanisms will also be crucial, given the expected pickup in demand.[19]

24. Fiscal institutional measures would help contain risks. Public financial management of state-owned enterprises (SOEs) could be strengthened through better internal controls for financial management; and monitoring of risks from public bodies including SOEs. Governance of SOEs

[18] The fiscal outturn in 2018 was impacted by the sale of the CCB and state-owned AMC of 7½ percent of GDP.

[19] See *Annex VIII. Potential Fiscal Impact of the Rollout of the National Health System,* IMF Country Report No. 18/337.

should be strengthened and privatization effort reinvigorated to raise economic efficiency and reduce contingent liabilities. Local government (LG) reform devolving more responsibilities as well as revenue autonomy to LG units is gaining renewed momentum. Ensuring PFM controls such as budget planning and reporting framework as well as expenditure control at the LG level would be important to safeguard fiscal sustainability. Ongoing efforts to modernize tax administration, including enactment of a new tax procedure code and a new IT system to support tax administration, should continue.

Authorities' Views

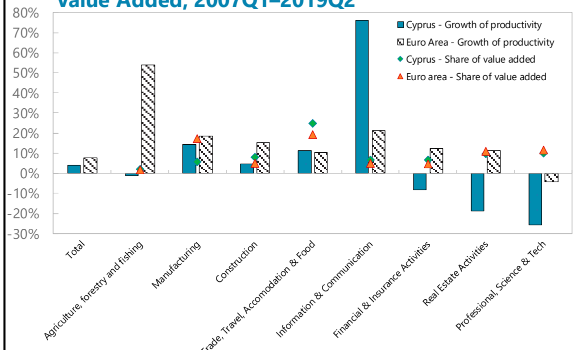
25. The authorities remain committed to maintaining spending discipline to safeguard a durable decline in public debt. The medium-term budget plan for 2020–22 envisages no new spending measures and will maintain the large fiscal surpluses that have bolstered confidence. Any windfall revenues such as from the CAMC will be saved toward public debt reduction. While the wage bill will increase gradually in part reflecting the ongoing gradual reversal of wage cuts planned through 2023, spending growth will remain below medium-term nominal GDP growth. The authorities recognized the risk of crowding out productive spending in areas such as technology and higher education. The authorities are committed to monitoring the NHS and the performance of public hospitals to ensure fiscal risks do not build up over the medium and long run. Ongoing efforts to reform SOEs, including the recent adoption of code of good governance and a plan to link SOEs' strategic plans to a three-year budget, could help improve performance. The pending local government reform is expected to general fiscal savings and improve the efficiency of service delivery.

D. Structural Reforms: Improving Productivity and Strengthening Growth Potential

26. Productivity enhancing structural reforms will be key for bolstering medium-term growth potential. Economic inefficiencies, as reflected in weak TFP growth, have contributed to slow labor productivity growth, particularly in the financial sector. The ICT sector has provided a strong boost. Nevertheless, the ICT sector remains small and Cyprus lags in its digital transformation, availability of human capital and R&D investments (Box 1). Cyprus's heavy reliance on the services sector—comprising 75 percent of its exports—which has experienced slower productivity growth, makes these reforms crucial for enhancing external competitiveness (Annex IV and SIP).[20]

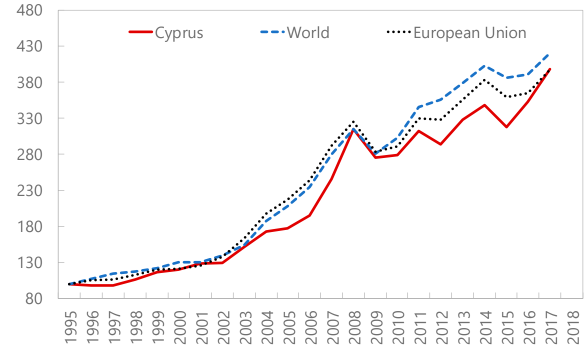
[20] See Ebeke, C, Frie, J.M., and Rabier, L., 2019, "Deepening the EU's Single Market for Services," IMF Working Paper (forthcoming).

Growth of Real Labor Productivity and Share of Value Added, 2007Q1–2019Q2



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

Export of Services
(1995=100)

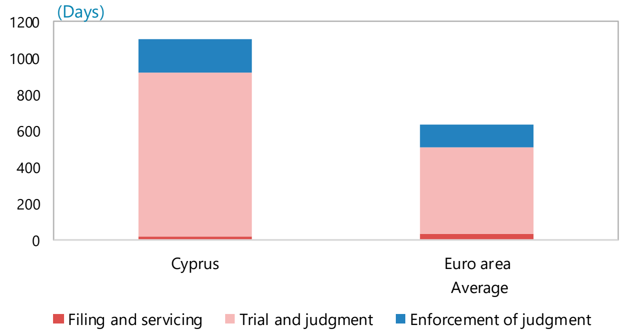


Source: WDI

27. While Cyprus has maintained its cost competitiveness, several structural bottlenecks pose challenges to investment and economic efficiency. *Access to financing* remains a key constraint given high borrowing costs and lack of alternative non-bank financing sources. These challenges also reflect difficulties in collateral execution and contract enforcement due to costly judicial processes and overall *inefficiencies with government bureaucracy* and effectiveness. Cyprus is also lagging in *investment in new innovation* and *R&D*, undermining the pace of adoption of new technologies and digitization. This process is also hindered by lack of adequately trained labor due to *skills mismatches* despite a well-educated labor force and a relatively flexible labor market.

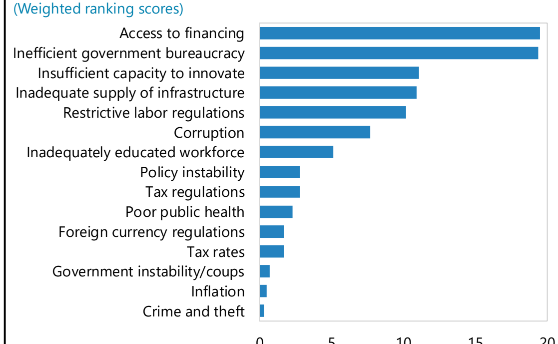
28. Structural reforms addressing these institutional challenges and encouraging investment in digitization, innovation and skilled human capital are needed. Policies to support investment in ICT infrastructure, and intangibles such as STEM training, R&D and technological innovation are needed to strengthen technological diffusion. Reducing remaining restrictions in implementing the EU Market Services Directive could facilitate more competition, attract FDI and facilitate greater innovation. By providing greater linkages and connectivity, these reforms would enable greater diversification of markets helping to reduce volatility and support faster growth. Greater efficiency and cost competitiveness are also key to sustaining growth in ICT-enabled trade of services given growing entry of lower cost service providers. Faster implementation of the government digital strategy is crucial to establish a well-functioning ICT ecosystem.

Time to Enforce Contracts
(Days)



Source: World Bank Doing Business, 2019; and IMF staff calculations.

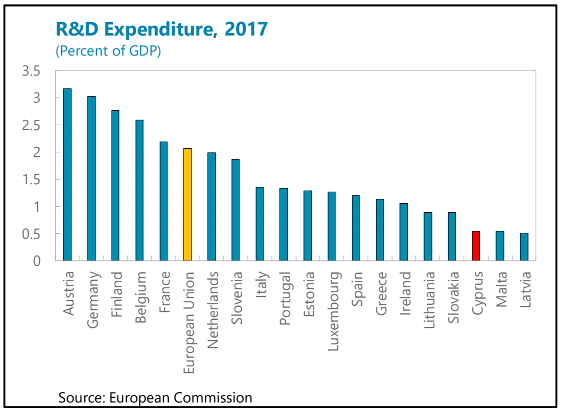
Most Problematic Factors for Doing Business
(Weighted ranking scores)

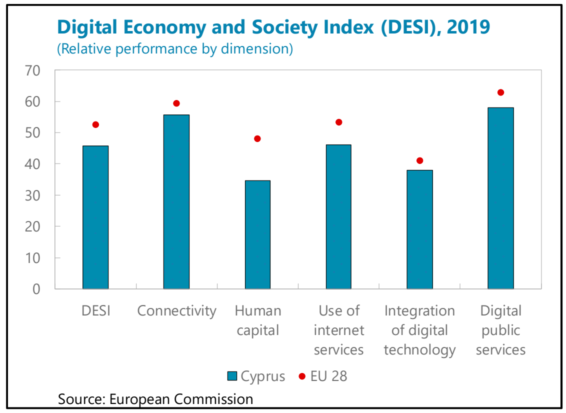


Source: World Economic Forum Global Competitiveness Index 2017-2018.

Box 1. Digitization and Technology Adoption in Cyprus

Cyprus lags in digital transformation and technology adoption. The use of digital technology in both businesses and public services ranks lower than in EU-28, and Cyprus particularly lags in human capital and digital skills. While Cyprus does well in educational attainment and academic research output, this has not translated into technology adoption and innovation activity in the private sector, which is also evidenced by Cyprus's very low expenditure on R&D by the private sector.





The government's digital strategy focuses on promoting innovation and the digital transformation of public and private sectors. Key initiatives to promote digitization in the public sector (**e-government**) includes the following areas:

- New information system for the **Tax Department** to strengthen tax administration by raising productivity of staff and operational efficiency;
- **E-justice system** to deliver better service, such as faster court award, by improving the efficiency of the operation of courts;
- New **resources planning system** to improve core PFM functions including budget management and payroll; and
- **E-health projects** to support better provision of health services by enabling digital management of health care information.

Efforts are being made to promote technology adoption in the private sector by establishing a nation-wide digital ecosystem. The modernization and enhanced productivity in the public sector through e-government projects, if successfully implemented, could jump start demand for technology adoption, thus stimulating private-sector innovation activities. The newly appointed national Chief Scientist and the soon-to-be-established new Deputy Ministry of Innovation and Digital Policy will provide a centralized platform to bring together research community, entrepreneurship, private financing and government resources. These efforts are expected to create a more attractive investment climate for FDIs of regional and global technology companies and human capital development.

29. **Ongoing judicial reform efforts should continue to better enforce commercial claims, support debt workouts and reduce the cost of doing business.** The recent specialization of some judges in financial litigation and ongoing recruitment of additional judges should be complemented by reforms of the rules for civil procedures, clearance of the backlog of cases and introduction of the e-justice system. Strengthening the institutional framework for the insolvency service and insolvency

professionals is also important, which has been associated with higher rates of capital investment.[21] Efforts are needed to create a more efficient system of issuing and transferring title deeds and to clear their backlog.

30. Faster implementation of reforms aimed at strengthening public sector governance would help government effectiveness. Pending *civil service reform* legislation to improve the assessment of candidates for appointment and promotions and civil service structure would facilitate greater mobility and enhance efficiency. *Fiscal institutional reforms* in areas such as revenue administration, local government and SOEs would also help boost service delivery (¶25). Completing the electricity sector reforms including ensuring network access by producers would help increase efficiency by diversifying the energy mix and lowering costs. Enacting the draft amendments to the *Central Bank of Cyprus (CBC) legislation* and the Cypriot Constitution, establishing a new decision-making body, clarifying dismissal grounds and procedure and allowing for automatic recapitalization would help in strengthening the CBC's autonomy and governance.

31. Efforts to effectively mitigate inherent AML/CFT compliance risks are a key priority. Efforts to mitigate AML/CFT risks arising from gaps in areas such as preventive measures, transparency and beneficial ownership of companies and trusts, international cooperation, financial intelligence and investigations are crucial, also as part of the preparation for the upcoming MONEYVAL AML/CFT assessment. AML/CFT compliance risks could have a macro-critical impact (e.g. correspondent banking relationship pressures) should a negative assessment be published.

32. Ensuring that growth is inclusive is key to making it sustainable (Figure 8). Indicators for income inequality and the gender gap in Cyprus are comparable to those of European peers, which partly reflects a generally well-targeted social benefit program. While unemployment is rapidly declining, the share of youth not in employment, education or training and the number of long-term unemployed remain high. Programs focused on job retraining and improving linkages between educational and job opportunities would help. Any consideration of a national minimum wage should keep in view the impact on competitiveness and work opportunities for youths.

Authorities' Views

33. The authorities agreed that structural reforms are a crucial area of focus in their strategy for strengthening potential growth. Education, research and development and digital technology are policy priorities to raise productivity and strengthen competitiveness. Some progress has already been made, including setting up of research centers of excellence. The implementation of the national digital strategy and the planned establishment of Deputy Ministry of Innovation and Digital Policy next year will create a central coordinating body for cooperation between the public and private sectors. Plans are underway to develop equity funding as an alternative for SME financing, in addition to the existing credit guarantee scheme provided by the European Investment Bank.

[21] See IMF (2019), 'Strengthening the Euro Area: The Role of National Structural Reforms in Enhancing Resilience", Staff Discussion Note, 19/05.

34. The authorities are making efforts to move forward with institutional reforms. The long-delayed bill on civil service reform will be submitted to Parliament this year. The hiring of new judges is underway. Progress has been made with the review of the civil procedure rules and broader court reforms—such as the bill on establishing the court of appeals—aimed at reducing delays in adjudication of commercial claims and supporting the implementation of insolvency and foreclosure frameworks. Legislative work is underway to enhance the governance of the CBC. Continued efforts to mitigate AML/CFT risks are being made, including the implementation of CBC regulation to clarify the definition of shell companies this year. The authorities also noted that indicators of income inequality have declined back to pre-crisis levels and that introduction of a national minimum wage remains a policy goal when full employment is achieved.

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35. Cyprus has made significant strides in recovering from the financial crisis and in addressing its legacy challenges. The pace of recovery has been more rapid than many other post-crisis euro area economies. The unemployment rate has declined, although it is still above pre-crisis levels. Efforts to address high NPLs and banking system vulnerabilities have also gained momentum, leading to a more consolidated and deleveraged banking system with sharply lower NPLs. Although public debt has spiked in the process, strict spending discipline and large fiscal surpluses have helped Cyprus to capitalize on favorable market conditions and reduce debt vulnerabilities.

36. While economic growth is moderating, the near-term economic outlook remains favorable, albeit with significant downside risks. Growth is expected to reach around 3 percent in 2019–20, supported by continued robust investments and consumption demand. However, external risks from rising protectionist trade policies, a sharper-than-expected slowdown in euro area growth or a hard Brexit could affect this outlook. A negative assessment on Anti-Money Laundering/Combating Financial Terrorism (AML/CFT) compliance risks could affect confidence and deter investments. Reversal of reform initiatives that delay NPL resolution could negatively affect the capital position of banks and weigh on availability of credit, undermining financial stability.

37. Important challenges remain in sustaining the growth momentum over the longer term. Private sector deleveraging has been lagging given ongoing challenges in debt workouts. The NPL ratio remains among the highest in Europe, and banks suffer from low profitability, constraining credit and investment growth. Longer-term economic growth potential is hindered by weak productivity growth, reflecting financial sector weakness as well as broader institutional bottlenecks and a slow pace of technology adoption. Policies should thus focus on reforms to secure financial stability and boost growth potential by enhancing efficiency and productivity.

38. NPL resolution and sustainable debt workouts remain key priorities to strengthen the financial sector. Efforts should focus on ensuring a well-functioning NPL resolution toolkit through restructuring, foreclosure, and insolvency. Adequate supervisory oversight of durable restructuring is crucial. The finalization of the framework for electronic auctions and continued progress with complementary judiciary reforms aimed at reducing backlogs will also be key to improve collateral execution and incentives for debt workouts. Strengthening of the supervisory and regulatory framework of CACs should continue. It is also important to swiftly finalize the state-owned CAMC's governance and operational structure to maximize recovery. Minimizing moral hazard risks inherent in the *Estia* subsidy scheme is important to ensure that taxpayers are not called on to subsidize individuals who can service their mortgages.

39. Broader efforts to further improve bank balance sheets are needed. Narrowing interest margins, excess liquidity in a declining interest rate environment and an inefficient cost structure are creating pressures on profitability. Banks should continue to maintain adequate provisions and capital buffers to insulate against potential further losses from NPL sales and workouts and reduce property holdings to targeted levels. Close monitoring of macro-financial risks from the highly segmented property market is warranted. Policies should encourage lower cost-to-income ratios through rationalization of operational costs, diversifying income sources, and undertaking of digitization solutions.

40. Fiscal spending should remain firmly controlled to reduce risks to debt sustainability, while the composition of expenditure should seek to enhance efficiency. Fiscal performance has been strong but risks remain significant given high public debt levels. Expenditure growth should be capped at the rate of nominal medium-term output growth to keep debt firmly on a downward path. Prioritizing public spending to support structural reform efforts would help achieve faster and more inclusive medium-term growth. To this end, the wage bill is already relatively high, and its growth should be contained below that of nominal GDP, to prevent crowding out of more productive expenditure. There is scope to improve the efficiency of education spending, including by reallocation towards investment in innovation and human capital. Strict monitoring and finetuning of the regulatory framework to control incentives and costs of services is key to containing risks from the NHS.

41. Productivity enhancing structural reforms are key for bolstering medium-term growth potential. While Cyprus has maintained its cost competitiveness, it suffers from low labor productivity growth and faces challenges to investment and economic efficiency. These include difficulties with access to finance, costly and lengthy judicial processes, inefficient government administration, low investment in new innovations, and skills mismatches. Policies to support greater market diversification, competition, and technology adoption are needed to enhance competitiveness. The authorities' strategy to improve investment in ICT infrastructure, STEM training, and research and development innovation and to ease access to finance are welcome.

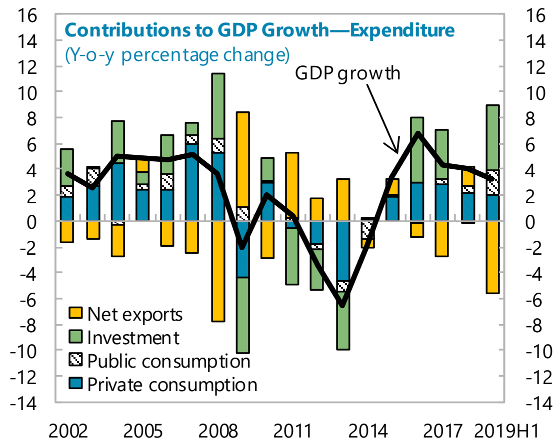
42. Efforts to reform public sector governance and efficiency should be renewed. In addition to efforts to improve efficiency of the judiciary, strengthening the institutional framework for the insolvency service is also important. Approval of pending legislation to reform the civil service and to strengthen the governance and autonomy of the Central Bank of Cyprus should also be expedited. Fiscal institutional measures for enhancing governance of state-owned enterprises, public financial management controls at the local government level and reforms in tax administration would help contain risks while improving public efficiency.

43. Ensuring that growth is inclusive is key to sustaining growth. Programs focused on job retraining and improving linkages between educational and job opportunities would reduce skills mismatches and allow growth dividends to benefit the youth and long-term unemployed.

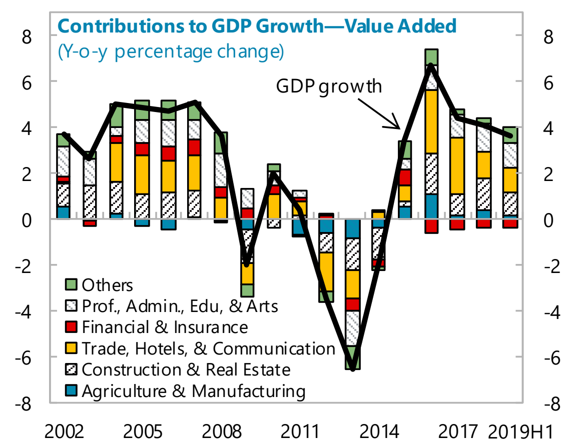
44. It is recommended that Cyprus remains on the standard 12-month Article IV consultation cycle.

Figure 1. Cyprus: Macroeconomic Performance

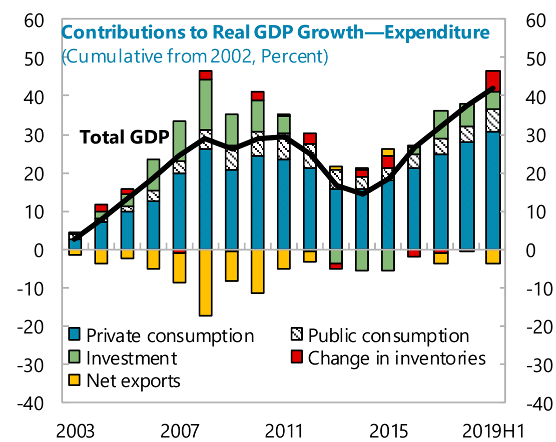
Economic growth has been strong, supported by domestic demand…



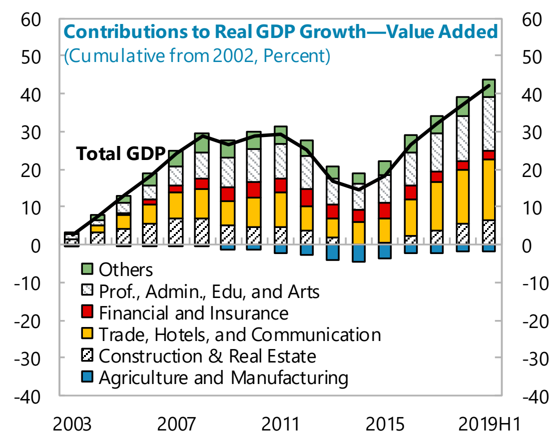
…although signs of moderation are emerging.



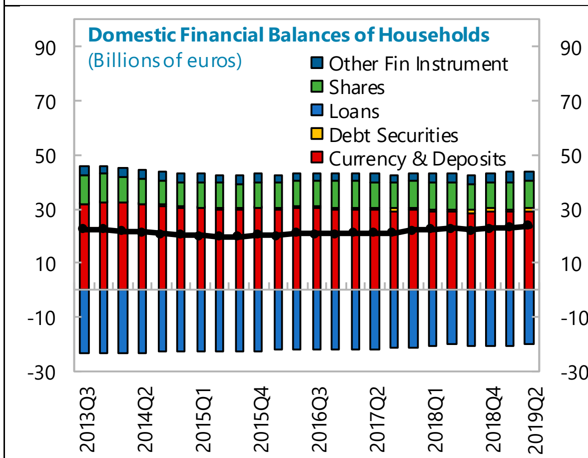
In cumulative terms, private consumption has been the major contributor to growth since the crisis…



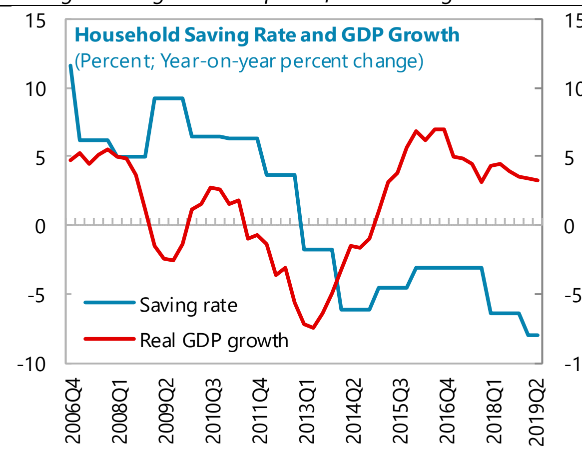
…while professional services and tourism have been main contributors on the production side.



Net financial assets of households remain large…



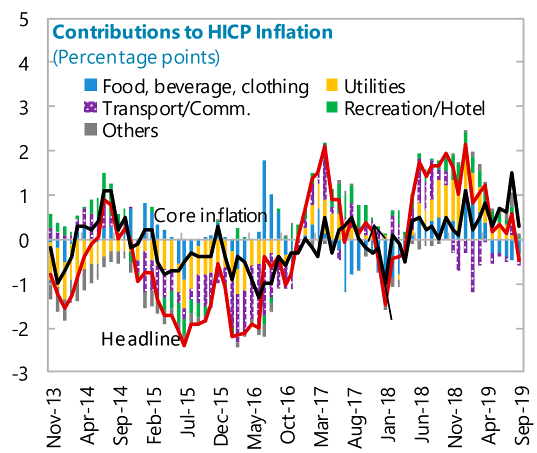
…allowing households to continue drawing down their savings to mitigate the impact of the banking crisis.



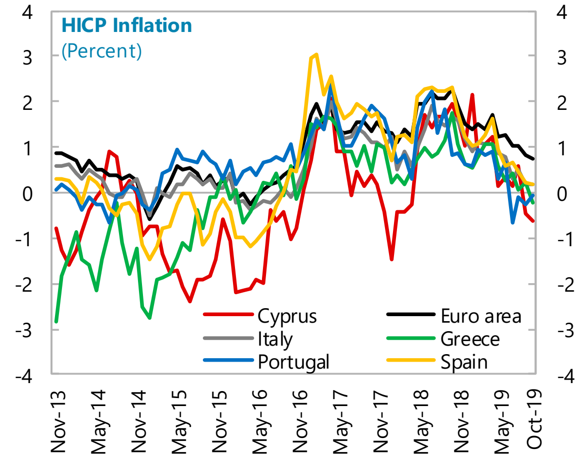
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 2. Cyprus: Inflation and Labor Market

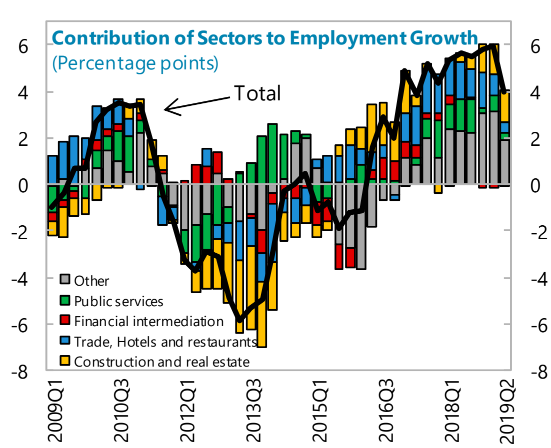
Headline and core inflation were mostly subdued in 2019.



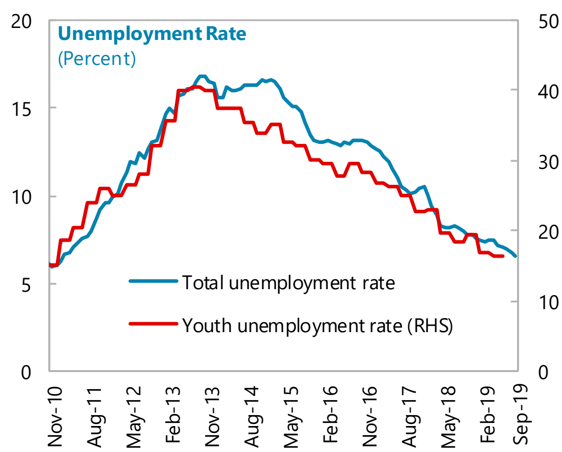
Headline inflation has been broadly in line with the trends in other euro area countries.



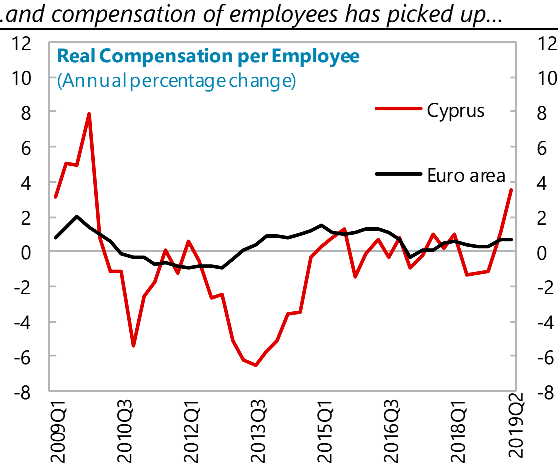
Employment growth remains strong…



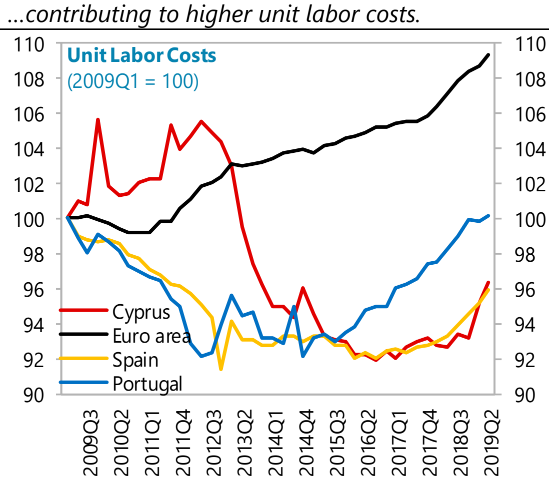
…and unemployment rate is declining…



…and compensation of employees has picked up…



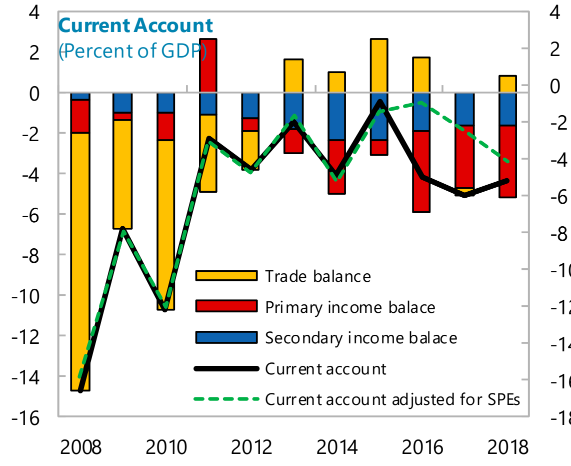
…contributing to higher unit labor costs.



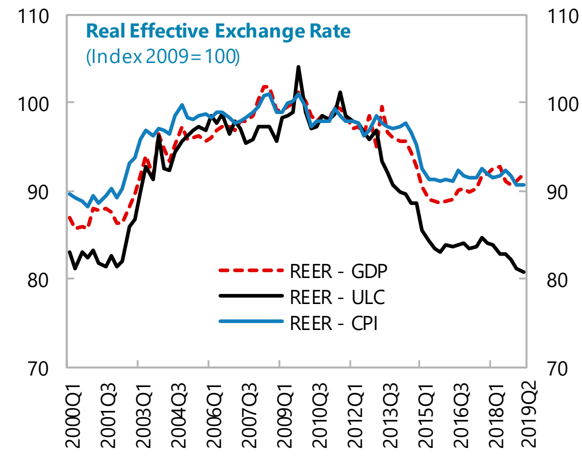
Sources: Cystat; ECB; Eurostat; and IMF staff calculations.

Figure 3. Cyprus: External Indicators

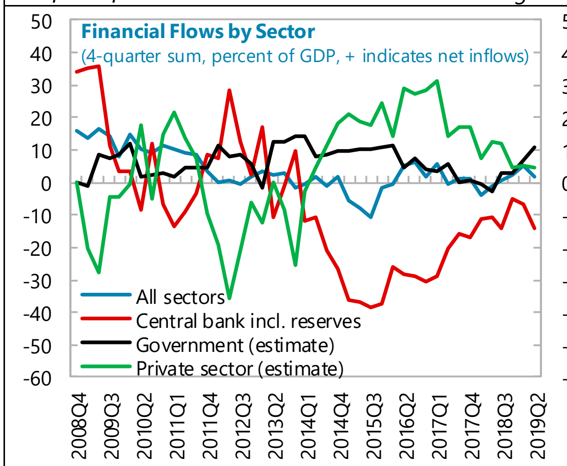
The underlying current account deficit has widened…



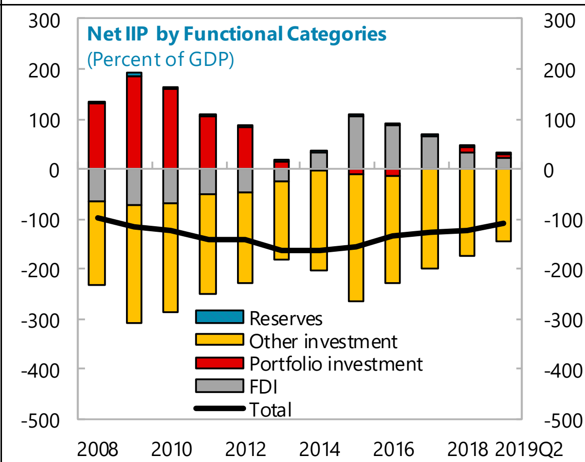
…although the real effective exchange rate stayed at post-crisis low.



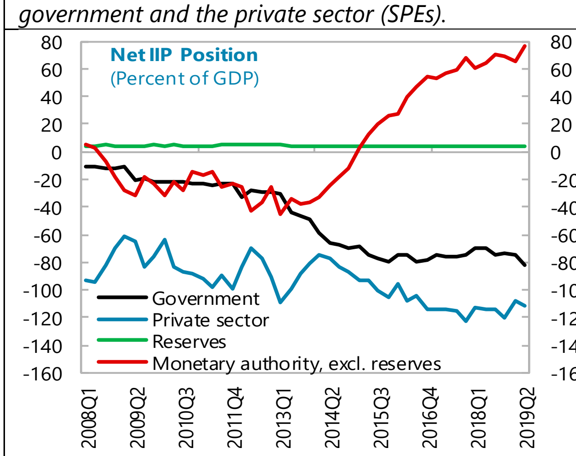
Net capital inflows to the private sector and net outflows from CBC have declined but remain large.



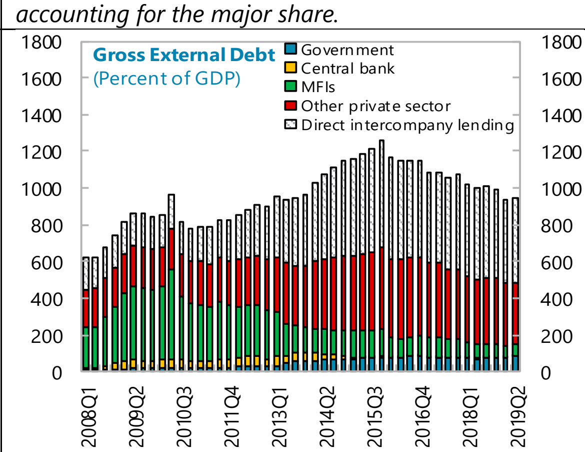
Net IIP remains highly negative…



…reflecting large negative IIP position of the government and the private sector (SPEs).



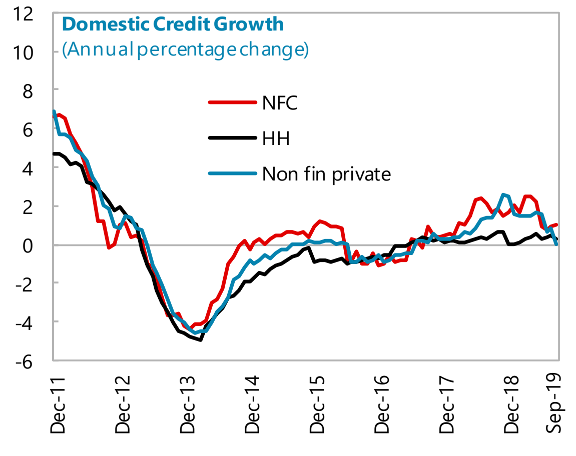
Gross external debt is near post-crisis low, with SPEs accounting for the major share.



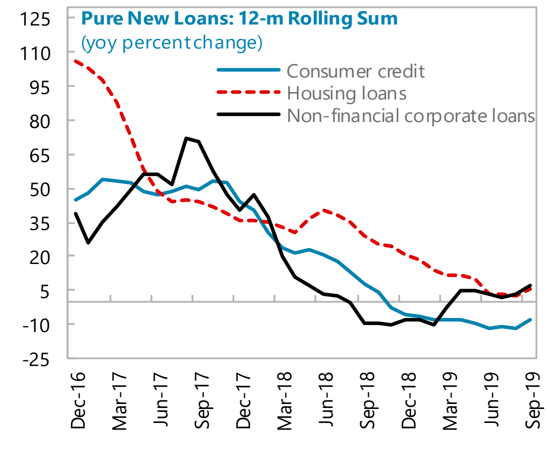
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Credit and Balance Sheets

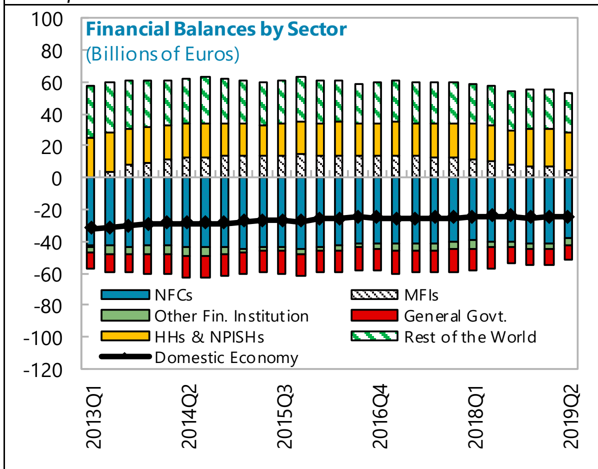
Domestic credit growth remains modest…



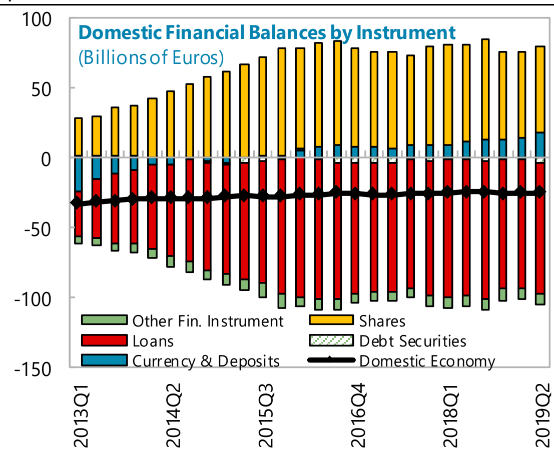
…and growth of pure new loans to households have decelerated.



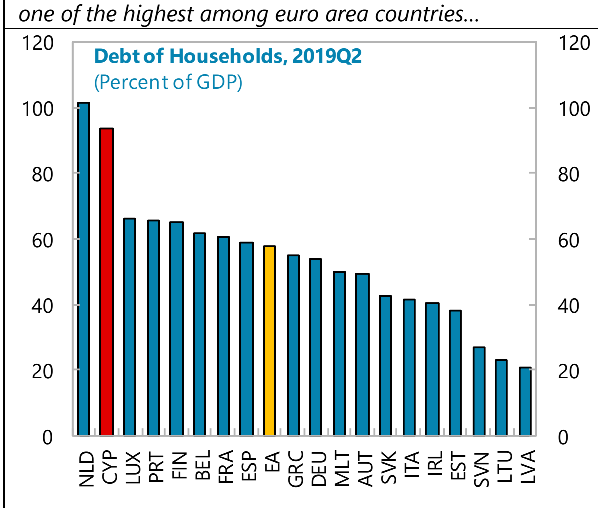
NFCs and the general government remain in large net debt position…



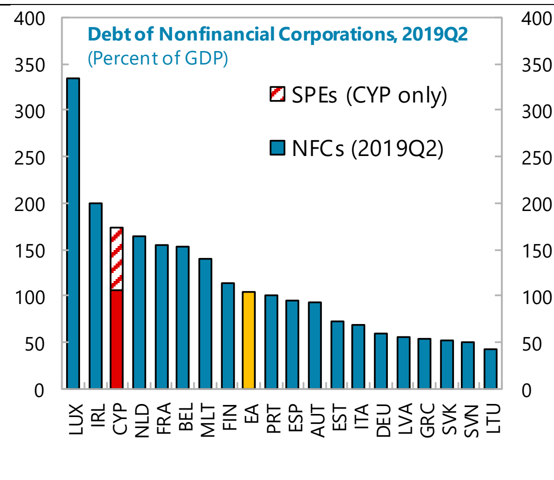
…and loans remain the largest component of net financial liabilities.



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



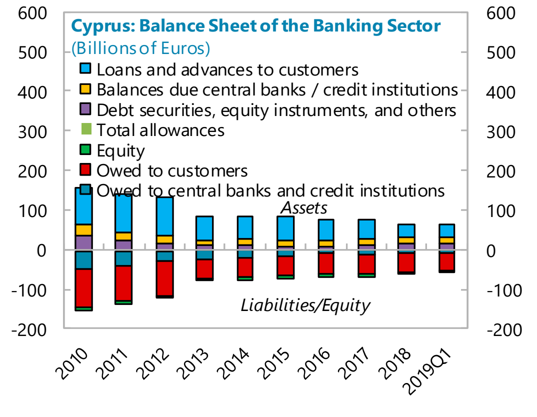
…and so does NFC debt.



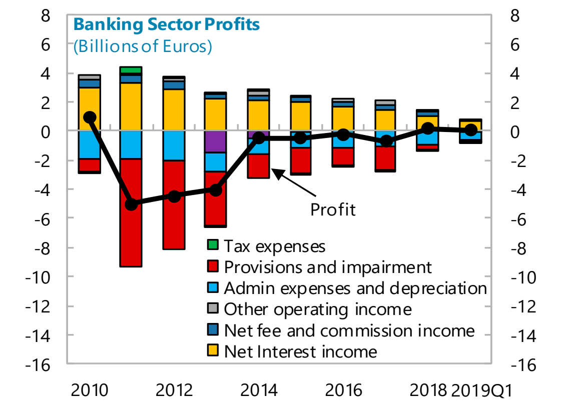
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 5. Cyprus: Banking Sector[1/]

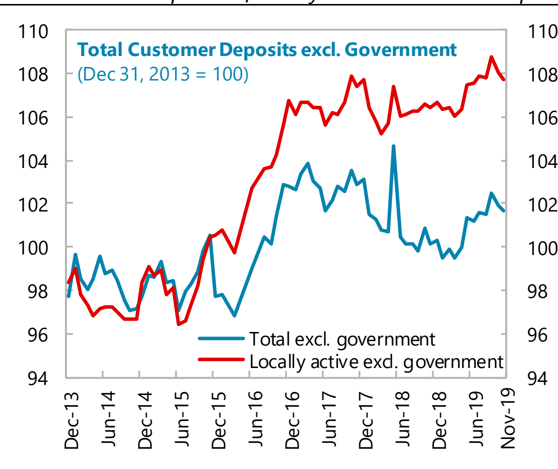
Banks have continued deleveraging, but at a slower pace…



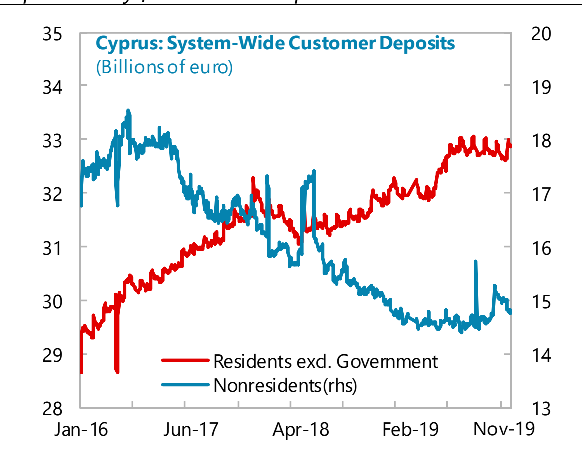
…and total profit of the banking sector remained slightly positive, driven by lower provisioning needs.



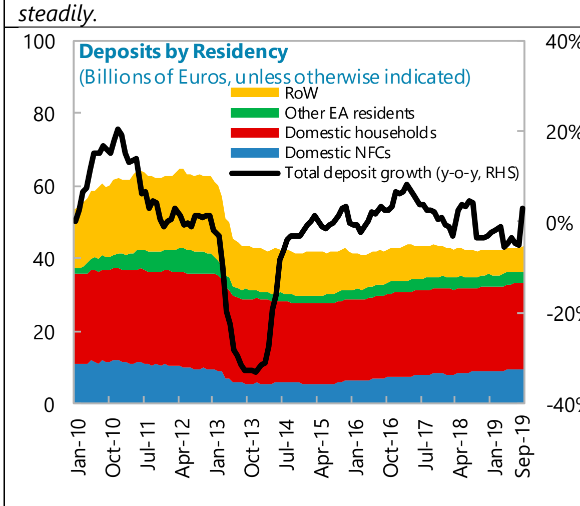
Total customer deposits of locally active banks went up…



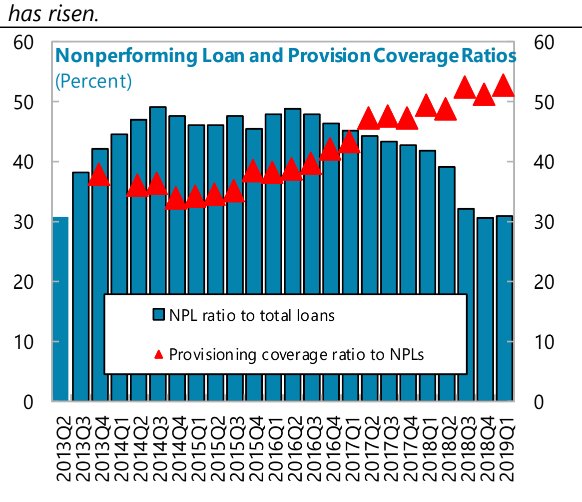
…particularly for residents' deposits…



…as deposits from households and NFCs are increasing steadily.



The NPL ratio were stable, and provisioning coverage ratio has risen.

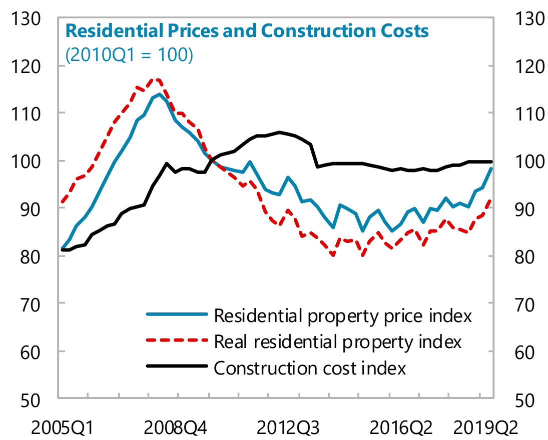


Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff calculations.

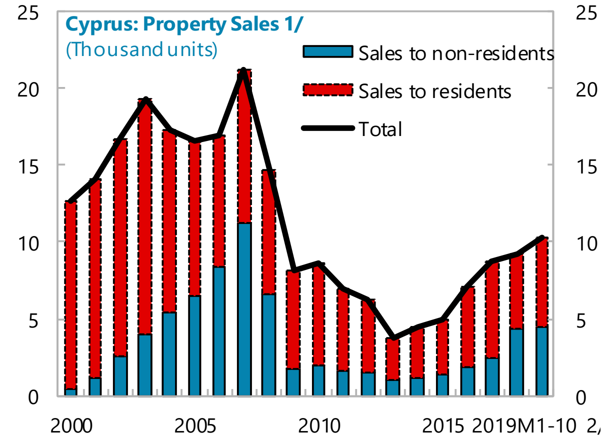
[1/] At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Housing Market

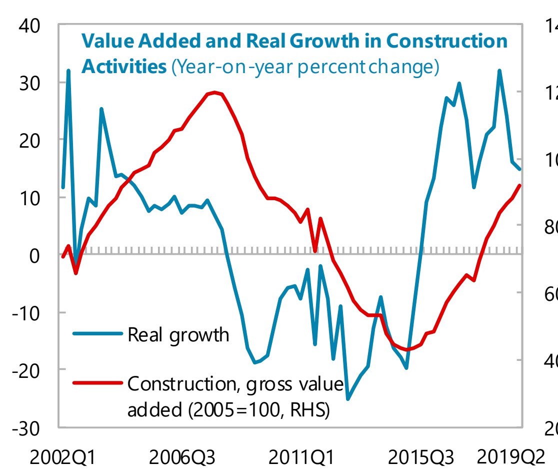
Transaction-based property prices are rising.



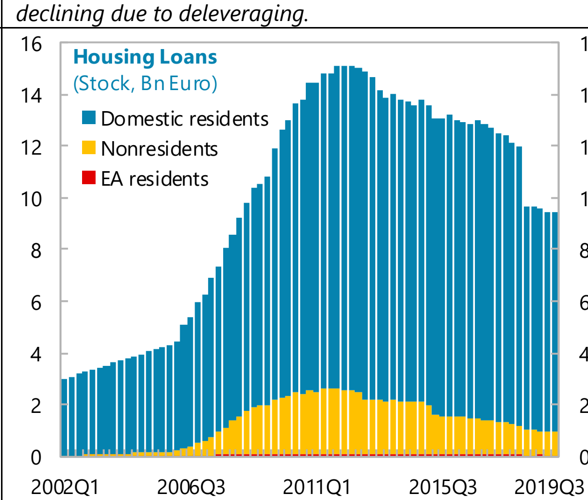
Property sales are recovering, with an increasing sales to non-residents.



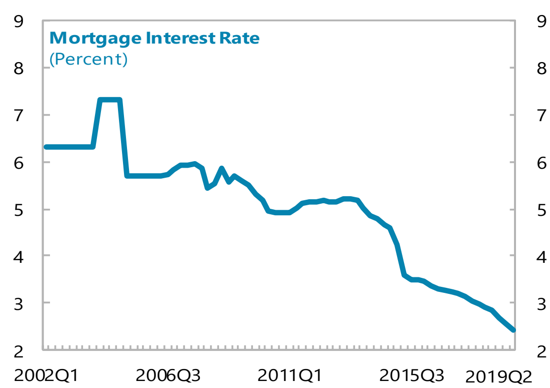
Growth in construction activities continues to be strong…



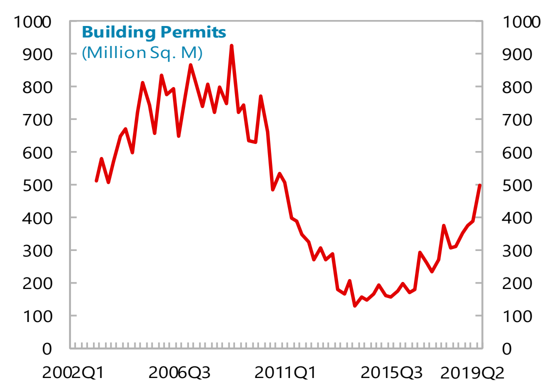
…while at the same time the stock of housing loans is declining due to deleveraging.



Mortgage interest rates continue to decline…



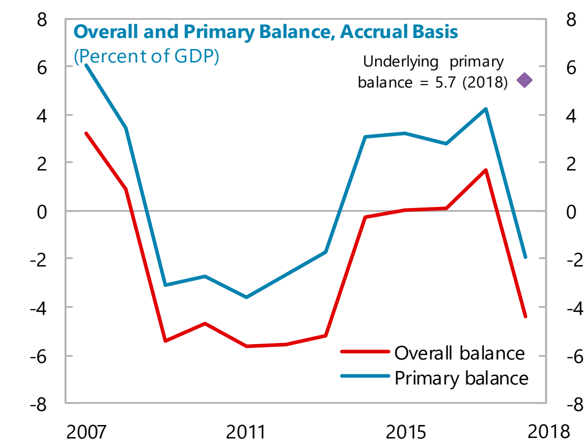
…and the issuance of building permits is on an upward trend.



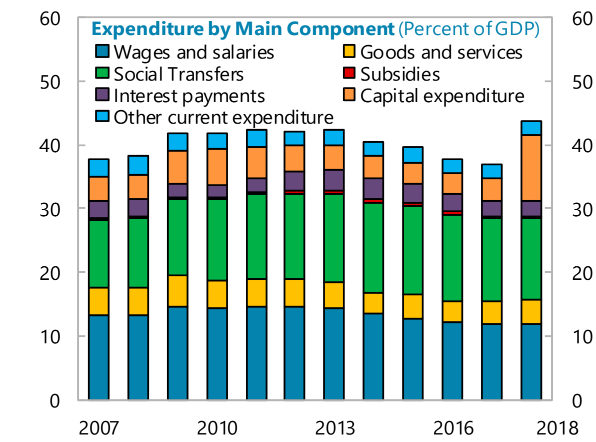
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.
1/ Post-2018 and pre-2018 data on sales to non-residents are not directly comparable as the methodology to compile data has changed.
2/ Annualized.

Figure 7. Cyprus: Fiscal Developments

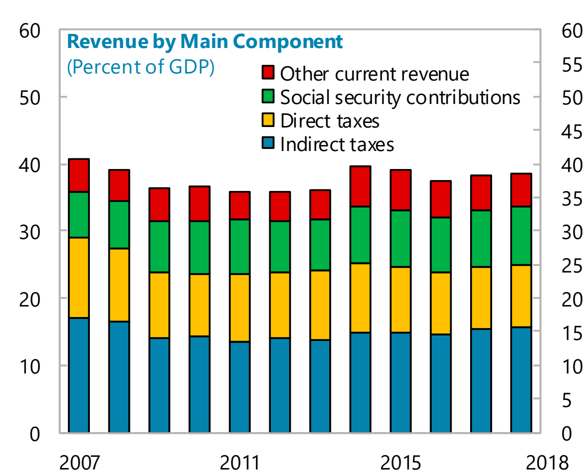
Adjusted for the one-off CCB transaction, the primary fiscal balance improved n 2018…



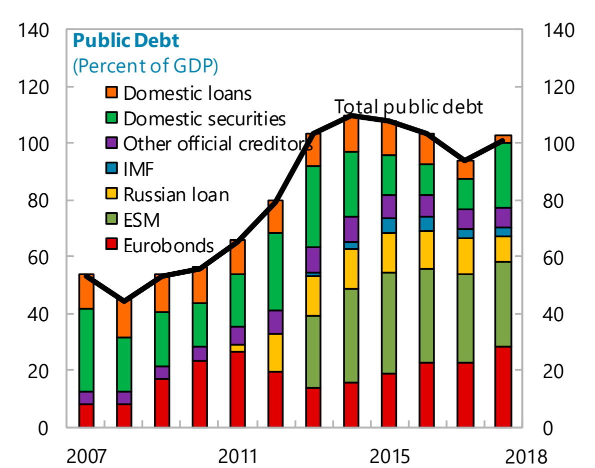
…as expenditure remained contained.



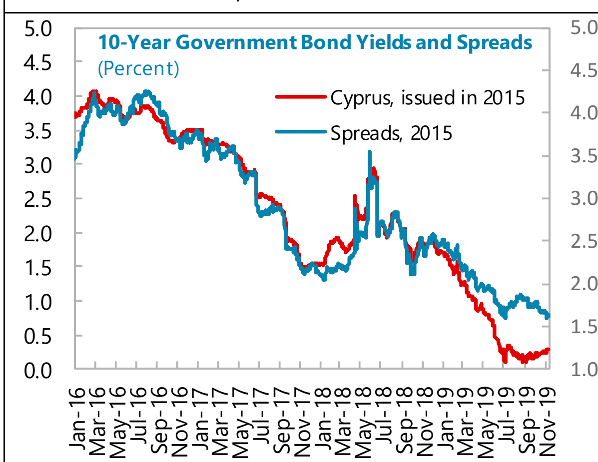
…and revenue collection rose.



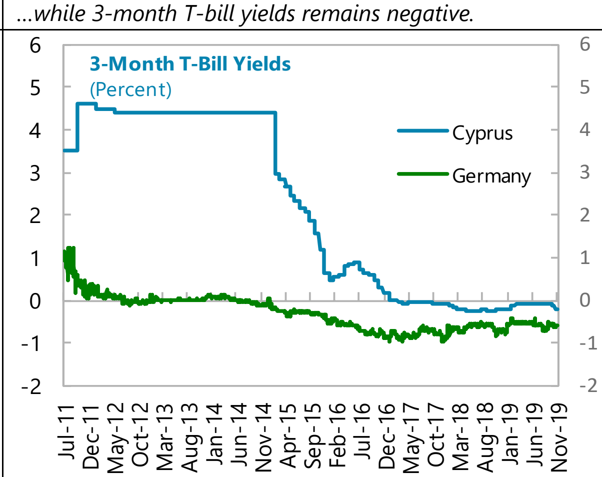
Public debt has risen as bonds were issued to resolve the CCB.



Market conditions are favorable…



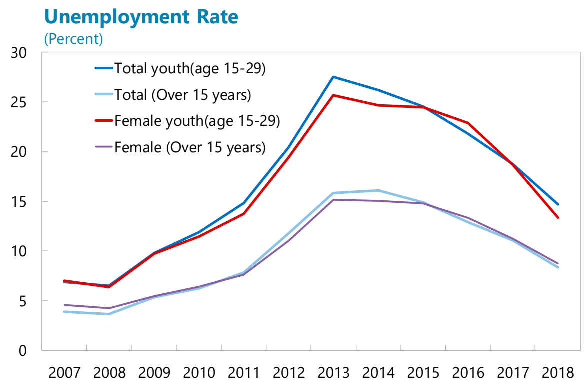
…while 3-month T-bill yields remains negative.



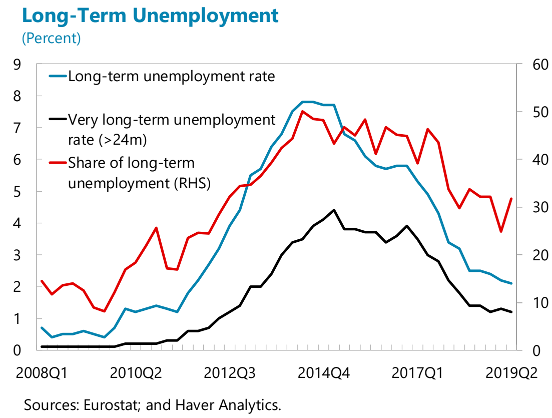
Sources: Bloomberg Finance LP; Ministry of Finance; and IMF staff estimates.

Figure 8. Cyprus: Growth Inclusiveness Indicators

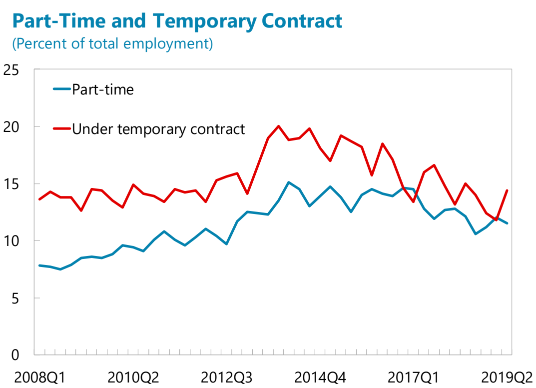
Unemployment rates are approaching the pre-crisis low…



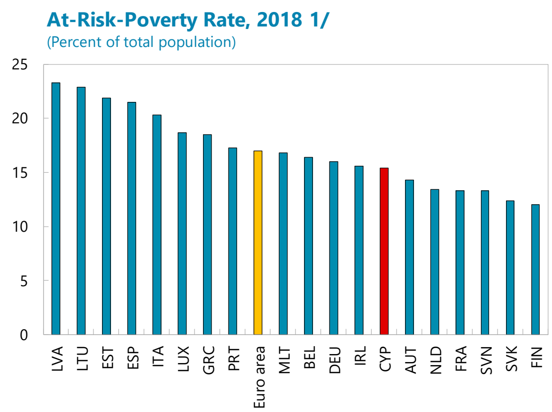
…Long-term unemployment has also declined although it remains higher than pre-crisis levels.



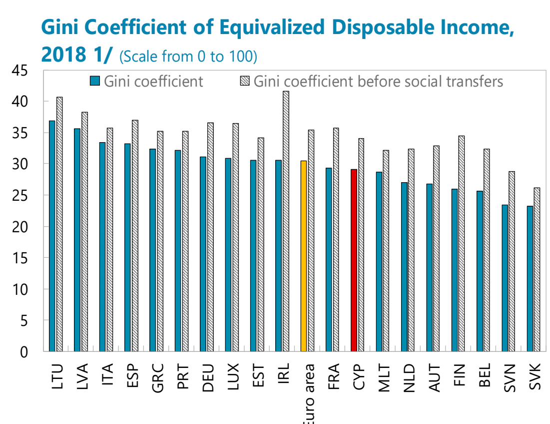
The share of part-time employment and temporary workers also declined since the crisis.



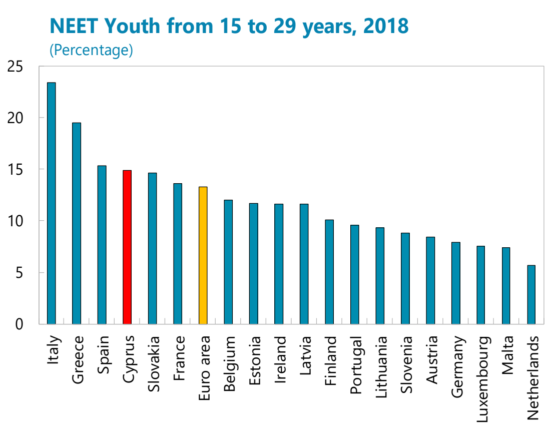
…with the poverty level in Cyprus at below euro area average.



Income equality is comparable to European peers…



but young population who are inactive are relatively large.



Sources: Eurostat, Haver Analytics; and IMF staff calculations.
1/ Latest data in 2017 for Euro area, France, Luxembourg, Ireland and Slovakia.

Table 1. Cyprus: Selected Economic Indicators, 2016–2024

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
Real Economy	(Percent change, unless otherwise indicated)								
Real GDP	6.7	4.4	4.1	3.1	2.9	2.8	2.6	2.5	2.5
Domestic demand	8.2	7.2	2.5	4.4	3.5	2.9	2.7	2.5	2.5
Consumption	3.4	4.0	3.3	3.5	3.0	2.5	2.5	2.5	2.5
Private consumption	4.4	4.5	3.3	3.6	3.2	2.5	2.5	2.6	2.6
Public consumption	-0.9	2.1	3.5	4.0	2.4	2.4	2.3	2.4	2.1
Gross capital formation 1/	37.9	22.1	-0.9	7.8	5.9	4.2	3.7	2.5	2.5
Foreign balance 2/	-1.1	-2.7	1.5	-1.3	-0.7	-0.1	-0.1	0.0	0.0
Exports of goods and services	7.2	8.7	4.6	0.2	2.1	3.4	3.4	3.4	3.4
Imports of goods and services 1/	9.0	12.8	2.4	1.9	3.0	3.4	3.5	3.3	3.3
Potential GDP growth	1.8	2.2	2.5	2.6	2.8	2.8	2.8	2.8	2.7
Output gap (percent of potential GDP)	-3.0	-1.0	0.6	1.0	1.1	1.2	1.0	0.8	0.6
HICP (period average)	-1.2	0.7	0.8	0.7	1.6	1.8	2.0	2.0	2.0
HICP (end of period)	0.1	-0.3	1.1	1.2	1.3	1.8	2.0	2.0	2.0
GDP deflator	-0.8	1.7	1.4	0.9	2.0	2.2	2.3	2.3	2.4
Unemployment rate (percent, period average)	13.0	11.1	8.4	7.0	6.0	5.4	5.2	5.1	5.0
Employment growth (percent, period average)	1.4	4.6	5.6	2.5	2.0	1.5	1.2	1.0	1.0
Labor force	-0.9	2.3	2.5	1.0	0.9	0.9	0.9	0.9	0.9
Public Finance	(Percent of GDP, unless otherwise indicated)								
General government balance	0.1	1.7	-4.4	3.6	2.4	2.8	2.8	3.0	3.7
Revenue	37.7	38.6	39.2	41.4	43.7	44.2	44.0	43.9	44.4
Expenditure	37.6	36.9	43.6	37.8	41.3	41.4	41.1	40.9	40.7
Primary Fiscal Balance	3.0	4.2	-2.0	5.9	4.8	4.9	4.8	4.7	5.3
General government debt	103.4	93.9	100.6	94.8	87.9	83.7	76.6	71.9	64.2
Balance of Payments									
Current account balance	-4.2	-5.1	-4.4	-5.2	-4.8	-4.3	-3.9	-3.3	-3.0
Trade Balance (goods and services)	1.7	-0.4	0.8	-1.4	-1.3	-0.7	-0.1	0.5	1.1
Exports of goods and services	70.8	73.0	73.1	70.6	70.9	70.6	70.6	70.7	70.7
Imports of goods and services	69.0	73.4	72.3	72.0	72.2	71.3	70.7	70.1	69.6
Goods balance	-22.1	-25.0	-22.1	-21.0	-20.6	-20.4	-20.1	-19.8	-19.5
Services balance	23.8	24.6	22.9	19.6	19.2	19.7	20.0	20.3	20.6
Primary income, net	-4.0	-3.0	-3.5	-2.4	-2.1	-2.2	-2.4	-2.4	-2.6
Secondary income, net	-1.9	-1.7	-1.7	-1.4	-1.4	-1.4	-1.4	-1.5	-1.5
Capital account, net	0.1	0.4	0.6	0.4	0.3	0.3	0.3	0.3	0.3
Financial account, net	-1.9	-0.9	-2.5	-4.8	-4.5	-4.0	-3.6	-3.0	-2.7
Direct investment	-10.7	-6.9	-34.5	-14.1	-13.2	-13.0	-13.0	-13.1	-13.4
Portfolio investment	-19.1	-2.0	12.5	-6.9	-2.6	-0.6	-0.2	-0.3	0.0
Other investment and financial derivatives	28.0	8.0	19.3	16.1	11.3	9.6	9.6	10.3	10.7
Reserves (+ accumulation)	-0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 3/	0.7	-1.3	0.0	0.0	-0.2	-0.7	-0.6	-0.6	-0.4
Errors and omissions	2.2	3.7	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	13.6	16.0	14.7	14.0	15.9	16.6	17.1	17.6	17.8
Government	3.3	5.0	6.0	5.8	4.7	5.0	5.1	5.2	5.9
Non-government	10.2	11.0	8.8	8.2	11.2	11.6	12.1	12.3	11.9
Gross capital formation	17.8	21.1	19.1	19.2	20.7	20.9	21.0	20.9	20.8
Government	3.2	3.3	10.3	2.2	2.2	2.2	2.2	2.2	2.2
Private	14.5	17.8	8.8	17.0	18.5	18.7	18.8	18.7	18.6
Foreign saving	-4.2	-5.1	-4.4	-5.2	-4.8	-4.3	-3.9	-3.3	-3.0
Memorandum Item:									
Nominal GDP (billions of euros)	18.9	20.0	21.1	22.0	23.1	24.2	25.4	26.7	28.0
Underlying primary fiscal balance 4/	3.0	4.2	5.4	5.9	4.8	4.9	4.8	4.7	5.3
External debt	1147.8	1074.5	990.9	972.2	944.0	922.2	900.7	881.3	863.8
Net IIP	-134.2	-126.5	-121.3	-121.5	-120.3	-118.5	-116.5	-114.1	-111.4

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

1/ Estimated negative growth of gross capital formation in 2018 reflect the base effect of volatile special purpose entities (SPEs) activity.

2/ Contribution to real GDP growth.

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

4/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction and state-owned AMC of 7.4% of GDP.

Table 2. Cyprus: Fiscal Development and Projections, 2016–2024 [1/]

(Percent of GDP)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
Revenue	37.7	38.6	39.2	41.4	43.7	44.2	44.0	43.9	44.4
Current revenue	37.5	38.1	38.6	40.9	43.4	43.9	43.7	43.7	44.1
Tax revenue	23.9	24.5	24.9	24.9	24.7	24.6	24.5	24.5	24.5
Indirect taxes	14.6	15.3	15.7	15.5	15.3	15.3	15.2	15.2	15.2
Direct taxes	9.3	9.2	9.1	9.4	9.4	9.4	9.3	9.3	9.3
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	8.2	8.5	8.7	11.2	14.3	14.9	14.9	14.9	15.4
Other current revenue	5.4	5.1	5.0	4.8	4.5	4.4	4.3	4.3	4.3
Capital revenue	0.2	0.4	0.6	0.5	0.3	0.3	0.3	0.3	0.3
Expenditure	37.6	36.9	43.6	37.8	41.3	41.4	41.1	40.9	40.7
Current expenditure	34.4	33.6	33.3	35.6	39.1	39.1	38.9	38.7	38.5
Wages and salaries	12.0	11.8	11.7	12.2	12.7	12.9	13.0	13.1	13.0
Goods and services	3.5	3.6	3.8	4.0	3.8	3.6	3.5	3.5	3.5
Social Transfers	13.6	13.1	12.8	14.1	17.5	18.0	18.0	18.0	18.0
Subsidies	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Interest payments	2.7	2.5	2.4	2.3	2.4	2.1	2.0	1.7	1.6
Other current expenditure	2.1	2.3	2.2	2.5	2.5	2.3	2.1	2.1	2.1
Capital expenditure	3.2	3.3	10.3	2.2	2.2	2.2	2.2	2.2	2.2
Capital transfers, payable	0.7	0.5	4.4	0.2	0.2	0.2	0.2	0.2	0.2
Gross capital formation less NFA disposal	2.6	2.8	5.9	2.0	2.0	2.0	2.0	2.0	2.0
Overall balance	0.1	1.7	-4.4	3.6	2.4	2.8	2.8	3.0	3.7
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.4	1.7	-4.4	3.6	2.4	2.8	2.8	3.0	3.7
Net financial transactions	0.4	1.7	-4.0	3.6	2.4	2.8	2.9	3.0	3.7
Net acquisition of financial assets	-5.1	-3.6	9.2	1.6	0.0	2.9	-0.3	1.9	-0.6
Currency and deposits	-5.1	-3.6	9.2	1.6	0.0	2.9	-0.3	1.9	-0.6
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.5	-5.3	13.2	-2.0	-2.4	0.1	-3.2	-1.1	-4.3
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-5.0	0.4	20.6	6.2	-2.5	0.5	-2.8	-0.7	-4.2
Loans	-0.4	-5.7	-7.4	-8.2	0.1	-0.5	-0.4	-0.4	-0.2
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Underlying expenditure 2/	37.6	36.9	36.0	36.3	36.3	36.0	35.8	35.8	35.8
Output Gap	-3.0	-1.0	0.6	1.0	1.1	1.2	1.0	0.8	0.6
Underlying overall balance 3/	0.1	1.7	3.0	3.6	2.4	2.8	2.8	3.0	3.7
Primary balance 5/	2.8	4.2	-2.0	5.9	4.8	4.9	4.8	4.7	5.3
Primary balance (ESA2010)	2.8	4.2	-2.0	5.9	4.8	4.9	4.8	4.7	5.3
Underlying primary balance 3/	2.8	4.2	5.4	5.9	4.8	4.9	4.8	4.7	5.3
Structural overall balance 3/	1.3	1.6	2.3	2.2	1.9	2.3	2.5	2.7	3.5
Structural primary balance 3/	4.0	4.1	4.7	4.5	4.2	4.4	4.5	4.5	5.0
Public debt	103.4	93.9	100.6	94.8	87.9	83.7	76.6	71.9	64.2
Public debt net of cash holding	98.1	90.6	98.1	91.0	84.2	77.4	70.8	64.5	57.7

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

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

3/ Excludes the fiscal impact of the sale of the CCB transaction and state-owned AMC of 7.4 percent of GDP.

Table 3. Cyprus: General Government Financing Requirements and Sources, 2019–2024

(Millions of Euros, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024
			Projections			
Gross borrowing needs	2,732	1,139	701	1,732	1,032	1,227
Overall deficit	-789	-563	-685	-726	-810	-1,039
Primary surplus	-1,302	-1,104	-1,194	-1,225	-1,260	-1,471
Interest payments	513	541	509	499	449	432
Amortization	3,488	1,702	1,386	2,459	1,842	2,266
Medium- and long-term	3,288	1,363	915	2,003	1,386	1,856
Foreign	2,158	542	88	1,088	1,089	1,438
Eurobonds	199	458	0	1,000	1,000	1,350
Russia	1,875	0	0	0	0	0
Other	84	84	88	88	89	88
Domestic	1,131	822	827	915	297	418
Short-term	200	300	300	300	300	300
EU and IMF	0	39	171	156	156	110
Stock-flow adjustment 1/	33	0	0	0	0	0
Gross financing sources	2,732	1,139	701	1,732	1,032	1,227
Privatization receipts	0	0	0	0	0	0
Market access	3,050	1,150	1,400	1,650	1,550	1,050
Medium- and long-term	2,750	850	1,100	1,350	1,250	750
Foreign	2,750	650	900	1,150	1,150	650
Domestic	0	200	200	200	100	100
Short-term	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0
Use of deposits 2/	-318	-11	-699	82	-518	177
Net placement	-438	-552	14	-809	-448	-1,326
Medium and Long Term Debt	-538	-513	185	-653	-292	-1,216
Domestic Securities	-1,131	-622	-627	-715	-197	-318
Eurobonds	2,401	42	750	0	0	-850
Domestic Loans	0	0	0	0	0	0
Foreign Loans	-1,809	66	62	62	-95	-48
Short term (Net increase)	100	0	0	0	0	0
EU and IMF	0	-39	-171	-156	-156	-110
<u>Memorandum item:</u>						
Cash holding (eop)	831	842	1,540	1,458	1,976	1,800
General government debt (eop)	20,818	20,266	20,279	19,471	19,179	17,963
General government debt (eop, percent of GDP)	94.8	87.9	83.7	76.6	71.9	64.2
General government net debt (eop, percent of GDP) 3,	91.0	84.2	77.4	70.8	64.5	57.7

Sources: Cypriot authorities; and Fund staff projections.

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

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

3/ General government debt minus cash holding.

Table 4. Cyprus: Balance of Payments, 2016–2024

	2016	2017	2018	2019	2020	2021	2022	2023	2024
				Projections					
				(Percent of GDP)					
Current Account Balance	-4.2	-5.1	-4.4	-5.2	-4.8	-4.3	-3.9	-3.3	-3.0
Trade Balance (Goods and Services)	1.7	-0.4	0.8	-1.4	-1.3	-0.7	-0.1	0.5	1.1
Goods Balance	-22.1	-25.0	-22.1	-21.0	-20.6	-20.4	-20.1	-19.8	-19.5
Exports	13.8	13.6	17.1	16.4	17.3	16.9	16.6	16.4	16.1
Imports	35.8	38.6	39.2	37.3	37.8	37.3	36.7	36.1	35.6
Services Balance	23.8	24.6	22.9	19.6	19.2	19.7	20.0	20.3	20.6
Exports	57.0	59.4	56.0	54.2	53.7	53.8	54.0	54.3	54.6
Imports	33.2	34.8	33.1	34.6	34.4	34.0	34.0	34.0	34.0
Primary Income	-4.0	-3.0	-3.5	-2.4	-2.1	-2.2	-2.4	-2.4	-2.6
Secondary Income	-1.9	-1.7	-1.7	-1.4	-1.4	-1.4	-1.4	-1.5	-1.5
Capital Account	0.1	0.4	0.6	0.4	0.3	0.3	0.3	0.3	0.3
Financial Account (- financing)	-1.9	-0.9	-2.5	-4.8	-4.5	-4.0	-3.6	-3.0	-2.7
Direct Investment	-10.7	-6.9	-34.5	-14.1	-13.2	-13.0	-13.0	-13.1	-13.4
Portfolio Investment	-19.1	-2.0	12.5	-6.9	-2.6	-0.6	-0.2	-0.3	0.0
Financial Derivatives	1.8	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Investment	26.2	6.4	19.3	16.1	11.3	9.6	9.6	10.3	10.7
Reserves (+ accumulation)	-0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	2.2	3.7	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current Account Balance adjusted for SPEs 1/	-0.6	-1.9	-3.4	...	...	...	...	...	...
Program Financing 2/	0.7	-1.3	0.0	0.0	-0.2	-0.7	-0.6	-0.6	-0.4
Private Net Capital Flows 3/	-28.4	-16.9	-4.7	...	...	...	...	...	...
o/w Portfolio Investment	-22.4	-6.7	17.3	...	...	...	...	...	...
o/w Other Investment	2.9	-4.9	12.6	...	...	...	...	...	...
o/w MFIs	13.7	-1.9	C	...	...	...	...	...	...
o/w Non-MFIs	-10.8	-3.0	C	...	...	...	...	...	...
Gross External Debt	1147.8	1074.5	990.9	972.2	944.0	922.2	900.7	881.3	863.8
o/w Short-term Debt	250.2	209.8	164.0	155.9	150.9	150.4	151.1	152.5	157.5

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

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

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

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

Table 5. Cyprus: External Financing Requirements and Sources, 2016–2024

(Millions of Euros)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
			Projections						
GROSS FINANCING REQUIREMENTS	**65,305**	**60,227**	**54,639**	**49,366**	**47,537**	**47,862**	**50,632**	**52,722**	**55,436**
Current account deficit ("-" = CA surplus)	796	1,022	931	1,136	1,112	1,042	993	886	842
Medium- and long-term debt amortization	10,936	11,717	11,664	13,564	12,127	11,862	13,061	13,259	13,806
Public sector	276	609	697	2,158	542	88	1,088	1,089	1,438
Banks	887	762	636	530	514	504	499	496	494
Other private	9,773	10,345	10,331	10,876	11,071	11,270	11,474	11,673	11,875
Short-term debt amortization	53,573	47,221	42,044	34,666	34,259	34,785	36,422	38,421	40,677
Public sector	246	293	313	360	400	466	541	630	732
Central Bank	201	275	296	344	400	466	541	630	732
General government and SOEs	45	18	17	16	0	0	0	0	0
Banks	22,493	17,997	17,174	13,407	11,286	9,950	9,556	9,366	9,272
Other private	30,834	28,932	24,556	20,899	22,573	24,370	26,324	28,425	30,673
EU and IMF	0	267	0	0	39	171	156	156	110
SOURCES OF FINANCING	**65,180**	**60,227**	**54,639**	**49,366**	**47,537**	**47,862**	**50,632**	**52,722**	**55,436**
Capital account (net)	16	83	130	77	74	64	74	84	84
Foreign direct investment (net)	2,022	1,381	7,301	3,091	3,050	3,151	3,317	3,486	3,759
Cypriot investment abroad	5,699	14,835	-2,617	6,336	6,679	6,989	7,333	7,699	8,033
Foreign investment in Cyprus	7,722	16,216	4,684	9,426	9,728	10,140	10,650	11,185	11,792
New borrowing and debt rollover	60,373	53,423	49,434	49,324	47,977	50,093	52,532	54,993	58,310
Medium and long-term borrowing	13,152	11,380	14,768	15,064	13,192	13,671	14,110	14,316	14,216
General government	125	850	1,500	2,750	650	900	1,150	1,150	650
Banks	394	254	213	463	473	484	489	486	514
Other private	12,633	10,275	13,054	11,852	12,069	12,287	12,471	12,679	13,052
Short-term borrowing	47,221	42,044	34,666	34,259	34,785	36,422	38,421	40,677	44,094
Public sector	293	313	360	400	466	541	630	732	852
Central Bank	275	296	344	400	466	541	630	732	852
General government and SOEs	18	17	16	0	0	0	0	0	0
Banks	17,997	17,174	13,407	11,286	9,950	9,556	9,366	9,272	9,635
Other private	28,932	24,556	20,899	22,573	24,370	26,324	28,425	30,673	33,608
Other	2,769	5,339	-2,225	-3,125	-3,564	-5,446	-5,291	-5,841	-6,717
Of which: Net errors and omissions	412	751	268	0	0	0	0	0	0
FINANCING GAP	**125**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	0	0	0	0	0	0	0	0	0
IMF	125	0	0	0	0	0	0	0	0
ROLLOVER RATES									
General government	45%	138%	212%	126%	120%	1023%	106%	106%	45%
Central bank	137%	108%	116%	116%	116%	116%	116%	116%	116%
Private	94%	90%	90%	101%	103%	106%	106%	106%	109%
Banks	79%	93%	76%	84%	88%	96%	98%	99%	104%
Non-financial corporates	102%	89%	97%	108%	108%	108%	108%	108%	110%

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

Table 6. Cyprus: Financial Soundness Indicators, 2012–2019 [1/]

(Percent, unless otherwise specified)

	2012	2013	2014	2015	2016	2017	2018	2019Q1
Capital Adequacy								
Regulatory capital ratio	7.3	13.5	15.3	16.6	16.8	16.3	17.5	18.0
Tier I capital ratio	6.3	12.3	14.6	16.0	16.4	15.4	16.6	17.1
Asset Quality								
Non-performing loans (NPLs) to total gross loans 2/	27.1	44.4	47.5	45.3	46.4	42.5	30.5	30.9
Non-performing loans (NPLs) to total gross loans (local operations) 3/	22.6	44.4	47.8	45.8	47.2	43.7	30.3	30.6
Provisions to NPLs	...	...	33.9	38.3	42.3	47.3	51.2	52.6
Restructured loans classified as NPLs to total NPLs	...	28.0	33.9	40.1	40.8	40.9	44.9	45.2
Earnings and Profitability								
Return on assets 4/	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.4	0.7
Return on equity 4/	-69.5	-69.5	-8.1	-7.4	1.7	-10.9	8.7	10.5
Net interest income to gross income ratio	78.9	86.2	78.4	81.2	75.3	70.8	67.2	75.8
Net fees and commissions income to gross income ratio	16.0	13.4	11.6	13.8	14.6	16.5	19.5	19.5
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	1.9	2.0
Liquidity								
Cash, trading and available-for-sale assets to total assets ratio	8.6	7.0	14.4	19.8	22.9	27.9	27.6	26.1
Others								
Total loans and advances to total assets ratio	82.9	83.6	73.4	73.6	69.1	64.1	54.6	54.3
Total deposits (other than from credit institutions) to total assets ratio	71.7	63.8	63.0	65.1	74.9	75.7	79.2	80.2

Source: Central Bank of Cyprus.

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

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

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

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

Table 7. Cyprus: Indicators of Fund Credit, 2013–2026 1/

(Millions of SDRs)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Disbursement	222.8	148.5	321.8	99.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service	1.6	3.8	7.5	13.1	236.2	11.4	12.5	42.2	147.9	133.1	130.7	91.5	53.0	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	11.4	12.5	10.9	9.7	7.3	4.9	2.8	1.4	0.7
Total debt service, in percent of														
Quota	1.0	2.4	4.8	4.3	77.7	3.8	4.1	13.9	48.7	43.8	43.0	30.1	17.4	2.9
GDP	0.0	0.0	0.1	0.1	1.4	0.1	0.1	0.2	0.8	0.6	0.6	0.4	0.2	0.0
Exports of goods and services	0.0	0.0	0.1	0.1	1.9	0.1	0.1	0.3	1.1	0.9	0.9	0.6	0.3	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	4.9	5.4	3.4	3.3	3.2	2.9	2.0	1.3	0.7	0.3	0.0	0.0
In percent of exports of goods and service	2.3	3.8	7.0	7.6	4.6	4.5	4.5	4.1	2.9	1.9	1.0	0.4	0.0	0.0

Source: IMF staff estimates.

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

Annex I. Status of Article IV Recommendations

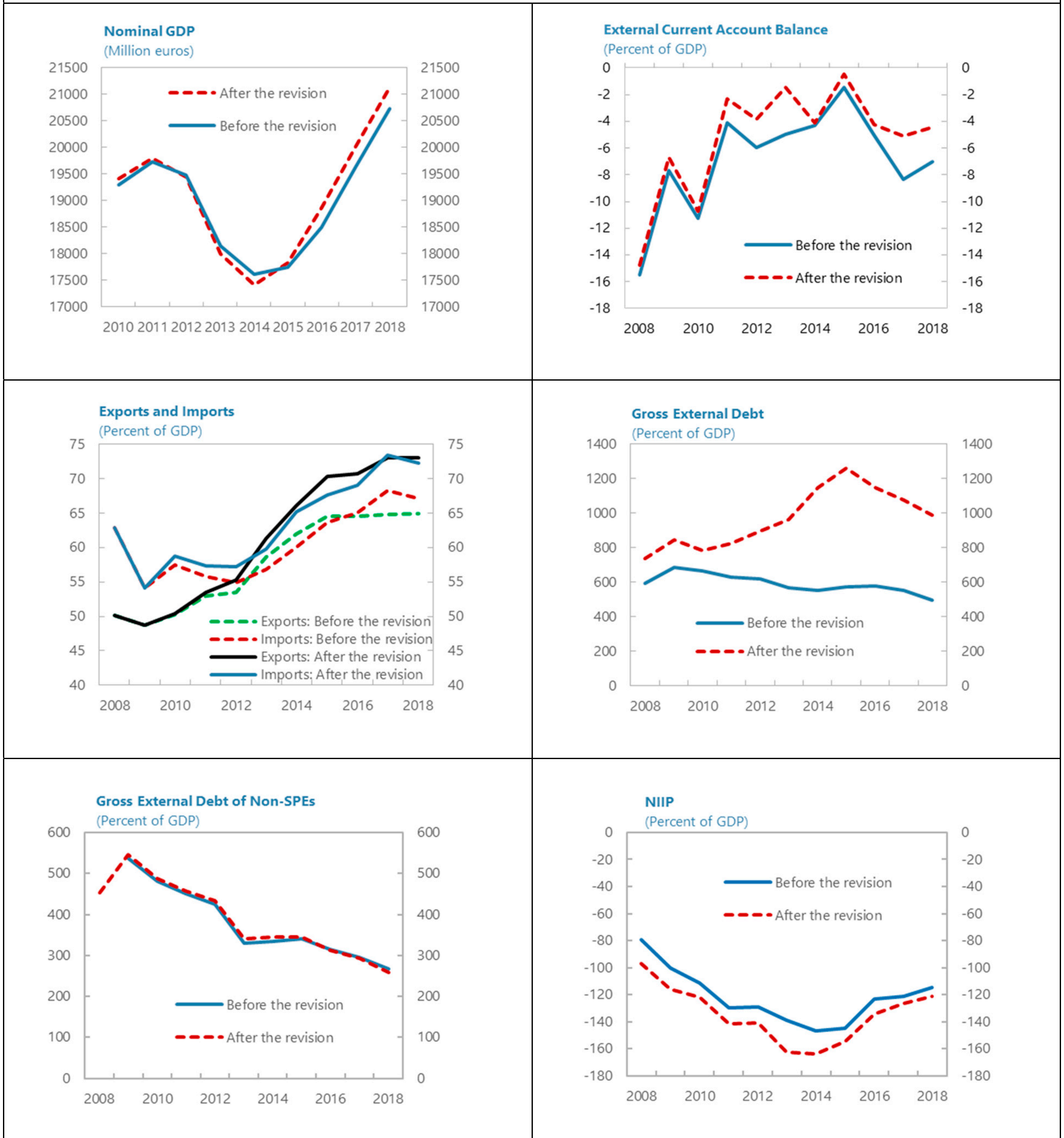
Past Policy Recommendation	Policy Actions
Strengthen Financial Sector Policies	
Reduce private sector debt and high NPLs, including by: (i) addressing impediments in the foreclosure and insolvency frameworks and asset sales legislation; (ii) relying on a broad set of tools that includes burden sharing and keeps banks well provisioned and capitalized; and (iii) strengthening supervisory and governance framework for credit-acquiring companies (CACs), including the government-owned CAMC.	The amendments to the foreclosure and insolvency legislation and the sales of loans law as well as the adoption of a law on securitization have enhanced the toolkit to address NPLs (2018). Banks have made significant progress in offloading NPLs. However, their successful workout outside of the banking system is still needed, Parliament recently made further amendments to foreclosure law to weaken the effectiveness of its framework. A subsidy scheme aimed at encouraging vulnerable borrowers to start servicing their loans through burden sharing is about to be implemented, but its coverage is rather broad. CAMC has yet to become fully operational.
Ensure Fiscal Sustainability and Avoid Procyclicality	
Cap fiscal spending and wage bill by medium term GDP growth and nominal GDP growth, respectively, to avoid procyclical policies, prevent structural loosening and mitigate risks stemming from the high level of public debt.	Thea authorities have contained fiscal spending and wage bill within medium term GDP growth and nominal GDP growth, respectively. Some fiscal loosening took place during 2017–2019. A more durable mechanism to keep the public-sector wage bill in check has not been adopted by Parliament. The government has decided to reverse crisis-era public wage cuts gradually starting in 2018.
Mitigate fiscal risks from the introduction of a public health insurance system.	Reforms are ongoing to make the public health sector more competitive.
Focus on implementing key reforms in public financial management (PFM) and revenue administration (RA); pass the law on creation and functioning of SOEs.	PFM and RA reforms are being implemented, supported by Fund technical assistance. Legislative reform of SOEs, however, has stalled.
Implement Structural Reforms	
Strengthen judicial efficiency and commercial claims enforcement.	The legislation for the establishment of a commercial court is [currently undergoing legal vetting]. An action plan is being drawn based on issues identified in a functional review of the Cyprus's Court System prepared by the Irish Institute of Public Administration.
Strengthen central bank governance and undertake Local government and civil service reforms.	The amending legislation to strengthen the governance and autonomy of the CBC is [undergoing legal vetting]. A draft law on local government reform is currently being prepared [under discussion in Parliament]. Civil service reform has largely stalled.
Continue to improve the AML/CFT framework, including by ensuring effectively mitigating inherent AML/CFT risks.	A cap on the number of citizenships granted under the CIP has been introduced and the required period for holding investment lengthened; and a Committee for Supervision and Control as well as a Registry of Service Providers for the CIP scheme have been established.

Annex II. Revision of National Accounts Data and External Statistics

1. **Cyprus's national accounts data were recently revised, as part of a five-year benchmark revision.** On October 21, the Statistical Service of Cyprus (CYSTA) released a major revision in National Accounts data series according to the Harmonized European Revision Policy and the National Revision Policy. The revised data suggest a steeper economic contraction during the 2012–13 crisis and a faster subsequent economic recovery. The cumulative impact on nominal GDP was minor, with the 2018 nominal GDP level revised upward by 2 percent compared to the previous estimate. The cumulative contribution of private consumption to real GDP growth between 2002 and 2018 is now smaller, and the contribution of the net export is larger. The revision reflects mainly regular data verification performed by Eurostat, incorporation of 2015 Household Budget Survey, and data revisions from annual economic surveys, Government Financial Statistics as well as the Balance of Payments statistics (¶2). Higher nominal GDP levels imply lower ratios of macroeconomic variables to nominal GDP.

2. **Sizable revisions were made to external sector statistics.** The current account balance has been revised upward by 1.6 percent of GDP on average for 2008–18. The upward revision reflects mainly a large upward revision to services exports resulting from an expanded coverage of Cypriot entities offering financial services abroad, which outweighed a more modest upward revision to imports. The financial account balance, external debt and NIIP also saw revisions as a result of an expanded coverage of financial SPEs, which use their balance sheets for financial transactions. The financial account balance has been revised upward by 1.7 percent of GDP on average, with larger FDI outflows more than offsetting larger other investment inflows. While gross external debt was revised upward significantly, gross external debt excluding SPEs remain broadly unchanged. The revision of gross external debt has a less pronounced effect on NIIP, which was revised downward by -13 percent of GDP on average.

Cyprus: Revision of Natural Accounts Data and External Statistics



Source: Cystat.

Annex III. External Sector Assessment

Overall Assessment: *The external position of Cyprus in 2018 was moderately weaker than implied by medium-term fundamentals and desirable policies,* notwithstanding the sharp narrowing of the CA deficit and reduction in the REER since the banking crisis. The overall CA deficit improved in 2018 and is projected to slightly widen in 2019, while the underlying current account deficit, adjusted for one-off and SPEs, widened mainly due to a decline in services exports. Over the medium term, the current account deficit is set to narrow while the NIIP is projected to increase slightly in the near term and gradually decline over the medium term.

Potential Policy Responses: Maintaining financial stability through continued efforts to unwind the credit gap would be essential for external rebalancing by raising the current account and lowering net IIP liabilities. Structural reforms focused on investing in human capital and technological infrastructure would help to boost productivity and competitiveness for sustainable growth. Policies to boost service exports and enhance exports diversification, especially market diversification, would support export growth. Maintaining a prudent fiscal policy that avoids procyclicality would help safeguard the downward path of public debt and create space to absorb possible contingent fiscal shocks.

<table>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="5">Background. The net international investment position (NIIP) further improved to around -121 percent of GDP in 2018, compared to 2017 (-127 percent of GDP) and the peak in 2014 (-164 percent of GDP). The composition of foreign liabilities also changed, as FDI outflows decreased to 35 percent of GDP while other investment inflows declined to -172 percent of GDP. Excluding the contribution of SPEs' foreign financial positions, the underlying NIIP improved from -78 percent in 2014 to -40 percent of GDP in 2018. The NIIP is dominated by the private sector, which stood at -120 percent of GDP in 2018 and -38 percent excluding the effects of SPEs. Gross liabilities declined at 2421 percent of GDP in 2018[1], with around one third in the form of external debt. With CA deficit projected to widen in 2019, the NIIP-to-GDP ratio is expected to slightly weaken in 2019 then gradually improve over the medium term with lower CA deficits.
Assessment. External vulnerabilities have been reduced with the strengthening of the NIIP in recent years. The size of NIIP remains significant reflecting Cyprus's role as a financial center and the effects of SPEs. NIIP remains broadly sustainable. The large gross liability position present vulnerabilities but is mitigated by matching assets of similar maturity.</td></tr>
<tr><td>2018 (% GDP)</td><td>NIIP: -121
(underlying -40)</td><td>Gross Assets: 2300
(underlying 344)</td><td>Debt Assets:567
(underlying 267)</td><td>Gross Liab.: 2421
(underlying 384)</td><td>Debt Liab.:990
(underlying 259)</td></tr>
<tr><td>Current Account</td><td colspan="5">Background. The overall current account (CA) deficit narrowed in 2018 to 4.4 percent of GDP, while the underlying current account deficit widened to 3.4 percent after adjustment for the effects of SPEs. The underlying trade balance declined from 3.6 percent of GDP in 2016 to 0.7 percent of GDP in 2018, mainly due to increases in imports of goods and services outweighing increases in exports. The income balance after adjustment for SPEs was -4.1 percent of GDP, reflecting negative NIIP and outward remittances.
Assessment. Staff assesses that the CA gap in 2018 was -2.3 percent of GDP, which corresponds to an assessment that the external position was weaker than warranted by fundamentals and desirable policy settings. Policy gaps, reflecting deviations of current policy settings in Cyprus and the rest of the world (ROW) from their desired settings, contribute 4.3 percentage point. This net effect can be</td></tr>
</table>

[1]Gross assets and gross liabilities have been revised up significantly mainly due to enhanced coverage of financial SPEs. The net effects on NIIP are, however, small.

<table>
<tr><td></td><td colspan="5">decomposed into the contribution from (i) the private credit gap (-1.3 percentage point) reflecting Cyprus's still large credit gap relative to the ROW's and the private credit growth gap (1.4 percentage point) reflecting the deleveraging needed; (ii) fiscal policy (0.8 percentage point) that is due to the ROW as Cyprus's cyclically-adjusted fiscal balance is considered appropriate; (iii) public health expenditure gap (3.1 percentage point); and (iv) change in reserves and capital control (total 0.4 percentage point).</td></tr>
<tr><td>2018 (% GDP)</td><td>Actual CA (underlying): -3.4</td><td>Cycl. Adj. CA: -3.2</td><td>EBA-lite CA Norm: -0.9-0.9</td><td>CA Gap: -2.3</td><td>Policy Gap: 4.3</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="5">Background. The real effective exchange rate stayed at post-crisis low in 2018 with slight depreciation, as low wages held down ULCs. PPI of capital goods remained subdued and PPI of intermediate goods declined further. In the first half of 2019, there was another 1 percent depreciation compared to Q4 2018.

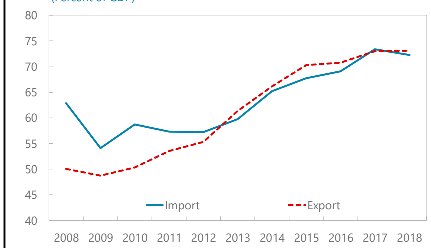
Assessment. The EBA-lite REER model estimates a small REER undervaluation of 1.5 percent in 2018, and the external sustainability (ES) model suggests a REER undervaluation of 0.2 percent. Whereas the EBA-lite CA model points to an overvaluation of around 4.4 percent. Considering all estimates and the uncertainties around them, staff's assessment is based on the EBA CA model and estimates the REER gap in 2018 to be in the range of -1.5 to 4.4 percent in 2018.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="5">Background. Net capital inflows further decelerated in 2018 to 4.7 percent of GDP for the private sector (including SPEs), from 17 percent in 2017. Net FDI inflows increased to 34.5 percent of GDP (largely due to SPEs), while private net portfolio outflows reached 17 percent of GDP as residents increased their acquisition of foreign assets. Net public outflows from the central bank declined to 5 percent in 2018 from 17 percent in 2017, with TARGET2 balance stayed at 37 percent of GDP.

Assessment. With sizable external debt of the public and private sectors, Cyprus remains exposed to financial market risks.</td></tr>
<tr><td>FX Intervention and Reserves</td><td colspan="5">Background. The euro has the status of a global reserve currency.
Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
</table>

Annex IV. Export Competitiveness

1. **Cyprus's exports made a robust recovery in the post-crisis period albeit at a slower pace in recent years.** With imports growth outpacing exports, the current account deficit (excluding Special Purpose Entities) increased from 0.4 (1) percent of GDP in 2015 to 4.4 (3.4) percent in 2018. Exports of goods have been stagnant as a share of GDP despite subdued unit labor cost and producer price indices for external markets over the past five years and relatively favorable competitiveness rankings. Exports of services have picked up rapidly from 2013, but has slowed significantly in 2018 with declining financial service exports and slower growth of other services sectors.

Trade Balance
(Percent of GDP)

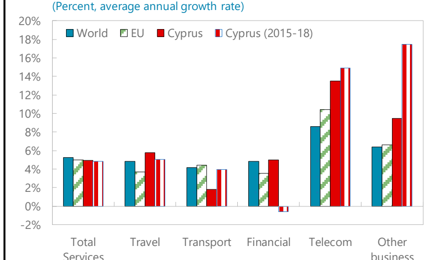


Sources: Central Bank of Cyprus; and IMF staff calculations.

2. **Overall export competitiveness has been hindered by limited opportunities for diversifying its product mix in a small island economy.** Export shares in the world market has been stagnant for goods while broadly in line with the euro area for services**.** Product diversification of goods exports remains limited. This reflects both extensive margin (number of export product categories) and intensive margin (more balanced shares of products in the export baskets). Cyprus' Economic Complexity Index (ECI), which measures of the capabilities and knowhow of the country as determined by the diversity and complexity of the products it exports, has also been stagnant. Given its strategic location, more progress has been made in diversifying its export markets.

3. **Services exports, heavily concentrated to Europe, have performed well in line with global and EU-wide trends.** The recent growth has been fueled by sectors such as ICT, business services and travel, buoyed by the recovery in Europe and the impact of technological advances on global ICT-enabled trade. Growth in financial services exports, however, has been lagging significantly since 2015. Services exports growth rate has also been more volatile, reflecting the heavy concentration of export destinations in the European market, namely the UK, Russia and the EU.

Export Services Growth, 2010-2018
(Percent, average annual growth rate)



Sources: IMF BOPS; and IMF staff calculations

4. **Policies to support greater market diversification, enhance competition and efficiency and strengthen technological adoption would help sustain exports growth.** Diversification into newer, higher growth economies outside Europe that are rapidly catching up would also help reduce volatility. Policies to ensure competition, greater efficiency and contestability of markets would help attract more FDI and improve the quality and cost of services. It will also help to encourage innovation and investment, which is key for ICT-enabled sectors with easier entry of low-cost service providers. Given the large share of financial services in Cyprus's exports, which continues to suffer from inefficiencies, stronger efforts to address these challenges will also be critical. Greater investment in STEM training as well as technological investments would help support technological upgrading, strengthen efficiency and improve exports growth.

Annex V. Debt Sustainability Analysis

The Public Debt Sustainability Analysis for Market-Access Countries indicates that in the baseline, public debt is on a rapid downward path after a sharp one-off increase in 2018. However, risks to debt sustainability remain high and debt reduction could be temporarily halted by an adverse short-term growth shock or a fiscal shock, including from contingent liabilities. If a combination of macro-fiscal shocks and a contingent liability were to materialize, public debt would rise to, and remain at, a very high level. Gross public financing needs have recently increased and could rise further under macro-fiscal and contingent liability shocks but are expected to remain below high vulnerability thresholds.

A. Baseline Scenario

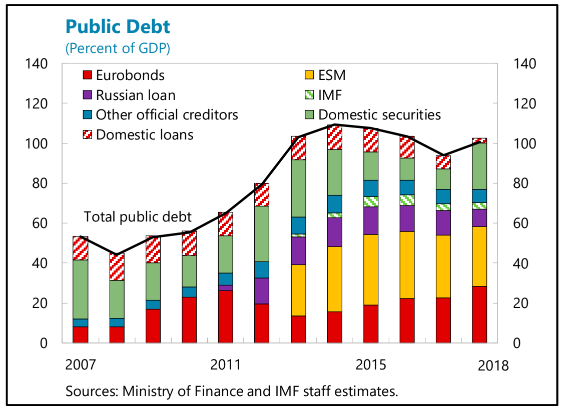
1. One-off factors led to an increase in the debt ratio last year after a sharp decline in 2017.[1] The government took advantage of rapidly-rising cash balances arising from the increasing primary surplus and strong growth in 2017 to repay part of its debt to the Fund and the CBC ahead of schedule. As a result, public debt declined sharply to 93.9 percent of GDP at end-2017 from 103.4 percent of GDP a year earlier. However, as part of the conditions to sell assets and liabilities (primarily customer deposits) of the CCB to Hellenic Bank, the government placed €3.19 billion domestic bonds (15 percent of GDP) at the CCB in July 2018. Despite an early repayment of the remaining balance of the debt owed to the CBC (€483 million) at end-2018, this transaction contributed to an increase in public debt to 100.6 percent of GDP at end-2018.

2. Public debt is projected to resume a rapid decline from 2019. Projected high primary surpluses and robust economic growth will support a durable decline in public debt to 64 percent of GDP by 2024.

3. The placement of domestic bonds at the CCB has increased gross public financing needs (GPFN). The debt issuance to the CCB was implemented through a private off-market placement of domestic bonds, which are being redeemed gradually over a five-year period beginning last year. Nevertheless, following the debt management operation to repay early the loan to Russia this year (€1.56 billion), GPFN will remain well below the benchmark for advanced economies (20 percent of GDP) over the projection horizon. Looking forward, the authorities plan to issue medium- or long-term Eurobonds each year to maintain a cash buffer sufficient to cover gross financing needs on a nine-month forward rolling basis.

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

B. Risk Assessment



4. High NPLs poses a risk to the sustainability of public debt. As part of the CCB sale, the government agreed to an Asset Protection Scheme (APS) covering the loan portfolio transferred to the HB (€2.6 billion), although the eventual loss to which the government is exposed will likely be much smaller.[2] In addition, broader risk from NPLs at other systemic banks could spill over to the government's balance sheet if higher provisioning and recapitalization needs cannot be met through private financing. On the other hand, the baseline scenario conservatively assumes zero recovery from the NPLs in the public AMC.

5. Cyprus's current high level of public debt also leaves it vulnerable to macro-fiscal shocks. Under the baseline, Cyprus's public debt ratio is projected to remain above the benchmark for advanced economies (85 percent of GDP) until 2021. The probability that public debt to GDP could remain high over the medium-term has diminished somewhat. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 85 percent until 2024 with a probability of 17 percent (fan chart in Annex Figure 1).[3]

6. Gross public financing needs are susceptible to a range of shocks. In the event of short-duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would jump several percentage points of GDP, although it remains well below the 20 percent benchmark.

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

- Given Cyprus's role as a financial center and business hub, private sector short-term foreign liabilities are very large, reflecting mainly nonresident deposits in Cypriot banks and foreign debts of nonfinancial corporates, although they are estimated to have declined in 2018 on ongoing reductions in non-resident deposits at Cypriot banks. The private sector GFN may create pressure if liabilities are not rolled over or flows reverse, although gross liabilities are to a considerable extent matched by gross assets of a similar duration.

- 74 percent of public debt is owed to non-residents. However, about 55 percent of this debt reflects official financing from the ESM and the IMF, and loans from the European

[2] Independent estimates put likely fiscal cost at €120 million (0.6 percent of GDP).

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

Investment Bank and the Council of Europe Development Bank.[4] Cyprus also issued 15- and 30-year Eurobonds this year, lengthening the average maturity of the stock of Eurobonds. The relatively low and/or fixed interest rate on official liabilities, combined with long maturities and the back-loaded repayment schedule on a significant share of debt, mitigates interest rate and financing risks.[5]

- Cyprus's sovereign credit has recently been upgraded to investment grade, reflecting lower levels of uncertainties owing to the resolution of the CCB and the passage of a long-delayed legislative package to strengthen the insolvency and foreclosure frameworks. The 10-year sovereign bond spread relative to German bonds—an indicator of market perception of sovereign risk—was around 106 basis points on average in the past three months, below the lower risk-assessment benchmark.

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

C. Realism of Baseline Assumptions

8. **GDP growth and fiscal outturns have surpassed staff's forecasts in recent years, in contrast to previous excessive optimism.** Recent GDP growth and the fiscal balance have been stronger than expected, due in part to robust external demand and private financial inflows that have substituted for new bank lending. This over-performance occurred despite the sizable structural fiscal consolidation during the program. In contrast, projection errors during 2012–13 indicate excessive optimism although these errors reflect difficult-to-foresee events (damage to the sole power plant in 2011 and the write-down of banks' holdings of Greek public debt in 2012). The relatively high 3-year average level of projected cyclically-adjusted primary balance is underpinned by consistent overperformance of tax revenue in recent years and the authorities' commitment to expenditure restraint.

D. Stress Tests and Alternative Scenarios

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

- **Growth shock.** A one standard deviation (4.1 percentage points) decrease in growth during 2020–21, accompanied by (i) a 51 and 106 basis points (bps) rise in interest rates in 2020 and 2021, respectively (corresponding to 25 bps rise per one percentage point reduction in primary balance), and (ii) a decrease in inflation by 0.25 percentage points per percentage point reduction in GDP growth, would raise public debt by 16 percentage points relative the baseline to 100 percent of GDP by 2021, before declining to 80 percent of GDP by 2024.

[4] The authorities announced their intention to make an early repayment of the full amount of outstanding Fund credit in 2020.

[5] The authorities estimate as of end-September 2019, the weighted average maturity of total debt is 7.3 years, while that of marketable debt is 6.3 years, significantly longer than at end-2018. The shares of debt that falls due within 1 year and 5 years are 7.2 percent and 42.7 percent, respectively.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.6 percent of GDP during 2020–21, accompanied by 40 bps rise in interest rates (corresponding to 25 bps rise per one percentage point reduction in primary balance) and an increase in the real interest rate by 490 bps during 2020–24 would raise public debt marginally to 67 percent and 66 percent of GDP, respectively.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 103 percent of GDP in 2021 before declining to 85 percent of GDP by 2024. Gross financing needs would peak at 11 percent of GDP in 2021–22 before falling back.

10. Under a scenario with a lower fiscal balance and realization of contingent liabilities from government guarantees and court cases, the public debt-to-GDP ratio declines very slowly. The primary fiscal balance is assumed to be permanently lower than in the baseline by ½ standard deviation, which could materialize from the reversal of expenditure measures implemented during the adjustment program or the higher-than-expected fiscal cost of the forthcoming National Health System (NHS) implementation. Further realization of contingent liabilities from government guarantees to public entities, pension deficits of public entities and court cases against the public-sector wage cuts implemented during the banking crisis (7 percent of GDP) is also assumed. As risk premiums rise, interest rate is higher than under the baseline by 270 basis points in 2020 and 40–60 basis points thereafter. Under this scenario, public debt would rise to 99 percent of GDP in 2020 and thereafter decline to 83 percent in 2024. Gross financing needs would spike to 16 percent of GDP in 2020 before declining to 7 percent in 2024.

11. Under an alternative adverse scenario of lower economic growth and primary fiscal balances combined with a further realization of contingent liabilities from the banking sector (adverse macro-fiscal-contingent liability (CL) scenario), public debt and gross financing needs remain high. Real GDP growth and the primary fiscal balance are assumed to be permanently lower than in the baseline by ½ standard deviation which could materialize from a productivity slowdown and an unforeseen fiscal loosening. These shocks are assumed to be accompanied by a decrease in inflation and a rise in interest rates. Further realization of contingent liabilities from the banking sector (13 percent of GDP) in 2020, on top of the support already provided to the CCB, is also assumed.[6] Under this adverse scenario, public debt would rise to 105 percent of GDP in 2020 and would decline only slowly to 98 percent of GDP in 2024. Gross financing needs would also spike to 20 percent of GDP in 2020 before declining to 9 percent of GDP over the medium term.

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

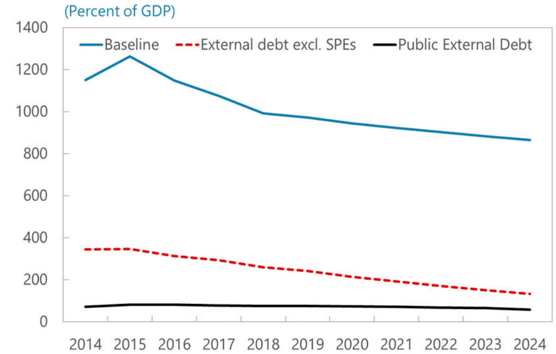
E. External Debt Sustainability Analysis

12. Cyprus's external debt declined from 1074 percent of GDP in 2017 to 991 percent of GDP in 2018 with continued recovery after crisis. [7] The high external debt level reflects its role as a financial center and the presence of SPEs. After excluding SPEs, gross debt amounted to 259 percent of GDP in 2018. Net debt is considerably smaller and declined from 482 to 424 percent of GDP for the economy and declined from 0 to -7 percent after excluding SPEs. The private sector continued to account for the bulk of Cyprus's external debt, of which external debt of MFIs declined from 98 to 74 percent of GDP, other private sector declined from 380 to 356 percent of GDP, and inter-company liabilities associated with direct investment declined from 516 to 483 percent of GDP in 2018.

F. Baseline Projections

13. External debt is projected to decline gradually over the medium term under the baseline scenario. Gross external debt is projected to decline from 972 percent of GDP (€214 billion) in 2019 to 865 percent of GDP (€242 billion) by 2024. Net external debt is projected to decline from around 399 percent of GDP to 246 percent of GDP by 2024. Government external debt as a share of GDP declines over the medium-term to around 58 percent of GDP on the assumption of continued fiscal prudence. Banks are forecast to reduce external debt to around 42 percent of GDP, mostly reflecting further declines in nonresident deposits. External debt of private nonbank sectors is also forecast to decline but remain high to around 336 percent of GDP in 2024, as projected current account deficits are assumed to be mostly financed by FDI inflows. Gross debt excluding that of SPEs is anticipated to fall to around 133 percent of GDP in 2024 from 241 percent of GDP in 2019.

External Debt Path
(Percent of GDP)



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

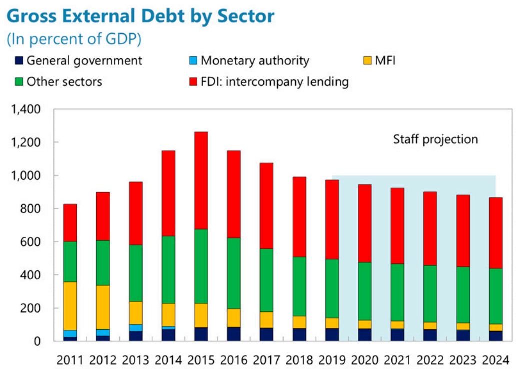
14. Nominal GDP growth is expected to remain the primary driver of the decline in the gross external debt ratio over the medium term. In the projection period, nominal GDP is

[7] Cyprus is a regional financial center and its external assets and liabilities are very large. The external DSA focuses on gross external debt and associated gross interest payments. However, changes in gross external debt may be accompanied by changes in gross external assets, which—in a financial center—could be large and volatile if SPEs engage in operations to expand or shrink their balance sheets, even though net positions may be unchanged. Large historical residuals in the external DSA suggest that indeed past increases in external debt were accompanied by increases in external assets. This notwithstanding, the DSA provides a tool for assessing risks emanating from macro-financial shocks in the presence of large gross external debt. Note the recent external debt data revisions reflect enhanced coverage of financial SPEs which have main effects on the gross and net debt of SPEs, while non-SPE data have minor changes (Annex II).

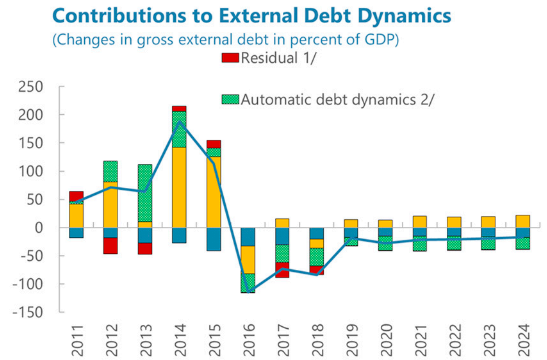
forecast to grow by 4.8 percent annually on average, contributing to an annual external debt reduction of 24.6 percentage points of GDP. At the same time, growth is expected to sustain the trade deficit (0.3 percent of GDP annually, on average), which together with net interest payments (8 percent of GDP annually, on average), is forecast to partially offset the denominator effect. The result would be an average annual decline in external debt by 10.1 percentage points of GDP.

Cyprus: External Debt Developments and Forecast, Including SPEs

Reductions in debt of the general government and private sector are expected to drive the fall in external debt.



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



Sources: Central bank of Cyprus, Ministry of Finance, and IMF staff estimates.
1/ Including valuation effects.
2/ Including the effects from interest rate, GDP growth, and price and exchange rate effects.

G. Risks to External Debt Sustainability

15. Standard bounds tests indicate that the baseline is vulnerable to macroeconomic shocks. Standardized shocks to interest rates and economic growth would significantly impede debt reduction, as the large size of external debt would markedly increase debt services costs in the case of higher interest rates and reduce the denominator effect on the debt-to-GDP ratio. On the other hand, standardized current account deficit shocks would have a more limited impact on the debt ratio.

- **Interest rates shock.** A two-percentage point increase in average interest rates on external debt throughout the projection period would worsen the income account and raise the external debt ratio by 105 percentage points above the baseline by 2024.

- **Growth shock.** A one-half standard deviation decrease in projected real GDP growth throughout the projection period could increase the external debt ratio by 90 percentage points by 2024 compared to the baseline.

- **Current account deterioration.** The impact of a one-half standard deviation shock to the current account balance is more limited, pushing debt-to-GDP ratio 22 percentage points higher by 2024 compared to the baseline.

- **Combination of shocks.** A combination of one-quarter standard deviation shocks to the nominal interest rate, growth, and current account would worsen the debt dynamics and raise the debt ratio by 109 percentage points by 2024 relative to the baseline.

- **Historical scenario.** Reversion of the growth rate, interest rate, inflation, and the current account balance to their average levels during the previous five years would drive the debt ratio higher by 38 percent of GDP by 2024 mostly reflecting near-zero inflation.

E. Gross Financing Needs

16. Gross external financing needs are projected to decline but remain elevated (over 190 percent of GDP) through the projection period. This reflects the projected stock of short-term debt of the private sector, which remains sizable even after declining roughly 137 percent of GDP over the last three years to around 162 percent of GDP. Around 86 percent of external debt owed by banks is short-term, while about one-quarter of external debt owed by other private sector borrowers is short-term. In this context, Cyprus faces rollover risk in the event borrowers do not have sufficient liquid assets or if market funding becomes too costly. The projected reduction in the GFN largely reflects banks' reduced non-resident deposits, as well as declining public sector debt.

F. Conclusion

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

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

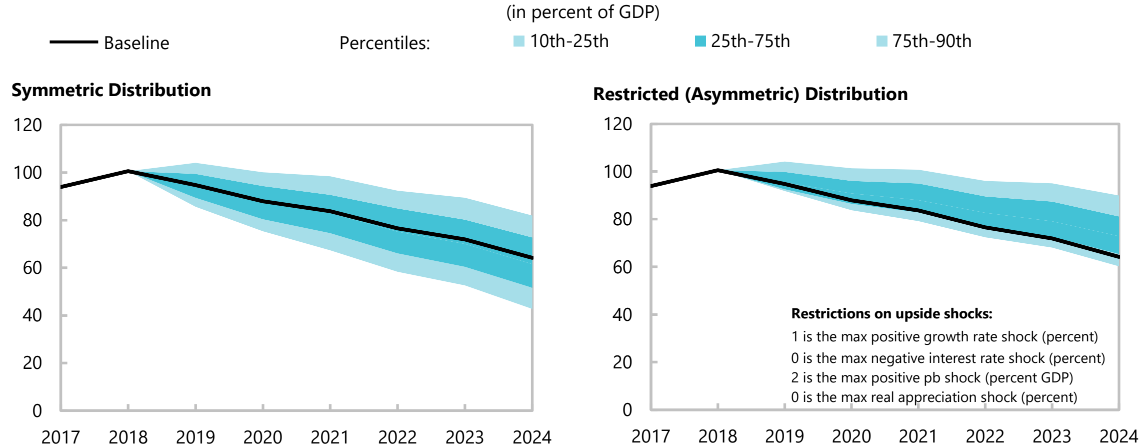
Figure 1. Cyprus: Public DSA Risk Assessment

Heat Map

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

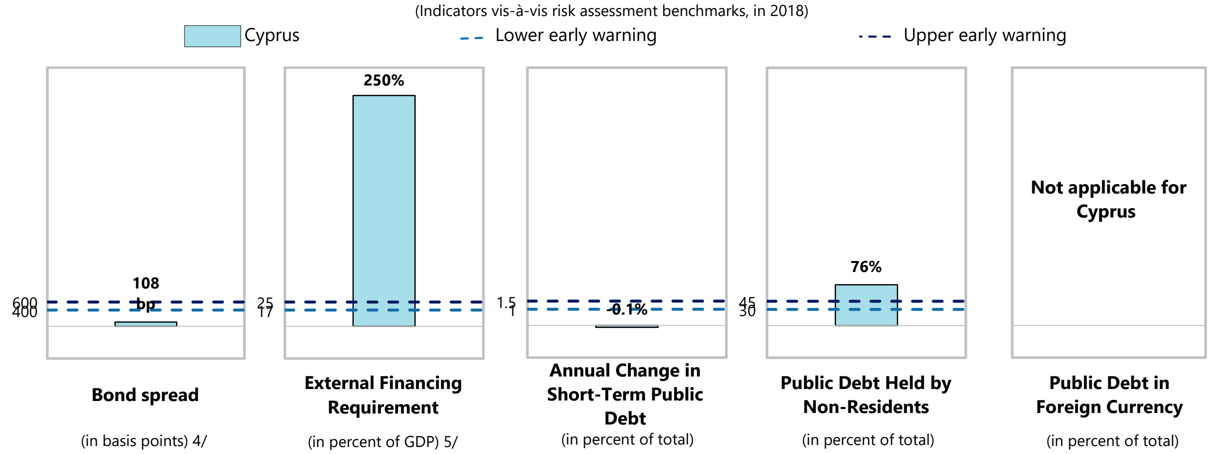
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

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



Source: IMF staff.

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

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

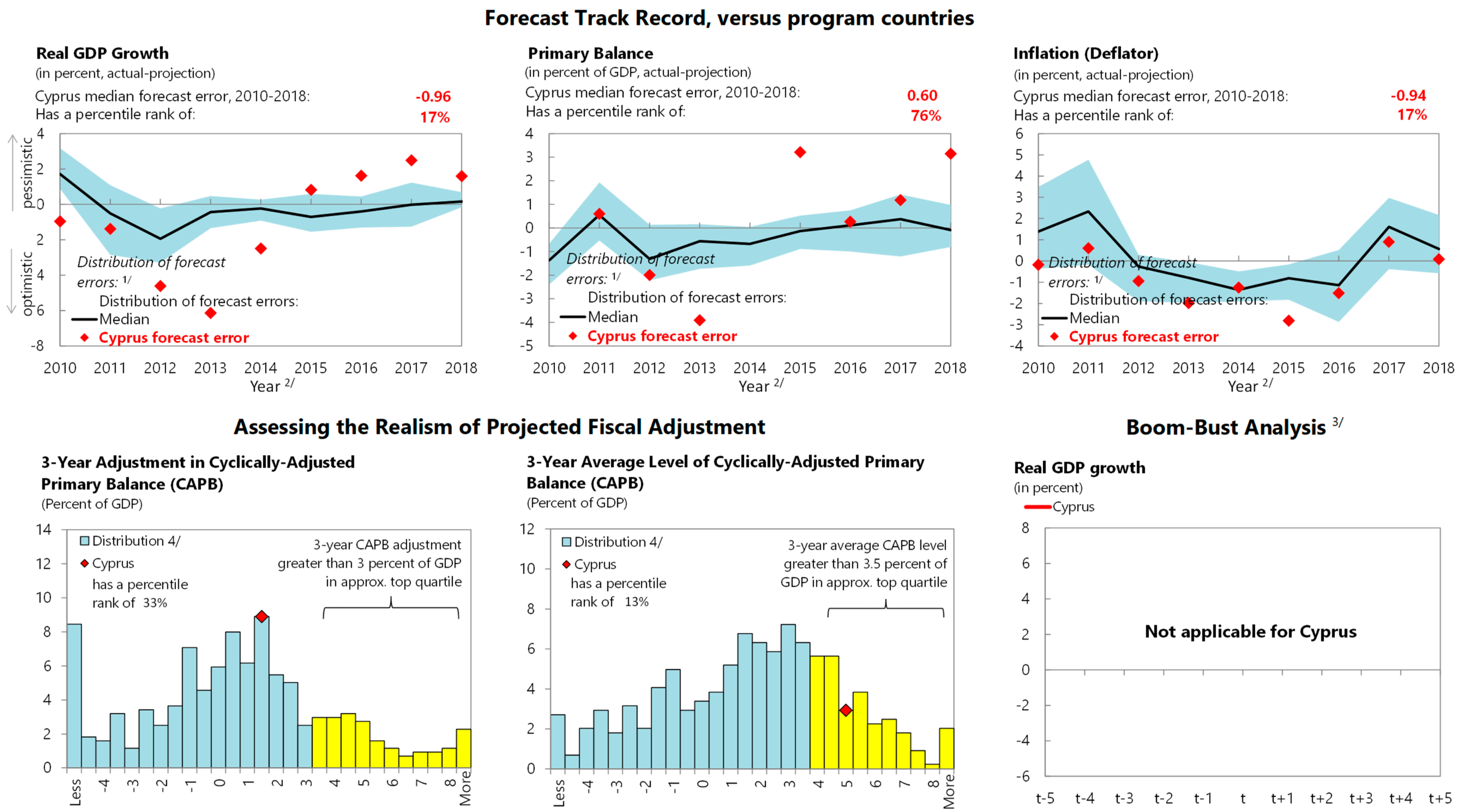
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Jul-19 through 30-Sep-19.

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

Figure 2. 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 obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Cyprus: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

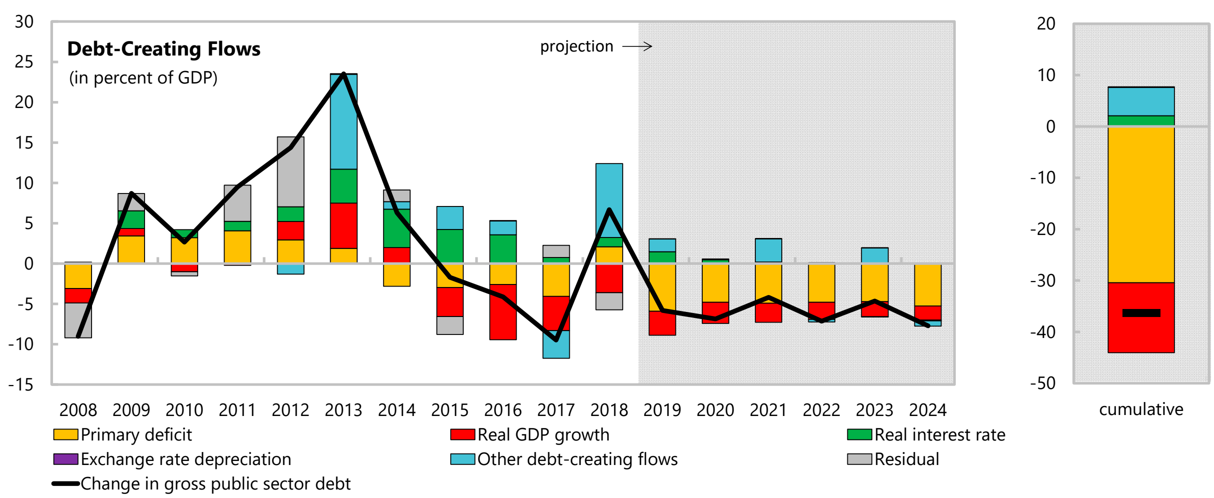
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	80.0	93.9	100.6	94.8	87.9	83.7	76.6	71.9	64.2
Public gross financing needs	13.5	9.6	15.5	12.3	4.9	2.9	6.8	3.9	4.4
Real GDP growth (in percent)	0.3	4.4	4.1	3.1	2.9	2.8	2.6	2.5	2.5
Inflation (GDP deflator, in percent)	0.7	1.7	1.4	0.9	2.0	2.2	2.3	2.3	2.4
Nominal GDP growth (in percent)	0.9	6.2	5.5	3.9	4.9	5.1	5.0	4.9	5.0
Effective interest rate (in percent) [4/]	3.9	2.6	2.7	2.4	2.6	2.5	2.4	2.3	2.2

As of September 30, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		109
5Y CDS (bp)		90
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	5.6	-9.5	6.7	-5.8	-6.9	-4.2	-7.1	-4.7	-7.7	-36.4	
Identified debt-creating flows	4.5	-11.0	8.8	-5.8	-6.9	-4.2	-7.2	-4.7	-7.7	-36.5	
Primary deficit	0.4	-4.1	2.1	-5.9	-4.8	-4.9	-4.8	-4.7	-5.3	-30.4	-2.5
Primary (noninterest) revenue and grant:	37.5	38.4	39.1	41.4	43.7	44.2	44.0	43.9	44.4	261.5	
Primary (noninterest) expenditure	38.0	34.4	41.2	35.5	38.9	39.2	39.1	39.2	39.1	231.1	
Automatic debt dynamics [5/]	2.3	-3.5	-2.5	-1.5	-2.1	-2.2	-2.0	-1.9	-1.9	-11.6	
Interest rate/growth differential [6/]	2.3	-3.5	-2.5	-1.5	-2.1	-2.2	-2.0	-1.9	-1.9	-11.6	
Of which: real interest rate	2.6	0.8	1.2	1.5	0.5	0.2	0.1	0.0	-0.1	2.1	
Of which: real GDP growth	-0.3	-4.2	-3.6	-3.0	-2.6	-2.4	-2.1	-1.9	-1.7	-13.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	1.8	-3.4	9.2	1.6	0.0	2.9	-0.3	1.9	-0.6	5.5	
Privatization/Drawdown of Deposits (+	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	1.8	-3.4	9.2	1.6	0.0	2.9	-0.3	1.9	-0.6	5.5	
Residual, including asset changes [8/]	1.1	1.5	-2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1	

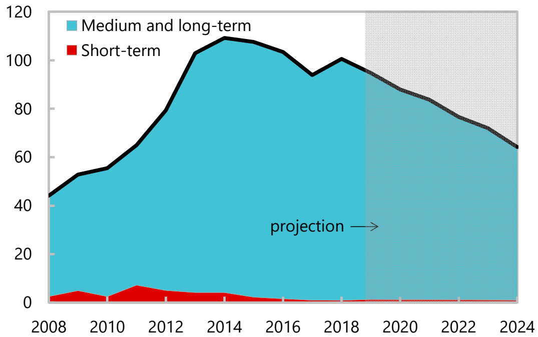


Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ))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

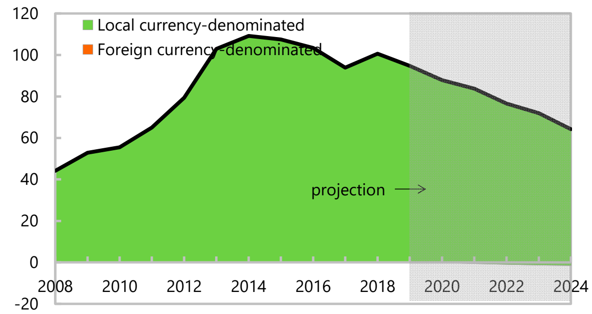
Figure 4. Cyprus: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



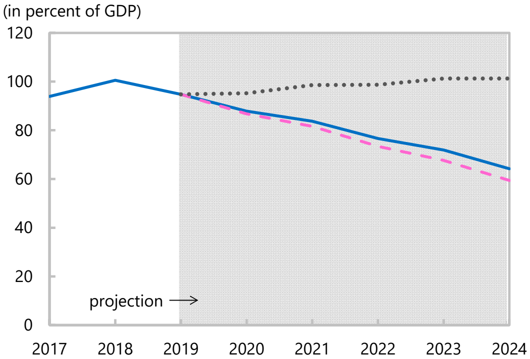
By Currency
(in percent of GDP)



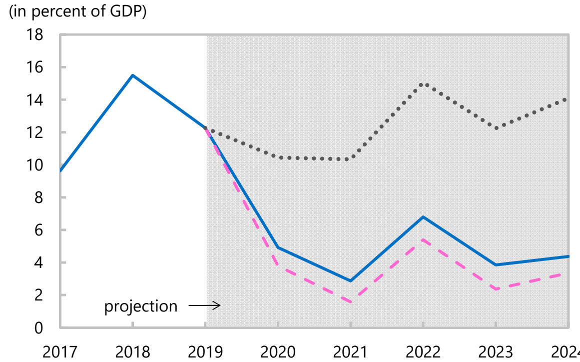
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

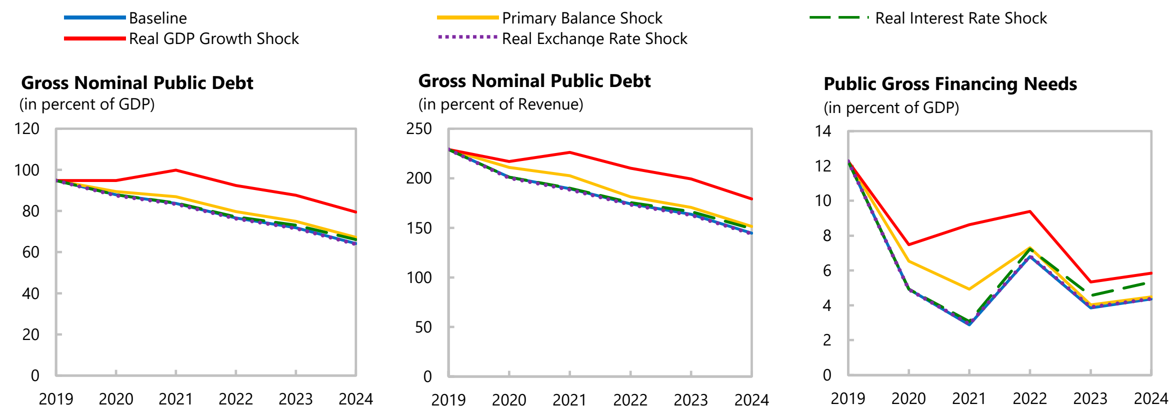
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary Balance	5.9	4.8	4.9	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.5	2.4	2.3	2.2
Constant Primary Balance Scenario						
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary Balance	5.9	5.9	5.9	5.9	5.9	5.9
Effective interest rate	2.4	2.6	2.5	2.5	2.3	2.3

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.1	0.7	0.7	0.7	0.7	0.7
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary Balance	5.9	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	2.4	2.6	2.7	2.9	3.0	3.2

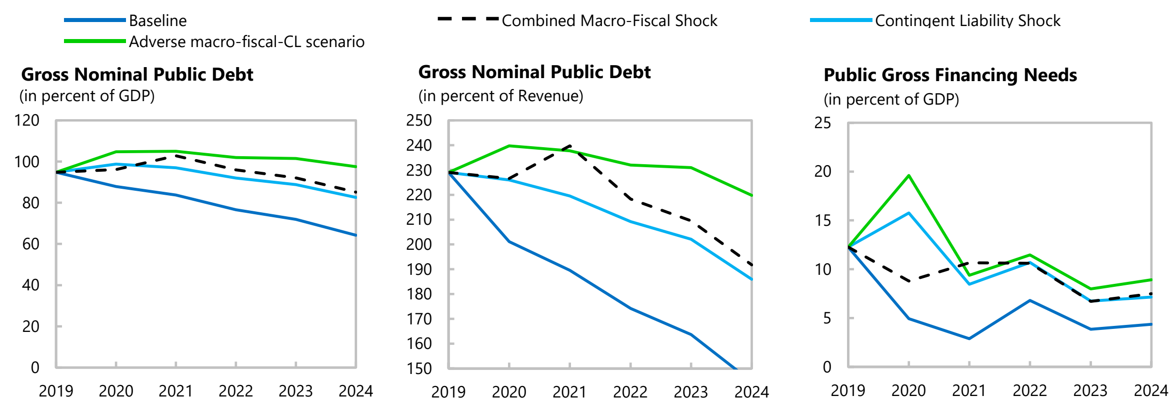
Source: IMF staff.

Figure 5. Cyprus: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



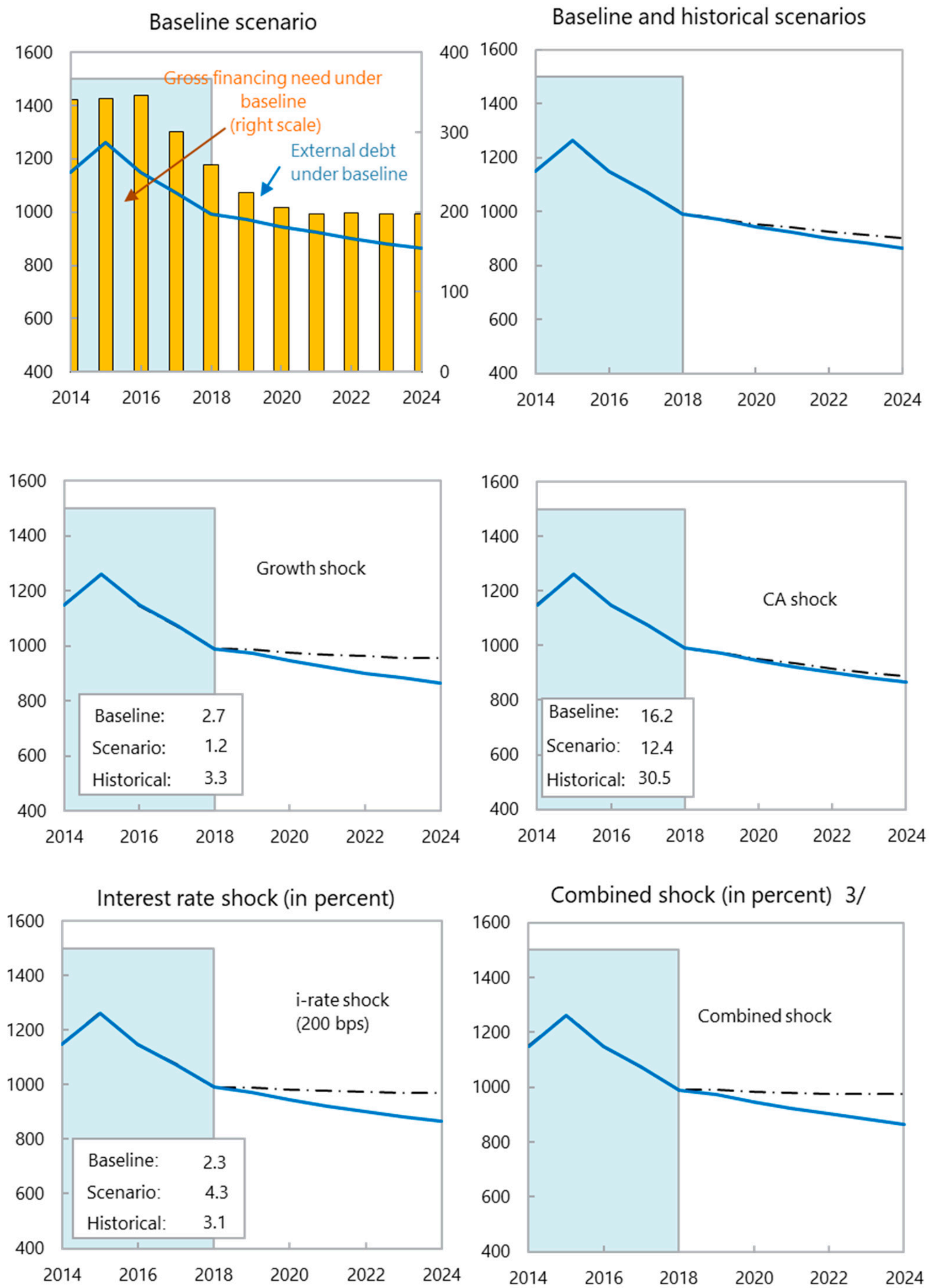
Underlying Assumptions
(in percent)

Primary Balance Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary balance	5.9	3.2	3.3	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.5	2.5	2.3	2.3
Real Interest Rate Shock						
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary balance	5.9	4.8	4.9	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.7	2.9	3.1	3.4
Combined Shock						
Real GDP growth	3.1	-1.2	-1.3	2.6	2.5	2.5
Inflation	0.9	0.9	1.2	2.3	2.3	2.4
Primary balance	5.9	1.5	-0.6	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.8	3.2	3.5	3.8

Real GDP Growth Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	3.1	-1.2	-1.3	2.6	2.5	2.5
Inflation	0.9	0.9	1.2	2.3	2.3	2.4
Primary balance	5.9	2.7	0.7	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.5	2.5	2.4	2.3
Real Exchange Rate Shock						
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.4	2.2	2.3	2.3	2.4
Primary balance	5.9	4.8	4.9	4.8	4.7	5.3
Effective interest rate	2.4	2.6	2.5	2.4	2.3	2.2
Contingent Liability Shock						
Real GDP growth	3.1	2.9	2.8	2.6	2.5	2.5
Inflation	0.9	2.0	2.2	2.3	2.3	2.4
Primary balance	5.9	-6.0	2.5	2.6	3.1	3.7
Effective interest rate	2.4	2.6	2.7	2.7	2.6	2.6

Source: IMF staff.

Figure 6. Cyprus: External Debt Sustainability—Bound Tests 1/ 2/
(In percent of GDP)



Sources: Ministry of Finance; Central Bank of Cyprus; and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead. Unlike the default settings, the path of non-debt creating flow is set to be the same as the baseline, because its historical average is influenced by exceptional flows during the crisis period and seems too optimistic.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Figure 7. Cyprus: External Debt Sustainability Framework, 2014–2024

(Percent of GDP, unless otherwise indicated)

	Actual							Projection						Debt-stabilizing non-interest current account 5/
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	
1 **Baseline: External debt**	1149	1263	1148	1074	991			**972**	**944**	**923**	**902**	**882**	**865**	**0.7**
2 Change in external debt	188.0	113.4	-115.0	-73.4	-83.6			-18.7	-27.7	-21.5	-21.3	-19.2	-17.3	
3 Identified external debt-creating flows (4+9+14)	178.7	99.1	-114.9	-46.2	-67.9			-18.3	-27.4	-21.2	-21.0	-18.9	-17.0	
4 Current account deficit, excluding interest payments	-27.5	-41.5	-32.9	-30.3	-20.3			-17.7	-15.2	-15.1	-15.4	-16.2	-17.7	
5 Deficit in balance of goods and services	-0.9	-2.6	-1.7	0.4	-0.8			1.4	1.4	0.7	0.1	-0.5	-1.1	
6 Exports	66.1	70.3	70.8	73.0	73.1			70.6	72.3	72.0	71.9	72.0	72.0	
7 Imports	65.2	67.7	69.0	73.4	72.3			72.0	73.7	72.7	72.1	71.5	70.9	
8 Interest receipts (negative)	-12.4	-16.5	-14.7	-13.2	-12.9			-12.4	-11.3	-11.5	-12.0	-12.7	-14.2	
9 Net non-debt creating capital inflows (negative)	142.3	125.6	-49.1	15.5	-16.5			14.1	13.2	19.9	18.7	19.7	21.6	
10 Net foreign direct investment, equity	182.4	159.4	-39.9	10.5	-20.1			-0.2	-2.4	-2.8	-2.4	-2.4	-2.7	
11 Net portfolio investment, equity	-12.8	-14.1	4.0	18.8	8.4			5.1	-1.3	3.5	0.7	0.6	-2.9	
12 Net sales of assets under other investment	-30.1	-14.7	-15.1	-15.4	-4.7			9.1	17.0	19.2	20.3	21.5	27.1	
13 Financial derivatives, net	2.8	-4.9	1.8	1.6	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
14 Automatic debt dynamics 1/	64.0	14.9	-32.9	-31.5	-31.1			-14.7	-25.4	-26.0	-24.3	-22.4	-20.9	
15 Contribution from nominal interest rate	31.6	41.9	37.1	35.4	24.7			22.9	20.1	19.4	19.4	19.6	20.8	
16 Contribution from real GDP growth	18.5	-37.9	-80.5	-47.1	-41.4			-29.2	-26.9	-25.2	-23.2	-21.9	-21.3	
17 Contribution from price and exchange rate changes 2/	13.9	10.9	10.5	-19.7	-14.5			-8.4	-18.6	-20.3	-20.5	-20.2	-20.3	
18 Residual (2-3 or 19+20+21+22)	9.3	14.2	0.0	-27.2	-15.7			-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	
19 Net accumulation of official reserve assets	0.0	0.0	-0.1	0.0	0.2			0.0	0.0	0.0	0.0	0.0	0.0	
20 Captial account flows, net (negative)	-0.8	0.0	-0.1	-0.4	-0.6			-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	
21 Errors and omissions, net (negative)	-1.7	-2.2	-2.2	-3.7	-1.3			0.0	0.0	0.0	0.0	0.0	0.0	
22 Changes in debt stock without flow transactions, incl. valuation changes, write-offs, and reclassifications	11.8	16.5	-17.2	-23.0	-14.0			-0.1	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	1739	1796	1622	1472	1356			1377	1306	1282	1253	1226	1201	
Gross external financing need (in billions of euros) 3/	59	61	65	60	55			49	48	48	51	53	55	
in percent of GDP	341	342	346	301	258			225	206	198	199	198	198	
Scenario with key variables at their historical averages 4/						5-Year Historical Average	5-Year Standard Deviation	**972**	**953**	**941**	**927**	**914**	**903**	Projected Average
Key Macroeconomic Assumptions Underlying Baseline														
Nominal GDP (in billions of euros)	17.4	17.8	18.9	20.0	21.1			22.0	23.0	24.2	25.4	26.7	28.0	
Real GDP growth (in percent)	-1.9	3.4	6.7	4.4	4.1	3.3	3.2	3.1	2.9	2.8	2.6	2.5	2.5	2.7
GDP deflator in euros (change in percent)	-1.4	-0.9	-0.8	1.7	1.4	0.0	1.5	0.9	1.9	2.2	2.3	2.3	2.4	2.0
Nominal external interest rate (in percent)	3.2	3.7	3.1	3.3	2.4	3.1	0.5	2.4	2.2	2.2	2.2	2.3	2.5	2.3
Growth of exports (euro terms, in percent)	4.2	8.9	6.5	9.6	5.6	7.0	2.3	0.4	7.4	4.6	4.9	5.0	5.0	4.6
Growth of imports (euro terms, in percent)	5.5	6.4	8.0	12.9	3.9	7.3	3.4	3.5	7.4	3.7	4.0	4.1	4.1	4.5
Current account balance, excluding interest payments	27.5	41.5	32.9	30.3	20.3	30.5	7.7	17.7	15.2	15.1	15.4	16.2	17.7	16.2
Net non-debt creating capital inflows	-142.3	-125.6	49.1	-15.5	16.5	-43.6	85.8	-14.1	-13.2	-19.9	-18.7	-19.7	-21.6	-17.9

Source: IMF staff estimates.

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

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

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

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

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

Annex VI. Developments in NPL Resolution in Cyprus

1. NPLs remain a significant part of banks' balance sheets in Cyprus. At end-2018, total NPLs in the banking system were €10.4 bn (30½ percent of total loans)[1]. About 70 percent of which were held by the largest two banks, Bank of Cyprus (BoC) and Hellenic Bank (HB). Aside from banks, state-owned asset management company (CAMC) holds additional NPLs of €6.9 bn. Around half of NPLs held by banks have been provisioned, with the remainder of these NPLs mostly backed by collaterals.

Cyprus: Non-Performing Loans by Credit Institutions, 2018

	NPLs (€ billions)	Provisions coverage (percent)
Total	**10.4**	**52**
Bank of Cyprus 1/	4.8	47
Hellenic Bank	2.5	55
RCB Bank LTD	0.0	82
Alpha Bank Cyprus Ltd	1.3	54
Eurobank Cyprus Ltd	0.1	62
Other banks	1.7	.
KEDIPES	**6.9**	

Sources: Central Bank of Cyprus; and banks' financial reports.

1/ NPLs for BoC includes the impact of Helix transaction and the impact of the agreement for sale of €33mn (gross book value) of retail unsecured NPLs (Velocity) signed in Decmeber 2018.

2. Compared with other high-NPL euro area countries, the NPL market in Cyprus is at a nascent stage. The first NPL portfolio sale in Cyprus was recorded in 2018, while NPL sales by banks in Italy, Ireland and Spain started in 2014.[2] Between 2018 and July 2019, seven NPL sales have taken place, with total NPL sales reaching €10 bn, versus the total completed NPL sales of over €205 bn in the European NPL market. The largest transaction (€6.9) in Cyprus, however, was a transfer of NPLs to CAMC. The second largest transaction was a sale by BoC (Helix transaction), involving €2.6 bn of NPLs.[3] The rest of NPL sales were smaller transactions, mainly by smaller banks to the subsidiaries of their foreign parents. Both BoC and HB plan to offload more NPLs by 2021, with the aim to reduce their NPL ratios to below 10 percent of their total loans.

3. Investor appetite for NPLs in southern European countries is expected to remain strong, with Cyprus as one of the target markets.[4] Italy, Spain and Greece are currently at the forefront of the attention of distressed assets investors,[5] but Cyprus is starting to gain traction. Around 16 percent of investors surveyed by Ashurst (2019) have already invested in Cyprus, and

[1] NPLs comprised of 38 percent of gross loans for households and 32 percent for NFCs, mostly SMEs concentrated in construction, tourism and trade sectors.

[2] See Deloitte, 2017, 'Shifting Momentum: Regulation Driving changes in European Loan Portfolio Markets'.

[3] These NPLs were transferred to a licensed Cypriot Credit Acquiring Company (CyCAC), which has changed its name to Gordian Holdings Limited in 2019H1. The shares in the CyCAC was initially held by BOC before being transferred to a SPV. Meanwhile, the SPV issued senior and junior debt instruments in the form of unrated tranches, and the buyer (Apollo investment fund) invest by way of junior loan made to the SPV.

[4] Information in this section is based on a survey conducted by Debtwire (2019), 'A Global NPL Perspective: Sellers and Investors Look to the Big Picture'.

[5] NPL sales in 2018 for euro-area countries include €103.6 in Italy, €43.2 bn in Spain, €13.9bn in Greece, and €8bn in Portugal. Top five buyers in Europe in 2018 were Cerberus (€29.7 bn), SGA (€18.3 bn), Lone Star (€15.1bn), Instrum (€13.7 bn), Barclays (€10.0bn).

30 percent of investors indicated their interest in buying NPLs in Cyprus. Overall, investors have preference for outright sales processes to the options of entering into either joint venture arrangements and synthetic transactions (securitizations). Buyers and sellers, however, have preference for different assets. Among all potential NPL investors, 44 percent cite SME loans and large commercial credits as top two asset classes that the market is more receptive to acquire, while for sellers, the most popular option (39 percent) is commercial real estate backed loans.

4. NPL workout by CACs, including the CAMC, is progressing. A range of NPL reduction solutions, including loan restructuring, foreclosures, and full settlements have been used for loan recovery. CACs frequently also use Debt-to-Asset swaps, contributing to sizable real estate holdings. In the case of the CAMC, which actively use the Debt-to-Asset swaps, real estate accounts for 8 percent of their total assets, as of end-June 2019.[6] With a sizable share of NPLs, of around 50 percent of GDP, now transferred to CACs, strengthening the supervisory and regulatory framework of CACs, including data reporting and analysis of the progress with NPL resolution will be crucial.

NPL Sales in Cyprus

Date of the sale	Seller	Buyer	Gross Book Value of NPLs (€ mn)
June, 2018	Hellenic Bank	B2Kapital Cyprus Ltd	144
Sep. 2018	Cyprus Cooperative Bank	Cyprus Asset Management Company Limited (KEDIPES)	6,900
2018H1	Alpha Bank	AGI Cypre Ermis LTD 1/	9.5
2018H2	Alpha Bank	AGI Cypre Ermis LTD 1/	372
2018H2	National Bank of Greece (Cyprus)	CAC Coral Limited 2/	0.4
2019H1	Bank of Cyprus	Gordian Holdings Limited	2,638
2019H1	Bank of Cyprus	APS Loan Management Ltd	30
Total			**10,094**

Sources: Central Bank of Cyprus; and banks' financial statements.
1/ A SPV or subsidiary of the parent bank, Alpha Group Investments Ltd.
2/ A subsidiary of the NBG Group.

5. Policies should be geared towards addressing several impediments in establishing an active NPL market in Cyprus.

- **Lack of a stable regulatory regime is also hindering timely disposals of NPLs thus forcing banks to hold even higher levels of capital.** Cyprus ranked low versus other NPL markets in terms of the efficiency of regulatory regime for obtaining and operating under a license to be a servicer of NPLs.[7] Lengthy foreclosures with weak debt enforcement and insolvency frameworks have prohibited banks from freeing up

[6] The press release on September 2019 "Progress report of SEDIPES/KEDIPES up to Jun 30, 2019," available at: https://kedipes.com.cy/μη-κατηγοριοποιημένο/πρόοδος-διαχείρισης-σεδιπεσ-κεδιπεσ/ (in Greek).

[7] See Debtwire (2019).

regulatory capital and generating new capacity for lending. The 2018 amendments to the foreclosure and insolvency legislation and the sales of loans law helped to address these regulatory impediments, but the recent changes to the foreclosures law, currently under review by the Supreme Court and not yet in effect, could create significant delays to the foreclosure process adversely impacting the sale price of NPL portfolios.

- **Low profitability and capital ratios of banks in Cyprus could create difficulties to close the bid-ask spread.** In general, more conservative provisioning policies would reduce the gap between banks' bid prices and NPL investors' ask prices, but this requires banks to have adequate profits or capital.[8] High capital ratios would allow banks to write down NPLs, facilitating their sale at higher haircuts.

- **The relatively small size of Cyprus' NPL market implies higher costs for buyers.** At 2018, the volume of NPLs in the European market was around €714 bn,[9] versus the small volume of NPLs (around €17 bn) Cyprus. Undertaking securitization transaction investments and evaluating less mature NPL markets can thus be costly for investors. Poor data quality, and insufficient sell-side resources often add on to the transaction costs for buyers.

[8] There are several mechanisms to overcome the gap between bid and ask prices, including securitization, a guarantee on the equity tranche of NPLs, a forward purchase scheme in which the state funds partially the purchase price paid by the investor to the banks. For more details, see Fell, J., J. Grodzicki, R. Martin, and E. O'Brien, 2016, "Addressing Market Failures in the Resolution of Nonperforming Loans in the Euro Area, " Financial Stability Review, November, pp. 134–46 (Frankfurt: European Central Bank); and Santos, A.O., 2019, "Can Contingent Convertibles Help Private Asset Managers Fund their Acquisition of Nonperforming Loans from Portuguese Banks?" IMF WP/19/99.

[9] Source: European Banking Authority.

Annex VII. Household Leverage and Consumption in Cyprus[1]

1. **The credit-fueled housing boom following the 2012–13 banking crisis left Cypriot households highly leveraged and led to a fall of consumption**. European Central Bank's Household Finance and Consumption Survey (HFCS) provides a two-period (2010 and 2013–14) panel data on households' financial variables for seven euro-area countries: Belgium, Cyprus, Germany, Italy, Malta, Netherlands, and Spain. Cyprus stands out in terms of declines in consumption and income as well as a surge of a leverage ratio, defined as the ratio of a homeowner's mortgage balance for the primary residence to the value of the residence, over the period of the two surveys. The rise of the leverage ratio in Cyprus reflected mainly a drop of the value of primary house. However, estimated mean value of mortgage debt also increased, which might reflect penalty interests accrued on non-performing mortgage debt.

Whole Sample vs Cyprus: Consumption, Disposable Income and Leverage Ratio

	Whole sample	Cyprus
Change in consumption 1/	-6.36	-33.78
Change in disposable income 1/	-3.28	-41.94
Leverage ratio (wave 1 survey, percent)	17.5	18.8
Leverage ratio (wave 2 survey, percent)	17.3	27.0

Sources: HFCS; and Fund staff calculations.

1/ Change is calculated after transforming the variable x by $\log(x + (x^2+1)^{1/2})$. Because of data limitation, household consumption is defined as the amount spent on food at home and outside home.

2. **Empirical analysis suggests that high household leverage was negatively associated with household consumption growth.** A simple regression analysis of household consumption growth on disposable income growth and the level of and the change in the leverage ratio (LR) finds that the initial level of leverage is negatively associated with household consumption growth, consistent with the expected impact of a debt overhang. In the specification in the second column in the table, one percentage point higher leverage ratio is associated with roughly 0.2 percentage point lower consumption growth. The change in the leverage ratio is positively associated with household consumption growth. One percentage point increase in the leverage ratio is associated with roughly 0.1 percentage point higher consumption growth, although the estimated coefficient is not statistically significant.[2]

[1] This annex uses data from the Eurosystem Household Finance and Consumption Survey.

[2] The analysis is based on a simple regression and is subject to a potential omitted variable and endogeneity problems.

Cyprus: Regression Results for Estimated Consumption Function

	Whole sample	HH own a house	HH own a house	HH with mortgage	HH with mortgage
Δ income	0.077 **	0.089 ***	0.087 **	0.056	0.053
LR (wave 1)	-0.982	-0.213 *	-0.192	-0.409 **	-0.376 **
Change in LR			0.0936		0.117
Constant	-30.384 ***	-23.243 ***	-25.064 ***	-13.228 *	-16.979 **

Sources: Eurosystem Household Finance and Consumption Survey; and Fund staff estimation.

***, ** and * denote 1 percent, 5 percent and 10 percent statistical significance, respectively.

Annex VIII. Risk Assessment Matrix

Source of Risks and Relative Likelihood (Time Horizon)	Expected Impact of Risks	Policy Response
External Risks		
High (ST, MT)	Medium/High	
Rising protectionism and retreat from multilateralism: Escalating and sustained trade actions threaten the global trade system, regional integration, and global and regional collaboration.	The Cypriot economy is heavily dependent on foreign demand, including tourism from the UK and the EU. A slowdown that weighs on inward FDI from the UK, also could impact business services. In the short term, escalating trade tensions, including disorderly Brexit, could increase uncertainty about growth and higher financial market volatility. Weaker external demand would adversely affect long-term growth through its impact on the tourism sector, and FDI.	Seek to broaden sources of foreign demand. Restart structural reforms to make the economy more dynamic and flexible in response to demand shocks. In the event of a sharp slowdown, allow automatic stabilizers to operate.
High (ST, MT)		
Weaker than expected growth in Europe and buildup of financial vulnerabilities: Weak foreign demand, Brexit, or concerns about some high-debt countries makes some euro area businesses delay investment, while faltering confidence reduces private consumption. Further easing of monetary policy encourages risk taking and reduces financial resilience to shocks.		
High (ST)	Medium	
Sharp rise in risk premia: An abrupt deterioration in market sentiment (e.g., prompted by policy surprises, renewed stresses in emerging markets, or a disorderly Brexit) could trigger risk-off events.	Higher interest rates on private sector debt would raise debt service obligations, decreasing domestic demand and/or resulting in deteriorating loan quality.	Incentivize private-sector borrowers to engage with banks for restructuring and repayment by ensuring robust implementation of the strengthened framework for insolvency and foreclosure.
Domestic Risks		
High (ST, MT)	Medium, High	
Low NPL workouts: A weaker foreclosure framework due to policy reversals undermines NPL sales market and weakens 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.	Weaker collateral recovery increases provision and capital needs. Perceived loan forbearance leads to further increase in strategic default and moral hazard, with negative implications for banks' ability to extend new credit, as well as higher direct and contingent liabilities for the state.	Encourage banks to remain adequately provisioned and capitalized, implement the framework for insolvency and foreclosure. Strengthen bank profitability by addressing inefficient cost structure, diversifying income sources while maintaining underwriting standards.

Source of Risks and Relative Likelihood (Time Horizon)	Expected Impact of Risks	Policy Response
Medium (ST, MT)	Medium	
Renewed boom-bust cycle: Business cycle becomes increasingly dependent on construction activity leading to excess supply of luxury properties	GDP growth slows down sharply weighing adversely on employment, tax revenue and banks' asset quality.	Enact a comprehensive reform agenda to improve prospects for more diversified growth and gradually decouple CIP scheme from real estate in a timely manner.
Medium (ST, MT)	High	
Slow progress in effectively implementing the AML/CFT framework: Failure to effectively mitigate existing inherent AML/CFT risks, as well as any negative AML/CFT assessment, lead to lower investment and pressures on banks' ability to access correspondent banks.	Cyprus's attractiveness as a financial and business center is weakened, with adverse effects on foreign investment. Reductions in correspondent banking would weigh on the professional services sector and long-term growth.	Focus on the effective implementation of the improvements of the AML/CFT framework that have recently been adopted; expeditiously address any assessed areas for concern.

Annex IX. Banks in Cyprus: Staying Competitive in the Digital Age

1. **Cypriot banks have undertaken significant efforts to recover from the financial crisis; nonetheless, operational efficiency and profitability remain low.** The banking sector has become more consolidated and increasingly oriented towards the domestic market, following the decline of non-resident businesses, withdrawal of foreign banks and resolution of non-viable banks. However, the economy remains overbanked. Overall profitability of Cypriot banks has been persistently below the EU regional average, largely due to NPL provisioning costs. Operational profits were also low relative to EU peers due to the high share of personnel costs. Cost to income ratios have been also rising over the past few years. The current low-interest and low-growth environment are further undermining profitability.

2. **Digitalization is creating an opportunity but also an imperative for banks to lower costs and stay competitive.** Digitalization of financial services, despite the large initial costs, is seen as a means to maintain market share and stay profitable by cutting recurrent costs. At the same time, new entrance of fintech and bigtech companies, and digitalization of customers are motivating banks to accelerate their digital transformation. Cross country comparison suggests that more digital advanced countries tend to experience a lower cost-to-income ratio and higher operational capacity. Digital maturity is associated with increased profitability (Accenture, 2019): digital advanced banks have on average experienced an overall increase of return on equity (ROE) of 0.9 percent between 2011 and 2017, while the less digital advanced banks have seen a ROE decline of 1.1 percent. This divergence of profitability is expected to widen in the following years.

Euro Area Banking Sector: Digitalization vs Operational Capacity, 2018

	Deposits per branch (mn euro)	Population per branch	Population per ATM	Assets per bank employee (000' euros)
	Ratio to Euro area average			
Cyprus	0.6	0.5	1.1	0.5
Digital advanced countries 1/	1.2	1.4	2.2	1.7
Digital lagging countries 2/	0.5	0.8	0.9	0.8

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

1/ Digital advanced countries include Finland and Sweden, which were top two EU countries in terms of the use of mobile phone payments in 2017.

2/ Digital laggard countries include Bulgaria, Greece, and Italy, which ranked among bottom five EU countries in terms of use of mobile phone payments in 2017. The selection of countries are based on data avaialbility.

3. **In Cyprus, financial service digitalization is at a low level compared with digital frontier countries.** In 2017, 66 percent of adults in Cyprus used electronic payments versus above 95 percent of digital-frontier countries. Similarly, only 8 percent of adults in Cyprus have used mobile payment, versus above 25 percent in the digital frontier countries. Competition from domestic fintech companies appears largely absent thus far with existing companies mainly active in providing online trading platforms to global investors. In the field of digital payments, however, both fintech start-ups and incumbent banks have adopted innovative technologies to provide a range of payment solutions.

4. **Policymakers should support opportunities brought by the digital transformation while addressing the accompanied risks.** This includes building a forward-looking regulatory framework flexible to accommodate new innovations while maintaining high standards for integrity, soundness and consumer protection, and strengthening oversight of larger banks in a likely more consolidated banking system. Policies should be also geared towards ensuring sufficient supply of ICT skilled labor, while taking preemptive measures to help employees made redundant.

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 12, 2019

Prepared By | European Department (In consultation with other departments)

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FUND RELATIONS

(As of September 30, 2019)

Membership Status: Joined December 21, 1961; Article VIII

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

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	132.80	100.00
Holdings	50.47	38.00

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 2019)

	Principal	Charges/Interest	Total
2016	0.00	13.12	13.12
2017	222.38	13.78	236.16
2018	0.00	11.40	11.40
2019	0.00	12.54	12.54
2020	31.31	11.24	42.55
2021	138.19	9.94	148.13
2022	125.81	7.51	133.32
2023	125.81	5.07	130.88

Exchange Rate Arrangement and Exchange Restrictions:

Cyprus is a member of the euro area, and its currency—the euro—floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

Last Article IV consultation, Post-Program Monitoring discussions, and program relations:

Article IV. Cyprus is currently on a standard 12-month consultation cycle. The last Article IV consultation was concluded on November 28, 2018 (IMF Country Report No. 18/337).

EFF. Cyprus's three-year, SDR 891 million (293 percent of current quota) Extended Arrangement under the Extended Fund Facility (EFF) was approved by the IMF Executive Board on May 15, 2013. The total amount drawn was SDR 792 million (260.7 percent of quota). The EFF arrangement was coordinated with the European Stability Mechanism (ESM), which disbursed €6.3 billion. The ninth (and penultimate planned) review was completed on January 23, 2016 (IMF Country Report No. 16/26). The EFF arrangement was cancelled by the authorities on March 7, 2016, about two months before it was scheduled to expire. The cancellation coincided with the expiration of the three-year ESM program.

PPM and repurchases. The Fund initiated PPM on March 18, 2016. Board consideration of the Third Post-Program Monitoring (PPM) discussions was concluded on June 3, 2019(IMF Country Report No. 19/151). An early repurchase on July 11, 2017 reduced outstanding Fund credit to Cyprus to SDR 570 million (187.5 percent of quota), which is below standard PPM-eligibility thresholds. The Board approved a one-year PPM extension on August 2, 2017, June 4, 2018 and June 3, 2019.

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

Technical Assistance:

Department	Purpose	Date
FAD	Revenue administration	October–November 2014
FAD	Revenue administration	January–February 2015
FAD	Functional review of Ministry of Finance	February 2015
FAD	Government guarantees	February 2015
MCM	Cooperative credit sector restructuring	February–March 2015
FAD	Public financial management	March 2015
STA	Balance of payments	March–April 2015
FAD	Public financial management	August 2015
MCM	NPL management	August-September 2015
MCM	Macro-financial modeling	September 2015
MCM	NPL management	September 2015
FAD	Public financial management	September-October 2015

MCM	Financial aspects of reunification	November 2015
FAD	Revenue administration	November-December 2015
MCM	Central bank governance	December 2015
STA	Statistical aspects of reunification	December 2015
FAD	Fiscal aspects of reunification	December 2015
MCM	Financial aspects of reunification	December 2015
MCM	Financial aspects of reunification	January 2016
MCM	Financial aspects of reunification	February 2016
STA	Statistical aspects of reunification	February 2016
FAD	Fiscal federalism workshop	February 2016
FAD	Fiscal aspects of reunification	February-March 2016
MCM	Debt management	March 2016
FAD	Public financial management	March-April 2016
MCM	Financial aspects of reunification	April 2016
FAD	Revenue administration	April-May 2016
STA	Statistical aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	May 2016
MCM	Financial aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	June–July 2016
MCM	Financial aspects of reunification	June–July 2016
FAD	Revenue administration	October 2016
FAD	Spending review	October 2016
FAD	Fiscal aspects of reunification	November 2016
STA	Central bank financial statistics	January 2017
FAD	Revenue administration	March 2017
FAD	Spending review	April-May 2017
MCM	Financial stability	July 2017
MCM	NPL management	July 2017
MCM	Macro-prudential policy	September 2017
LEG	Insolvency legal framework workshop	September 2017
FAD	Spending review	September–October 2017
FAD	Revenue administration	October 2017
MCM	NPL management	November 2017
MCM	Financial stability	December 2017
FAD	Revenue administration	December 2017
FAD	Spending review	February 2018
LEG	Legal framework for NPL resolution	March 2018
FAD	Spending review and public financial management	September 2018
FAD	Policy Based Budget	September 2019

Two FAD long-term resident advisors provided technical assistance on public financial management (from February 2014 to October 2016) and on revenue administration (from July 2015 to December 2016).

STATISTICAL ISSUES

(As of October 8, 2019)

I. Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund is adequate for surveillance purposes.

National accounts and real sector data: Since September 2014, the Statistical Service of Cyprus (CYSTAT) publishes a full set of national accounts based on the European System of National and Regional Accounts (ESA 2010) methodology, including quarterly GDP estimates. The data are available from the first quarter of 1995; the quarterly and annual data are consistent, although the timing of revisions to annual and quarterly statistics may not coincide. CYSTAT publishes the Consumer Price Index, and the Harmonized Index of Consumer Prices (HICP) according to the methodology of EU member states. Control and quality assessment are ensured through the supervision of Eurostat.

Fiscal sector data: Ministry of Finance publishes monthly cash budget data based on ESA 2010 for the general government and its breakdown into central government, local government and social security fund.

External sector data: The Central Bank of Cyprus (CBC) compiles and disseminates online the statistics of the balance of payments and the international investment position on a quarterly and annual basis, according to the IMF's sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6). The data are released with roughly a one-quarter lag (e.g., 2018: Q2 data were released in September 2018). The data have included special purpose entities (SPEs) as residents since July 2014, when the BPM6 methodology was adopted, while SPEs had been treated as non-residents before that. Historical data up to 2008 were also revised in October 2015 with the same definition. The treatment of SPEs is fully in line with the international standards including the BPM6. Full data coverage of SPEs was achieved in September 2019. Some historical statistics on SPEs have been published since November 2017. Cyprus participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).

Monetary and financial sector data: Data on central bank balance sheet, key aggregate financial indicators for other monetary financial institutions, and financial positions of domestic institutional sectors are available from the CBC website and comply with European standards. The CBC also provides monthly monetary statistics to the IMF through the ECB. A structural break exists for some financial sector data due to the migration to Basel III (in 2014:Q1) and adoption of the European Banking Authorities definition of non-performing loans (in 2014:Q4).

Financial sector surveillance: Cyprus reported all twelve core financial soundness indicators (FSIs) and all thirteen encouraged FSIs for the deposit takers on quarterly basis up to Q1:2016. However, some FSIs have been missing or only partly reported since then. In addition, encouraged FSIs for the other sectors are not available.

II. Data Standards and Quality

Cyprus subscribes to the Fund's Special Data Dissemination Standard (SDDS), and the relevant metadata have been posted on the Dissemination Standards Bulletin Boards. Cyprus's economic database is comprehensive and of generally good quality. Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a wide range of economic and financial data, as well as a calendar of dates for the main statistical releases.

Cyprus is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted ESA 2010. No data ROSC is available.

Cyprus: Table of Common Indicators Required for Surveillance
As of October 8, 2019

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2019	Oct. 2019	M	M	M
Reserve/Base Money	Aug. 2019	Sep. 2019	M	M	M
Broad Money	Aug. 2019	Sep. 2019	M	M	M
Central Bank Balance Sheet	Aug. 2019	Sep. 2019	M	M	M
Consolidated Balance Sheet of the Banking System	Q1. 2019	Jul. 2019	Q	Q	Q
Interest Rates[2]	Current	Current	D	D	D
Consumer Price Index	Sep. 2019	Oct. 2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Aug. 2019	Sep. 2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug. 2019	Sep. 2019	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug. 2019	Sep. 2019	M	M	M
External Current Account Balance	2019: Q1	Jul. 2019	Q	Q	Q
Exports and Imports of Goods and Services	2019: Q1	Jul. 2019	Q	Q	Q
GDP/GNP	2019: Q2	Sep. 2019	Q	Q	Q
Gross External Debt	2019: Q1	Jul. 2019	Q	Q	Q
International investment position[6]	2019: Q1	Jul. 2019	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government, social security funds and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

Statement by Mr. Doornbosch Alternate Executive Director, and Mr. Cools, Advisor to the Executive Director on Cyprus
November 27, 2019

On behalf of the Cypriot authorities, we would like to thank staff for the in-depth discussions in Nicosia in September and the insightful staff report. **Six years after the start of the EFF program, Cyprus is turning the page.**

Cyprus has gone through a significant internal adjustment process which has drastically improved its cost competitiveness. Private and public debt levels are today on a downward path. Yearly GDP growth has averaged 4.6 percent over the last four years, and the government is recording solid primary surpluses. Unemployment has halved since 2014, and banks have significantly reduced their NPL levels. As a result of these macro-economic developments, Cyprus' sovereign rating was upgraded in 2018 to investment grade and is now assigned a stable or positive outlook.

In September 2019, the authorities signaled their intention to reimburse the remaining 570 million SDR of Fund credit, as the Fund credit borrowing cost currently exceeds the market rate of the Republic of Cyprus' bonds, as demonstrated by the recent issuances of 15- and 30- year Eurobonds at historically low rates.

While Cyprus is turning the page, the authorities are keenly aware of the risks ahead. **They therefore remain particularly committed to expenditure restraint and further NPL reduction.** They also agree that sustained efforts will be needed to improve Cyprus' competitiveness beyond cost competitiveness. Staff is rightfully recalibrating its advice towards more long-term structural issues to unlock Cyprus' growth potential.

Outlook

While real GDP is expected to remain robust in 2019 and beyond, driven by investment and private consumption, it is expected to ease to 3.2 percent in 2019 and 2.9 percent in 2020. The growth slowdown is due to the deterioration in the external environment, mainly reflecting the barriers imposed in international trade and uncertainty related to Brexit, which adversely affect external demand. Private consumption is expected to register a deceleration, reflecting - inter alia - the projected acceleration in loan repayments and the impact of changes in various social contributions, including the recent introduction of contributions towards the new General Healthcare System. The foreseen deceleration in investment emanates from the gradual completion of construction projects. These projects include foreign-financed ones and relate to ongoing tourism-related projects (marinas and casino), residential construction, renewable energy sources and education.

Risks to the outlook are tilted to the downside, due to slowing global growth and the expected decline in contribution of construction to GDP growth. Headline HICP inflation in 2018 was 0.8percent, and is expected to remain sluggish, despite the projected high growth rate. One explanation for the weak inflationary pressures is that, despite the strong employment growth, there is still significant slack in the labor market, restricting wage and unit labor cost growth. In addition, technological change may lower production costs and increase competition which may in turn constrain profit margins of firms, weighing on price growth.

Public Finances

Public finances are expected to return to nominal surpluses in 2019, after recording a temporary deficit of 4.4 percent of GDP in 2018, which reflected the one-off support measures related to the sale of the Cyprus Cooperative Bank. **Cyprus is expected to record a primary surplus of about 6.2 percent of GDP in 2019 and will continue to record solid primary surpluses on the forecast horizon.** As a result, Cyprus' public debt is on a firm downward trajectory. Despite spending pressures, the broad political consensus for spending restraint continues to hold. The authorities have capped expenditure growth to nominal medium-term economic growth, as reflected in the medium-term budget plan for 2020–22.

Financial Sector

Since last year's Article IV report, there has been continued significant progress in reducing NPLs, among others, as a result of the €2.6 billion sale of NPLs by Bank of Cyprus. However, despite significant progress, the level of NPLs is still very high compared to euro area average and efforts to reduce them need to continue.

In this light, Cyprus' two largest banks, holding around 70 percent of NPLs, plan to further offload NPLs, bringing their levels to below 10 percent of total loans, by the end of 2021. Strong investor appetite for NPLs has been fostered by the 2018 legislative changes strengthening Cyprus' foreclosure, insolvency and sales of loan laws. The recent parliamentary efforts to increase the role of the Ombudsman in debt work outs, which could potentially lengthen the duration of the judicial process, have been deferred to the Supreme Court. These efforts have arguably not affected investor appetite.

In relation to sales of NPLs, the restructuring of loans remains a significant challenge, as these loans are no longer recorded in the banking system but remain part of private debt and therefore continue to constitute a burden for the economy.

Staff rightly points out that the NPL workout by credit acquiring companies, including the public asset management company, is progressing. In addition to the 2018 legislative changes, four factors are contributing to a speedier debt work-out. First, the *Estia* burden sharing mechanism for distressed primary residence mortgage loans is currently being rolled out, after receipt of the first applications last September. Second, the electronic foreclosure mechanism (e-auction) will be launched soon. Third, additional judges to deal with the NPL backlog are being recruited. Finally, recovering real estate prices are helping banks to offload real estate they have onboarded as part of debt to asset swaps.

Banking profitability in Cyprus has been considerably affected by the need to hold provisions against NPLs. However, profitability issues stem from other sources as well. Staff's analysis on how increased digitization could improve bank profitability has been particularly appreciated. **Strengthened efforts will be needed to enhance financial service digitalization**. In this light, the digitalization transformation strategies by Cyprus' banks are an important development.

The authorities also remain committed to further strengthening AML/CFT compliance. Since the last Article IV report, they have strengthened the regulation of shell companies and the oversight of the Citizenship Investment Program ('CIP').

External Sector

The revision of National Accounts Data and External Statistics, as part of a five-year benchmark revision, has led to an upward revision of the current account balance by, on average, 1.6 percent of GDP for the period 2008–2018. This has led to a requalification by staff of Cyprus' external position from *'weaker than'* to *'moderately weaker than implied by medium-term fundamentals and desirable policies'*. The authorities consider the external sector developments affecting Cyprus to be in line with the fundamentals of the Cyprus economy. **The projected current account deficit, while expected to narrow, is considered to be at a sustainable level, in line with the overall domestic economic growth momentum.** Finally, the authorities appreciated the technical exchange with staff on the application of the EBA Lite model.

Competitiveness

The Selected Issues Paper provides a good insight in Cyprus' export competitiveness and helps to understand the key determinants of service exports and to set the right policies accordingly. While key recommendations, such as diversifying export markets and enhancing productivity, are not easy to implement in a small island economy reliant on services, the authorities remain fully committed to structural reform efforts to unlock Cyprus' growth potential. The 2019 Cyprus Competitiveness Report commissioned by the Cyprus Economy and Competitiveness Council highlights policy areas for further improvement, such as addressing low labor productivity, promoting entrepreneurship, improving business linkages and connectivity, and improving access to finance.

Continued improvement of public sector efficiency is also key to enhance Cyprus' competitiveness. Two ongoing far-reaching reforms are noteworthy here. The local governance reform on the one hand will increase professionalism and fiscal responsibility. The reform of the judiciary on the other hand, with increased specialization and capacity, will strengthen the business climate and legal certainty.