

Cyprus: Staff Report for the 2000 Article IV Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with *Cyprus*, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 23, 2000**, 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 July 18, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement released the day of the Board discussion, updating information on recent economic developments.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the August 3, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.
- a statement by the authorities of *Cyprus*.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (<http://www.imf.org>)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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CYPRUS

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation with Cyprus

Approved by Jacques R. Artus and G. Russell Kincaid

July 18, 2000

- The 2000 Article IV consultation discussions were held in Nicosia during May 11–23, 2000. The staff team met the Speaker of the House of Representatives, Mr. Kyprianou; the Minister of Finance, Mr. Klerides; the Governor of the Central Bank of Cyprus, Mr. Afxentiou; the Finance Committee of the House of Representatives; officials from government agencies and the Central Bank; and representatives of the private sector, including employers' associations and the chamber of commerce, trade unions, and the financial and academic communities.
- The staff team comprised Mr. Demekas (head), Mr. Disyatat, Ms. Glennerster, and Mr. Swagel, with Ms. Duff as Administrative Assistant (all EU1). Mr. Ioannou, Assistant to the Executive Director for Cyprus, participated in the discussions.
- In concluding the last Article IV consultation on July 30, 1998, Executive Directors commended the Cypriot authorities for the achievement of an enviable growth record over most of the past two decades, but noted the need for corrective measures to address fiscal and external imbalances, and for progress on structural reforms including financial and capital market liberalization.
- 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.
- Cyprus's statistics are generally of good quality and adequate for surveillance and the publication policy is open, but there are weaknesses in certain areas. For more details, see Appendix II.
- The current government has been in office since 1998, but lost its majority in the House of Representatives in January 1999. Legislative elections are slated for May 2001, with a presidential election due by February 2003.
- Negotiations for EU membership began on March 31, 1998. Cyprus has completed discussions on 16 of 31 chapters of the *Acquis Communautaire*, and aims to be ready for membership by January 1, 2003.
- The Central Bank of Cyprus hosted a press conference for the mission at the conclusion of the consultation discussions. The mission's preliminary conclusions were published, and the authorities are participating in the pilot project for publication of staff reports.

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I. BACKGROUND TO THE DISCUSSIONS

1. *Cyprus's economic performance in the past quarter century has been impressive but volatile, as the economy has come to rely on tourism as the main engine of growth.* Per capita GDP has more than tripled since 1974, and is now nearly 80 percent of the EU average, above that in several EU members. While development was initially spurred by the reconstruction after the war with Turkey, tourism has been the main engine for growth since the mid-1980s, and now accounts for over 20 percent of value added and around 40 percent of current account receipts (Figure 1). Traditional sectors of agriculture and industry are in long-term decline.

2. *Good economic management has until recently ensured full employment and low inflation, but significant structural rigidities remain.* Since the mid-1980s, the fiscal deficit has averaged 4 percent of GDP, the Cyprus pound has been kept within a $\pm 2\frac{1}{4}$ percent band around the central parity with the ECU (the euro since 1999), inflation has averaged 3.5 percent, and the unemployment rate has remained below 4 percent (below 3 percent for most of the 1990s—Table 1). At the same time, however, a desire to maintain social cohesion and the influence of powerful interest groups (notably unions) have perpetuated certain distortions, including financial and capital market controls, full wage indexation, and extensive government involvement in the economy (Box 1).

Box 1. Structural Rigidities

The **financial sector** operates under a **statutory 9 percent interest rate ceiling**, in place since the 1940s, which has stunted the development of the money market and skewed the allocation of bank credit toward low-risk projects. **Credit cooperatives** hold about a third of total bank assets but—in contrast to commercial banks—are not subject to reserve requirement and face weak prudential rules and lax supervision. The interest rate ceiling and growth of the cooperatives impede effective monetary management by the Central Bank of Cyprus (CBC).

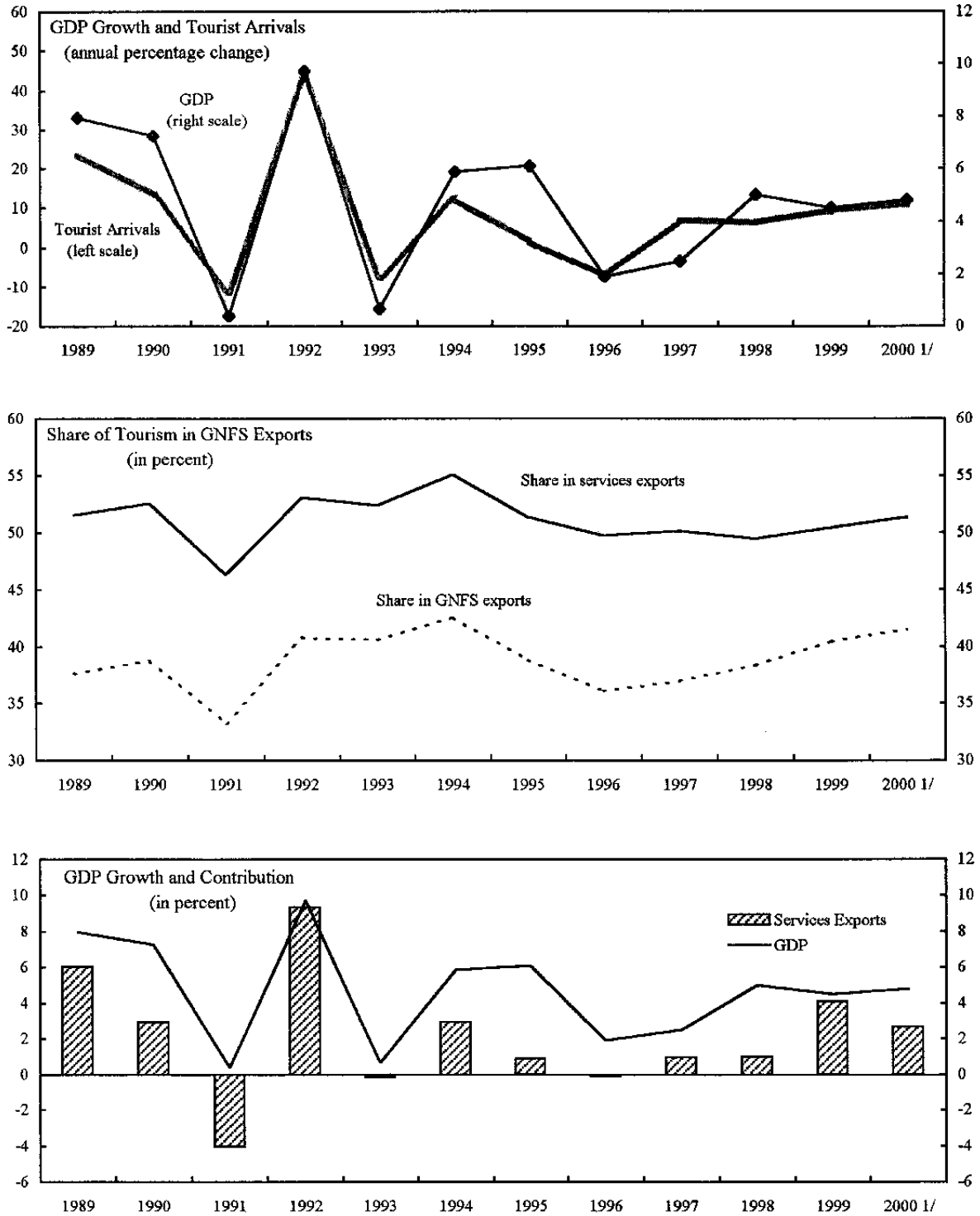
Most capital flows are controlled. Capital account liberalization was started in 1999 and is to be completed by the time of EU membership, but foreign borrowing and portfolio transactions by Cypriots are still controlled.

The **labor market** is flexible in certain respects (hiring and firing restrictions and unemployment compensation), but **wages are fully indexed to inflation** through a backward-looking cost-of-living adjustment (COLA) mechanism.

The state retains **full or majority ownership of public utilities and many businesses**, including energy generation, oil refining, telecommunications, Cyprus Airways, and the port, water, and sewer authorities.

3. *The agenda for economic reform is dictated by the priorities of EU harmonization, but implementation and—more broadly—the conduct of economic policy has recently been stymied by a political impasse between government and the House of Representatives.* The goal of preparing for EU accession, which enjoys broad political support, requires deep structural reforms across a wide front, including indirect tax increases and fiscal consolidation, financial and capital market liberalization, central bank independence, cooperative sector reform, and the opening of protected sectors, such as air travel and

Figure 1. Cyprus: Growth and Tourism, 1989-2000



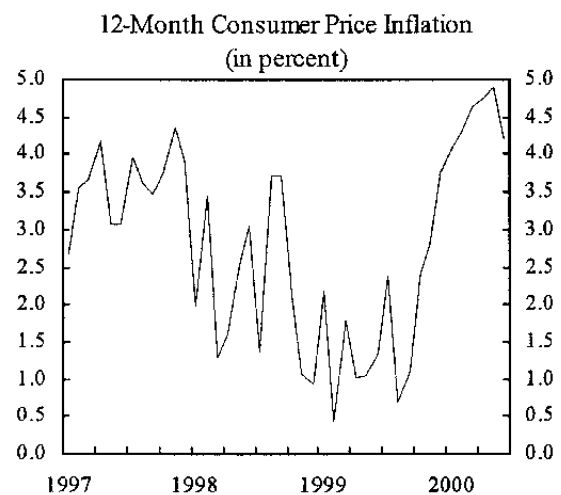
Sources: Central Bank of Cyprus; IMF, *International Financial Statistics*; and Fund staff calculations.

1/ Fund staff projections.

telecommunications, to foreign competition. The government has had difficulty getting House approval on central elements of this agenda, and indeed on key economic policy measures. The abolition of the interest rate ceiling, currently planned for January 1, 2001, was approved after long delays. The first of several VAT increases required for harmonization with the EU was passed in June 2000 after a 2-year delay in the House, but the additional revenues are to be offset by income tax concessions and higher social transfers. The countercyclical fiscal expansion in 1996–97 was not fully reversed after growth rebounded in 1998–99, leading to a higher debt burden and continuing fiscal imbalance. With elections in 2001 and 2003, mobilizing political consensus on controversial measures may become even more difficult in the period ahead.

II. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

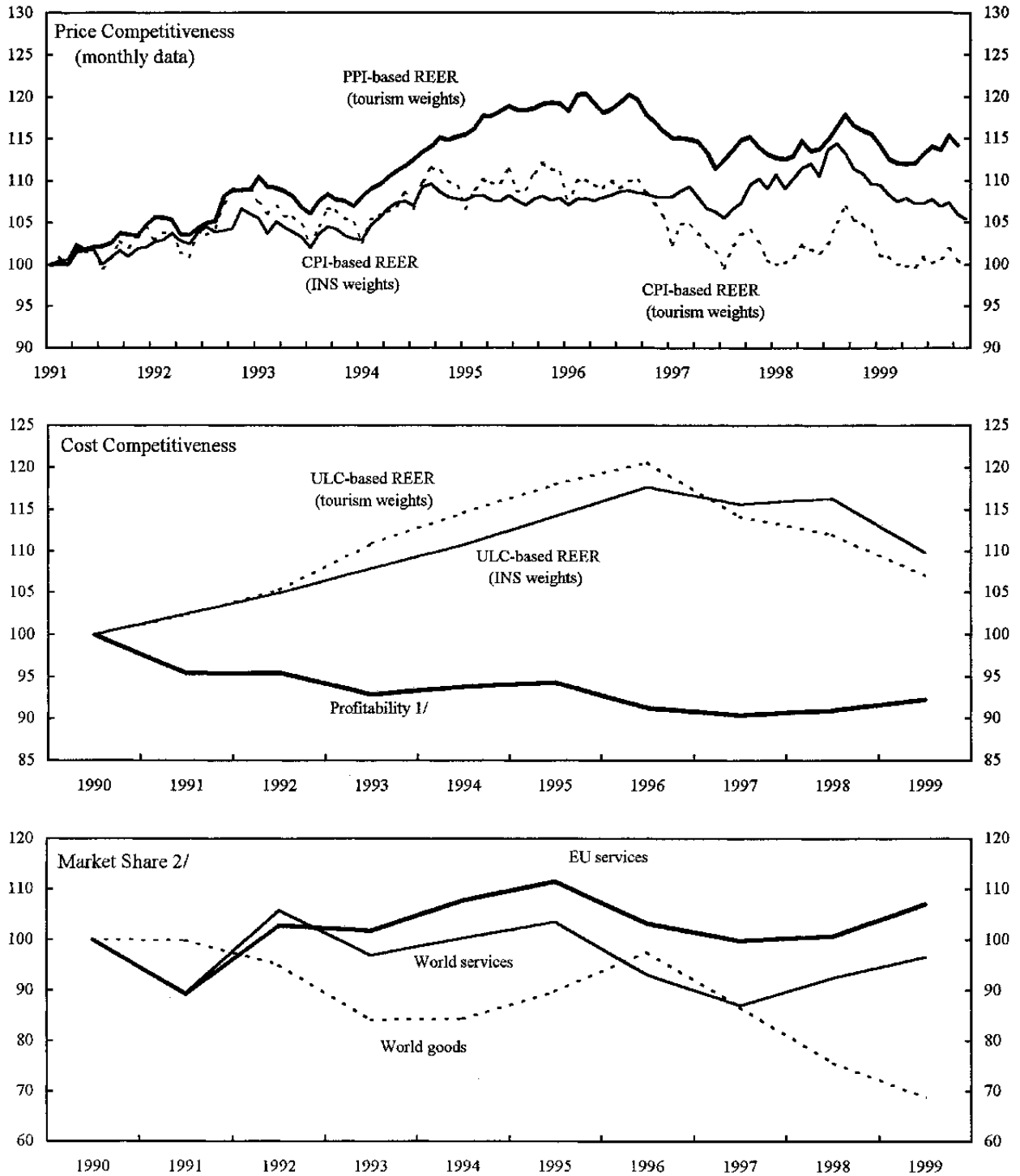
4. ***Growth remains strong, driven by a booming tourism sector, but domestic demand picked up in 2000 and there are risks to inflation.*** Accelerating growth of tourism has kept real GDP growth high (4.5 percent in 1999 and a projected 4.8 percent in 2000) and unemployment below 4 percent. At the same time, wage moderation kept inflation at very low levels for most of 1999 (CPI inflation averaged 1.8 percent), leading to an improvement in various measures of competitiveness (Figure 2). However, inflation accelerated sharply in late 1999 and early 2000 owing to higher energy and food prices and the weakness of the euro, to which the Cyprus



pound is pegged, and the hike in the VAT rate from 8 to 10 percent on July 1, 2000 will trigger a new round of price increases. These exogenous price shocks will become embedded in inflation owing to the COLA mechanism. In addition, the composition of demand in 2000 is shifting toward domestic consumption, as evidenced by trade data: the value of consumer goods imports rose by nearly 16 percent in the first four months of 2000 compared to the same period in 1999, while the value of capital goods rose by less than 3 percent. This surge in consumption, which may partly reflect the wealth effect from stock market gains in 1999, is likely to add to inflationary pressures. The associated rise in imports means that the current account deficit is likely to widen somewhat in 2000 to around 3½ percent of GDP, despite record net invisibles receipts (Figure 3).

5. ***Fiscal policy was tightened in 1999, thanks partly to one-off measures, but remains expansionary in 2000.*** Following a record 5.5 percent of GDP in 1998, the fiscal deficit was reduced to 4.1 percent of GDP in 1999 thanks mainly to postponements in defense-related outlays, and small indirect tax increases (Table 2). On current policies, the deficit is not likely to fall further in 2000, and might actually rise (Figure 4). The long-delayed VAT rate hike took effect in July 2000, and although the defense levy

Figure 2. Cyprus: Competitiveness Indicators, 1990-99

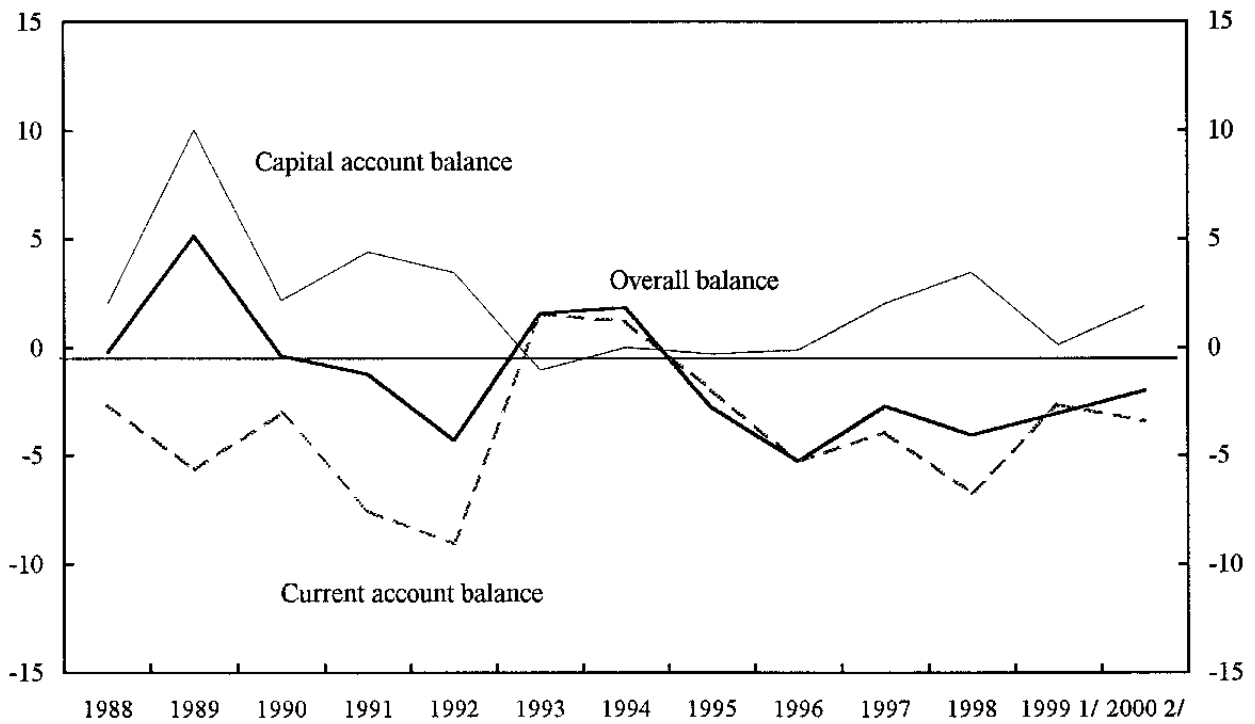
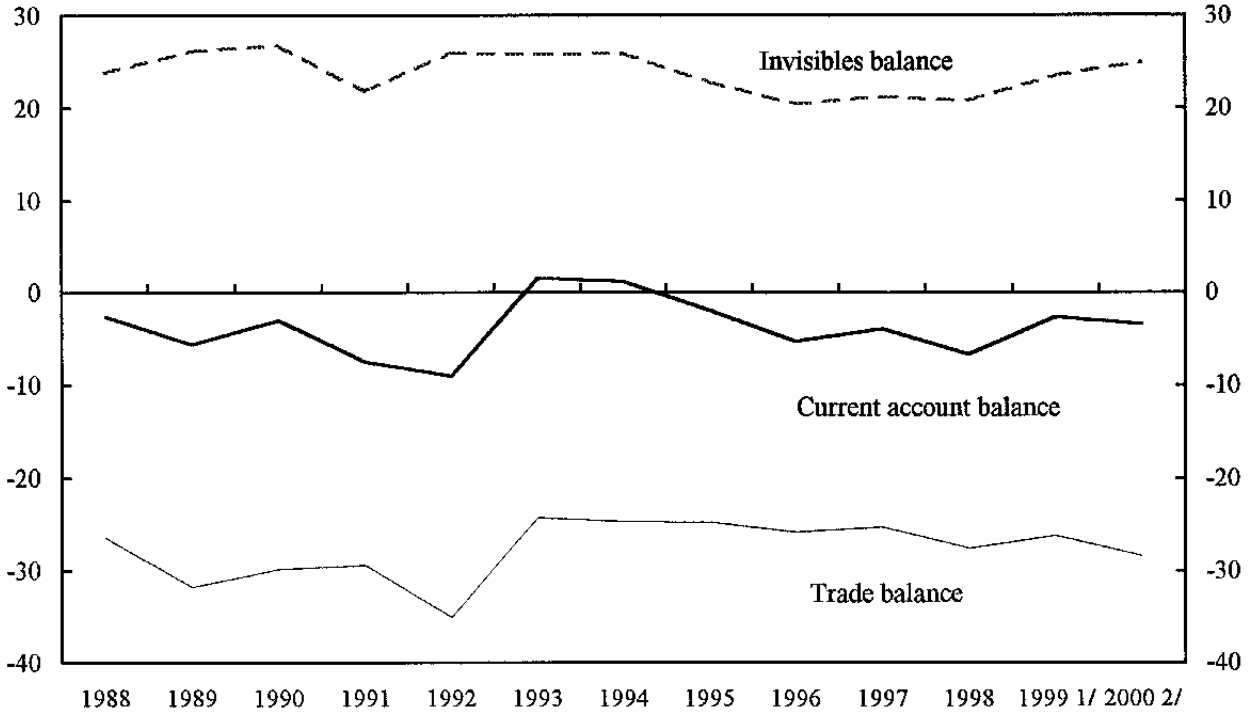


Sources: IMF, *International Financial Statistics*; WEO database; and Fund staff calculations.

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

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

Figure 3. Cyprus: Balance of Payments, 1988-2000
(In percent of GDP)

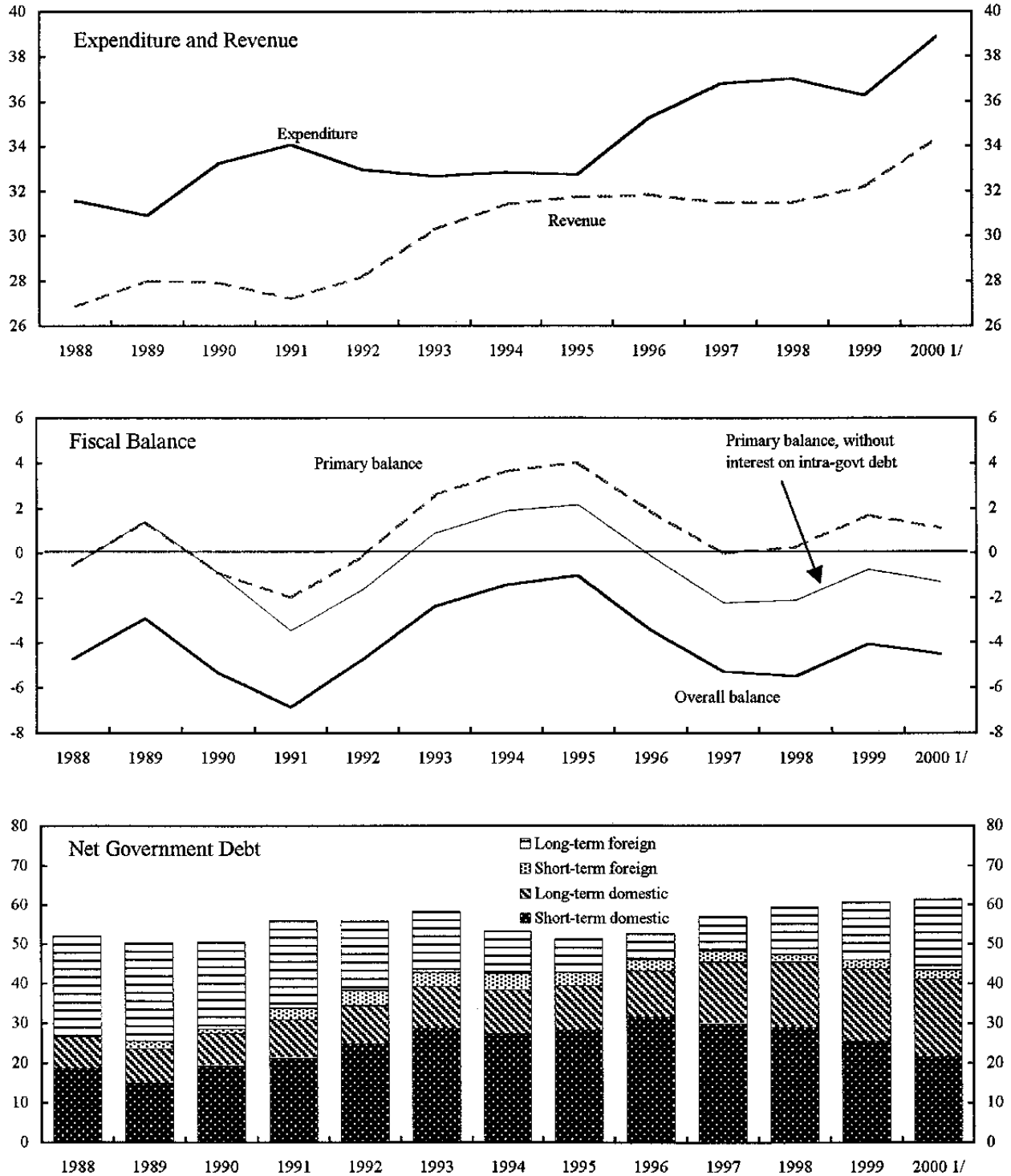


Source: Central Bank of Cyprus.

1/ Provisional.

2/ Fund staff projections.

Figure 4. Cyprus: Central Government Finances, 1988-2000
(In percent of GDP)



Source: Ministry of Finance.

1/ Fund staff projections assuming no additional measures are taken.

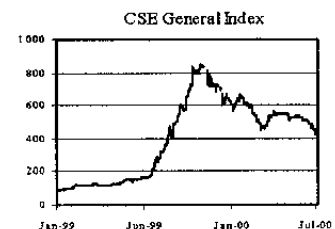
(supplemental income tax) was reduced, there appears to be a strong possibility of overperformance in other taxes (collection of personal and corporate tax in the first half of the year was nearly 30 percent above 1999 levels). In total, revenue will be more than two percentage points higher as a share of GDP than in 1999. However, this is to be fully offset by new expenditures, including additional social transfers, subsidies on fuel prices, home loans for refugees, and defense expenditures that were postponed from 1999. Thus, the ratio of consolidated government debt to GDP, which reached nearly 61 percent at end-1999, is likely to rise further in 2000. Slow progress in addressing the fiscal imbalance and the rising debt burden were cited as the main factors behind S&P's December 1999 downgrade of Cyprus's debt rating and Moody's May 2000 shift to a negative ratings outlook, though both ratings remain well within the investment grade range.

6. *Excessive liquidity growth—influenced by events on the Cyprus Stock Exchange—poses a threat to price stability and external balance, but financial market restrictions distort the money market and limit the ability of the Central Bank of Cyprus to manage liquidity.* Spurred by a wave of mergers, initial public offerings, and stock splits, the Cyprus Stock Exchange (CSE) index registered explosive growth in 1999, peaking in November and then falling sharply (Box 2). The boom was fed in part by bank lending for stock purchases, with private credit growth reaching 18 percent in the year to November (Figure 5). The existence of the interest rate ceiling forced the Central Bank of Cyprus (CBC) in mid-1999 to resort to bank-by-bank ceilings to slow credit growth down toward its 10 percent end-year target. Despite a temporary slowdown in December, the ceilings failed to curb credit growth, as the penalties for violation (withholding part of the interest due on bank reserves at the CBC) were ineffective. Developments in the Stock Exchange also had a profound impact on money demand. In particular, investment companies (closed-end funds) raised substantial capital and, in the first instance, recycled these into bank deposits, contributing to a fall in broad money velocity of 7.5 percent in 1999. Credit and broad money (M2) continued to grow rapidly in 2000 (20 percent and 18 percent in the year to April, respectively). In May 2000, following the consultation discussions, the CBC again imposed bank-by-bank

Box 2. Developments on the Cyprus Stock Exchange

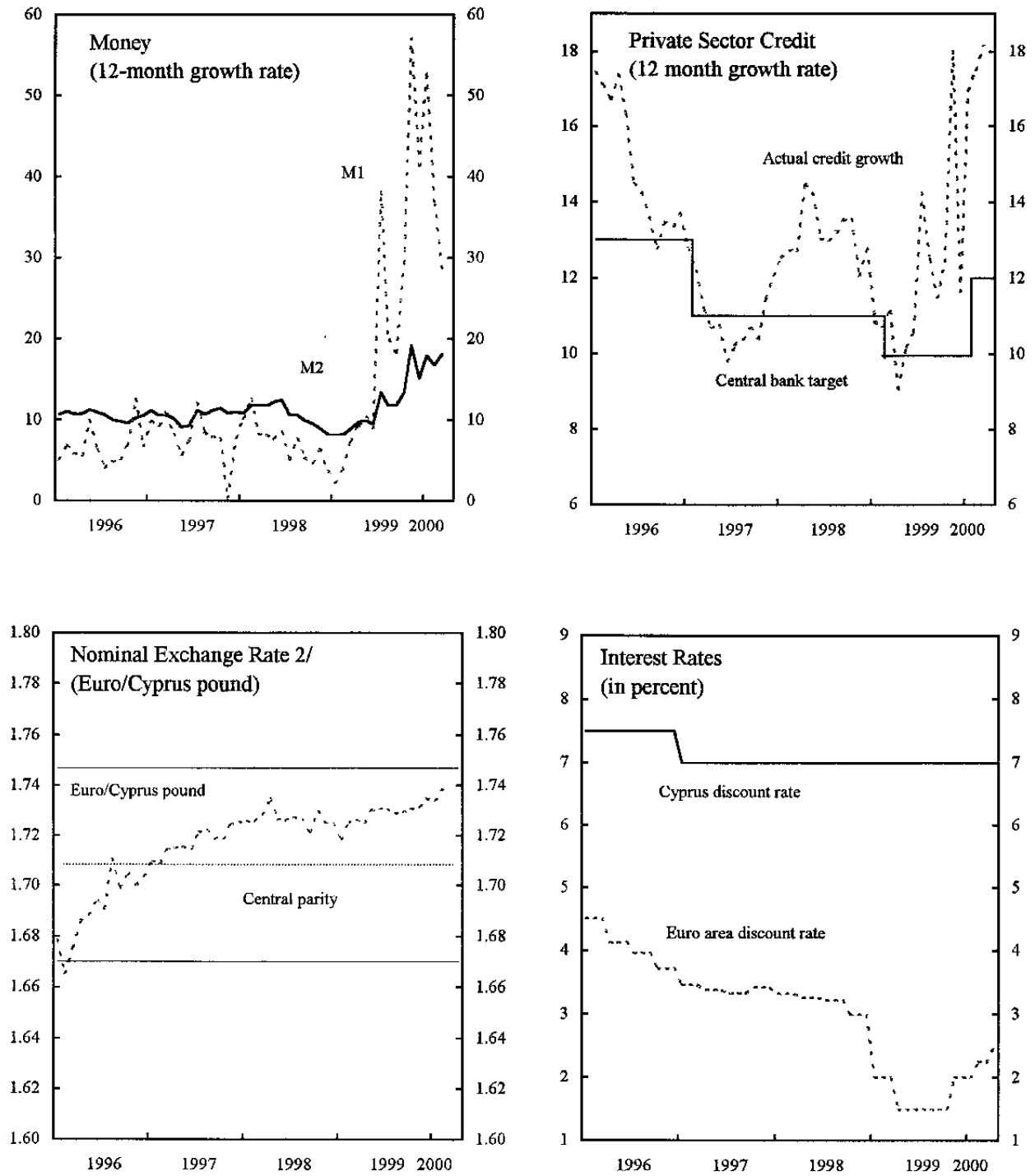
The official CSE started operating in March 1996 (the Chamber of Commerce operated an OTC market since 1986), but was insignificant until mid-1998, when tax incentives for newly-listed companies were introduced.

The CSE general index exploded in 1999, rising by 840 percent between January and November, before plunging to around 400 percent above the level at end-1998. A large number of individual investors were drawn into the market for the first time, with 25 percent of Cypriots now estimated to hold traded securities. Market capitalization is currently about 180 percent of GDP.



The rise was punctuated by a series of market closings lasting as long as 4 weeks in October, as the exchange and brokers struggled to complete back office paperwork. There have also been controversies involving private stock placements and initial public offerings.

Figure 5. Cyprus: Monetary Conditions, 1996-2000 1/



Source: IMF, *International Financial Statistics*.

1/ Monthly data through April 2000.

2/ Increase represents appreciation.

credit ceilings for the second half of 2000 (for an aggregate credit growth target of 12 percent during the year), and increased the reserve requirement by 1 percentage point to 8 percent effective July 1. Moreover, while leaving its official intervention rates unchanged, the CBC limited refinancing to banks.

III. REPORT ON THE DISCUSSIONS

7. *Against this background, discussions focused first on the near-term risks to macroeconomic stability and second on the medium-term challenges arising from financial and capital market liberalization.* As regards the former, the authorities and the staff generally agreed on the nature of these risks but differed on the assessment of their magnitude. As regards the latter, there was agreement on the potential long-term benefits from liberalization and broad agreement on the policies required to tackle successfully the challenges posed by the transition to the new environment.

A. The Macroeconomic Conjuncture

8. *The authorities saw the macroeconomic situation stabilizing in 2000, with current policies adequate to contain the fiscal deficit and keep inflation in check.* Inflationary pressures were seen as easing over the remainder of 2000 owing to continued wage moderation and the attenuation or reversal of exogenous shocks (notably higher energy prices, the depreciation of the euro—and thus the Cyprus pound—vis-à-vis the dollar and sterling, and the impact of drought on food prices). Domestic demand pressures were seen as relatively modest, with the decline in the stock market in early 2000 dampening consumer expectations and any wealth effects from last year. At the same time, however, the authorities acknowledged that the backward-looking indexation of wages through the COLA would prolong the disinflation process, that fiscal policy was expansionary, and that continuing credit growth posed a significant risk. Their strategy was (i) to reduce the 2000 fiscal deficit to no more than 4 percent of GDP, with revenue overperformance complemented by limits on discretionary expenditures, including a freeze on hiring civil servants except in defense, education, and health care; and (ii) to rely again on direct controls to curb credit growth with tougher penalties for violation (withholding the entire interest due on reserves).

9. *In the staff's view, the authorities underestimated near-term risks and their policy plans were therefore insufficient.* Staff thought that average inflation would likely exceed 5 percent in 2000, as the effects of the recent VAT hike and strengthening domestic demand would offset beneficial effects—if any—from reversals in oil prices or the exchange value of the pound. In this connection, the staff noted that the inclusion of VAT-related price increases in the COLA basket would transform these one-time shocks into higher inflation in 2000 and in following years (in view of the additional VAT and excise rate increases required for EU harmonization). Against this background, the staff questioned whether the authorities' fiscal policy target for 2000 was sufficiently ambitious and whether the CBC's initiatives to contain credit, while justified under the interest rate ceiling, would effectively address the underlying liquidity overhang.

- The current cyclical position called for a significant reduction of the fiscal deficit toward the level prevailing prior to the countercyclical expansion of 1996–97 in order to counter aggregate demand pressures and put public debt on a clear downward medium-term trend. Instead, without additional measures, the staff projected that the fiscal deficit in 2000 would increase to 4½ percent of GDP. Based on the strong revenue performance so far in 2000 and the possibility of deferring spending, reducing the deficit below 4 percent was indeed feasible. But this would again have to rely on postponement of certain outlays, which does not constitute a solid basis for adjustment in subsequent years.
- The CBC's decisions, following the consultation discussions, to raise the reserve requirement and re-impose credit ceilings with higher penalties for violation were appropriate under the circumstances, despite the deleterious side effects they might have on the financial system. However, the CBC's monetary program was predicated on the assumption of a further large decline in broad money velocity which, given developments in 1999, was doubtful (see Selected Issues paper for a detailed analysis). In these conditions, the CBC's policy stance in 2000 might not be consistent with the objectives of disinflation and external stability. More importantly, if the credit controls used by the CBC were effective, banks would be holding excess reserves at the start of 2001 when these controls expire, raising the prospect of a renewed surge in credit and money growth.

10. *While agreeing that more ambitious targets would have been desirable, the authorities felt that their policies would contain the risks for 2000 to acceptable levels and provide the basis for further adjustment in the future.* The authorities agreed that a more ambitious fiscal target would have been desirable. Nonetheless, noting that competitiveness continued to be strong; the projected current account deficit of 3½ percent of GDP in 2000 remained moderate by historical standards (Table 3); and external vulnerability was relatively low (see vulnerability indicators in Table 1), they saw a fiscal deficit of no more than 4 percent of GDP as providing a solid basis for continued gradual adjustment in 2001 and beyond. They underscored the importance of ensuring a wide political consensus behind this goal. As regards monetary policy, the liberalization of interest rates in 2001 would facilitate monetary management and obviate the need for direct controls, and the CBC stressed that it stood ready to use its new freedom to set interest rates as circumstances required.

B. Coping with the Challenges of Liberalization

11. *The authorities' plan for financial and capital market liberalization is appropriately sequenced, but delays in the initial steps have compressed the time available for its completion.* The authorities' plan has three stages, broadly ordered by the maturity of capital flows (Box 3). Liberalization has thus far taken place generally along the lines of the plan (one exception is the restrictions on overseas credit card usage, which were to have been eliminated in 1999 but some remain in place), but the CBC retains the right to delay *any* outflows deemed incompatible with balance of payments stability. Crucial elements of Phase 2, notably the liberalization of foreign borrowing by Cypriots, were postponed to January 1,

12. 2001, to coincide with the abolition of the interest rate ceiling. Complete liberalization of short-term capital flows is to take place at the time of EU accession, targeted for January 1, 2003. Given this target, the delay of Phase 2 until 2001 implied a compression of the period during which the economy could adjust to a liberalized environment. Indeed, the staff cautioned that any further delays in liberalization would likely leave too little time for Cyprus to be ready in 2003 for complete capital market liberalization, as required for EU accession. Discussions then focused on the prerequisites for successful capital account liberalization.

Box 3. CBC's Plan for Capital Account Liberalization	
(✓ = implemented; ✗ = not implemented)	
Phase 1	<ul style="list-style-type: none"> ✓ Liberalization of inward FDI and foreign ownership for EU citizens (some exceptions) ✓ Relaxation of restrictions on outward FDI ✓ Increase in the limits on nonresident participation in listed companies in the CSE, as well as on foreign holdings of resident investment companies ✗ Abolition of restrictions on use of credit cards by residents for payments abroad
Phase 2	<ul style="list-style-type: none"> ✗ Liberalization of medium- and long-term foreign borrowing by residents ✓ Liberalization of outward FDI (except for real estate) ✓ Partial liberalization of portfolio inflows ✗ Partial liberalization of portfolio outflows ✗ Relaxation of restrictions on borrowing in domestic currency by nonresidents
Phase 3	<ul style="list-style-type: none"> ✗ Complete liberalization of financial flows ✗ Liberalization of inward and outward real estate investment

13. *It was agreed that a sound medium-term fiscal framework was essential for ensuring macroeconomic stability, which is a sine qua non of successful capital liberalization.* In addition to being desirable in its own right, the authorities felt that such a framework was now required because of the

fundamental structural changes in public finances that the process of EU harmonization would cause over the next few years, notably indirect tax harmonization and new accession-related spending. The Ministry of Finance had prepared a *Strategic Plan for Fiscal Adjustment 1999–2002* targeting a gradual reduction in

**Strategic Plan 1999-2002
Deficit targets, in percent of GDP**

2000	4.0
2001	3.0
2002	2.0

the deficit to 2 percent of GDP by 2002 on the basis of a mix of increases in revenue (resulting from indirect tax harmonization) and restraint of annual discretionary expenditure growth to 1 percentage point less than that of nominal GDP. The *Plan* also called for rationalizing public transfers, improving the fairness and efficiency of the tax system, and ensuring private sector participation in the provision of public services.

14. *Based on its own medium-term analysis, the staff saw the Ministry's Strategic Plan as a good starting point for a medium-term fiscal policy framework, but it needed to be endorsed by the government and possibly the House, as well as extended and fleshed out*

with specific measures. The staff's baseline medium-term projections showed that present policies were unsustainable, as they would lead to a gradual widening of the twin deficits and a steady increase in the government debt-to-GDP ratio. An illustrative policy adjustment scenario (Box 4) ensured macroeconomic stability and, after an initial period of fiscal retrenchment during 2000–03, a higher sustainable growth rate (both staff scenarios are summarized in Table 4 and Figure 6 and presented in detail in the Selected Issues paper). The fiscal adjustment path in the staff's adjustment scenario was similar to that in the Ministry's Strategic Plan; indeed the latter targeted a faster decline in the overall deficit on the basis of a more optimistic projection of debt servicing costs. However, the staff noted that the Plan lacked an official imprimatur. In addition, while setting appropriate deficit goals and broad policy objectives, the Plan was short on detail and did not include specific quantitative measures and timetables. Finally, a fully fledged medium-term fiscal framework should also set objectives for the period after 2002, and be revised, updated, and extended over time to keep annual budgets in a medium-term perspective.

Box 4. The Staff's Policy Adjustment Scenario

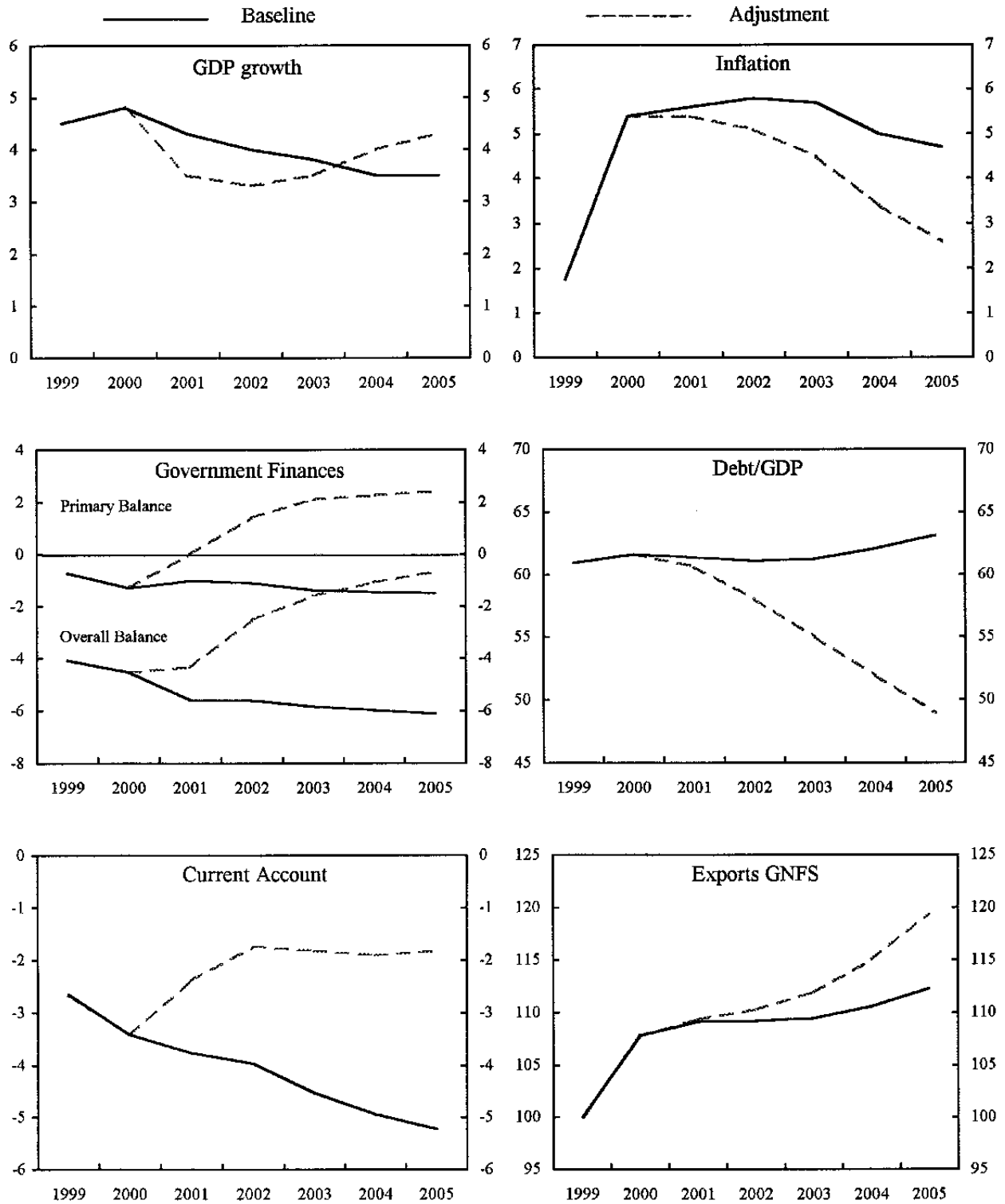
Assumptions: The external environment, including growth, interest rates, and inflation in Cyprus's partners, is taken from the latest WEO forecast. Cyprus's medium-term sustainable growth rate is estimated at 4–4½ percent. Over the medium term, domestic interest rates decline toward EU levels and the yield curve flattens.

Objectives and policies: Fiscal policy aims at reducing the deficit to around 2½ percent of GDP by 2002, which puts the debt-to-GDP ratio on a downward path, and lowering it further to below 1 percent of GDP in the longer term. These targets would provide room for countercyclical measures to address the wide output fluctuations to which Cyprus is prone, as well as put the economy in a good position eventually to meet the standards of the Stability and Growth Pact. The fiscal adjustment is based on gradual VAT and excise tax increases to EU levels by 2003, and maintaining the expenditure-to-GDP ratio at or slightly above its 2000 level through reallocation and rationalization of expenditures that would release funds to meet rising EU accession costs. The fixed exchange rate regime is maintained and capital account liberalization is completed by 2003. Structural policies aim at deregulation and market liberalization. The COLA is adjusted to exclude the impact of indirect tax increases.

Outcomes. The fiscal retrenchment initially reduces growth compared to baseline, but leads to lower interest rates, higher investment, and thus a return to the potential growth path over the medium term. Excluding the VAT from the COLA reduces the persistence of inflation, leading to improved competitiveness and export performance, and thus a sustainable current account deficit. Government debt falls below 60 percent of GDP by the end of 2002.

15. *Following capital account liberalization, the monetary and exchange rate policy framework would need to adapt to an environment of increased volatility.* The authorities and the staff agreed that, following liberalization, there could be substantial capital flows in both directions: inflows, as international investors—including expatriate Cypriots—take advantage of the new environment to increase both portfolio and direct investments in Cyprus; and outflows, as domestic residents move to diversify their portfolios into foreign assets. Although the impact of liberalization on net flows was hard to predict, capital flow volatility would certainly increase. Greater interest rate flexibility would help manage increased volatility. But greater exchange rate flexibility also had a role to play. The

Figure 6. Cyprus: Staff Medium-Term Projections, 1999-2005
(In percent or percent of GDP)



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

authorities therefore intended to move to a wider, ERM-type exchange rate band around the current central parity against the euro. At the same time, to keep the value of the central parity as a nominal anchor, the CBC intended to maintain the current fluctuation margins as a “softer” inner band. Finally, a practical consideration was the need to set up a foreign exchange market for the new, liberalized environment, and the CBC was preparing for this, using the recent experience of Greece as a model.

16. ***The staff supported this plan but stressed that the viability of the exchange rate would ultimately depend on the ability and willingness of the authorities to maintain consistent macroeconomic policies.*** The current central parity was in line with fundamentals.¹ A wider band would indeed help absorb increased volatility and deter possible speculative flows after liberalization while the inner band would, especially at the initial phase, help anchor prices and expectations and provide discipline. The staff, however, cautioned against regarding this plan as a panacea. The ability to maintain the exchange rate close to its central parity would ultimately depend on its compatibility with the underlying macroeconomic policies. An appropriate medium-term fiscal framework, as discussed above, was key in this regard. In addition, the CBC should be willing and able to take action to keep the exchange rate within the inner band, except in rare and exceptional circumstances when the wider bands could be used. Its willingness could be put to the test sooner rather than later: the staff recalled that the current credit controls risked creating a liquidity overhang in early 2001, which would require a prompt and decisive response. Moreover, the CBC’s ability to conduct monetary policy effectively should be guaranteed by speedy legislation of central bank independence, which was still at a preliminary stage.

17. ***In the authorities’ view, the Cypriot banking system was strong and could withstand the competitive pressures of a liberalized environment, but pockets of weakness existed in other parts of the financial sector.*** The authorities and staff agreed that one of the benefits of liberalization of interest rates and capital flows would be increased competition in the financial market, which was currently oligopolistic, with the attendant downward pressure on domestic credit rates and compression of bank margins. In addition, liberalization would allow banks to finance riskier projects that were previously not profitable under the interest rate ceiling. Finally, all participants in the financial sector would be faced with increased volatility in capital flows, interest rates, and exchange rate (after the widening of

¹ Relative price and cost indicators showed that, after a real appreciation in the mid-1990s, competitiveness had improved markedly in recent years. The staff’s analysis using the macroeconomic balance approach (along the lines of SM/98/178) suggested that the real value of the pound was in line with fundamentals. Although the exchange rate against the dollar and sterling was at a historical low, research by both the authorities and staff suggests that income effects dominate price effects in Cyprus’s current account receipts and, in addition, changes in the REER affect services receipts with very long lags. Simulations thus showed that even a sizeable and sudden appreciation of the euro would *ceteris paribus* have only a modest impact on the external position. For more details see the Selected Issues paper.

the band). Was the Cypriot financial sector in a position to withstand stronger competition, higher risk exposure, and greater volatility?

- It was agreed that the *commercial banking system*—the heart of the financial sector—was strong and well supervised (for a detailed assessment and international comparisons, see Selected Issues paper). The sector was dominated by two large Cypriot banks with established overseas branches, well-trained staff, and experience in operating in a liberalized environment abroad; together with foreign banks, they represented about three-quarters of the system. The legal framework and prudential standards were in line with EU directives. Moreover, in anticipation of liberalization, the CBC had raised the minimum capital requirement to 10 percent effective January 1, 2001.
- In contrast to banks, the *credit cooperatives* were weakly supervised. The authorities, however, noted that the traditional activities of cooperatives (small-scale collateralized lending to their members) were not risky and would not be affected by capital account liberalization. The staff cautioned the authorities not to underestimate the risks and urged them to strengthen supervision of cooperatives, also noting that the *status quo* was inconsistent with EU rules.
- The extraordinary growth of the *Cyprus Stock Exchange* exposed shortcomings in the infrastructure and regulation of the market, of which the authorities and market participants were fully aware. Appropriate measures were already under preparation to address them. The staff urged the authorities to proceed without delay, especially in the areas of investor protection, through legislation for mutual funds and financial services; effective market regulation, through strengthening of the Stock Exchange and the Securities and Exchange Commission and clarification of their respective roles; and clearing and settlement, through the completion of a central share registry.²

C. Other Issues

18. *While there are few restrictions on hiring and firing of workers in Cyprus, the COLA mechanism risks undermining competitiveness by locking in the inflationary stimulus of VAT rate hikes and supply shocks, such as oil price increases.* The authorities noted the strong support that the COLA enjoyed among many in Cyprus for its contribution to harmonious labor relations; indeed, industrial strife was rare in Cyprus. The staff suggested that it would nonetheless be important to exclude at least the effects of VAT increases from the COLA, in order to avoid these one-off measures being translated into persistently higher inflation. In response to the trade unions' argument that the significant price effects of VAT rate increases would undermine the purchasing power of households,

² The Selected Issues paper includes an evaluation of Cyprus's compliance with the core principles of the International Organization of Securities Commissions (IOSCO).

the staff noted that, at least in 2000, the entire additional revenue from the VAT rate increase was being spent on higher social transfers and tax relief.

19. ***In recent years, the authorities' efforts to improve the oversight of Cyprus's offshore sector have borne positive results.*** Although financial services are a small part of the offshore sector in Cyprus (146 entities with about US\$8.6 billion under management at the end of 1998, out of a total of about 41,000 entities, mostly in trading and shipping), the authorities have been actively trying to minimize its vulnerability to money laundering. A strong regulatory framework for offshore banks was in place, a modern Anti-Money Laundering Law had been introduced in 1996, and Cyprus had a good record of implementation and cooperation with other national supervisors. Examinations by the Financial Action Task Force (FATF) in 1997 and the Council of Europe in 1998 had both resulted in positive evaluations. The May 2000 Financial Stability Forum (FSF) Report on Offshore Centers mentioned Cyprus as a jurisdiction generally seen as having low quality of supervision; this Report, however, was not based on an assessment of supervisory practices in Cyprus. After a detailed assessment, the FATF concluded in June 2000 that Cyprus had a comprehensive anti-money laundering system and was cooperating in the international fight against money laundering. Nevertheless, during the Article IV consultation discussions, the CBC reiterated that it was committed to enhancing further the oversight of offshore financial units. In addition, in response to the recommendations of the OECD on harmful tax practices, the government announced its intention to phase out the preferential tax treatment of offshore companies (a 4.25 percent profit tax, compared with 20 percent for domestic companies) by the end of 2005. While firms were drawn to the offshore sector in Cyprus by a number of diverse factors, including location, high-quality infrastructure, a strong legal system, and double-taxation treaties, the authorities feared that the elimination of tax advantages could have a detrimental impact on the sector and thus on Cyprus's balance of payments (the offshore sector accounted for about 12 percent of invisibles receipts).

20. ***Microeconomic reforms and deregulation would improve efficiency and increase potential growth.*** The authorities noted that the growth of the stock exchange had created incentives for private firms to restructure and increase efficiency and profitability. This made the contrast with some inefficient public sector entities even starker. Although EU accession would force several of these sectors to open to competition (notably telecommunications and air travel), the authorities acknowledged that deregulation and opening the sectors to private sector participation would spur productivity growth and should be done for their own sake. The staff added that state-owned enterprises should be turned into public companies with proper management rules and, once a proper regulatory framework was in place, could be privatized. Furthermore, although the EU Association Agreement eliminated barriers on goods imports from EU members, extensive restrictions remain on agricultural products. The staff argued that, given the effect of the recent drought on food prices, reduction of agricultural protection would have a dampening effect on inflation and a disproportionately beneficial effect on low-income groups. Finally, the staff noted that agriculture accounted for less than 5 percent of value added but around three-fourths of water consumption, and recommended rationalizing water pricing to ensure an efficient allocation of this resource.

IV. STAFF APPRAISAL

21. ***The recent deterioration in the macroeconomic situation in Cyprus, while not unprecedented, is proving difficult to reverse.*** Rapid domestic consumption growth, coupled with full backward-looking wage indexation, raises concerns about inflation in 2000 and 2001. Without the record tourism receipts expected this year, the impact on the current account would have been more apparent. At the same time, macroeconomic management is impaired by structural rigidities in the financial market and the political impasse between the government and the House of Representatives. While the Cypriot economy is capable of pulling through without a hard landing—and indeed has done so in similar circumstances in the past—the stakes are now higher: macroeconomic adjustment will have to be accomplished in a changing economic environment as a result of the self-imposed timetable for EU harmonization.

22. ***In the short run, the authorities should use all available options to move toward a more cautious policy stance.*** Instead of taking advantage of the current strong cyclical position to make serious progress toward fiscal consolidation, deficit reduction in 2000 will likely be marginal and rely partly on postponed spending. The staff especially regretted the decision to spend the additional revenue from the VAT while, at the same time, fully compensating wage earners for the price impact of VAT through indexation, as this would prove destabilizing for inflation. The government should use all available discretion to contain expenditures below budget levels and, jointly with the House, impose a moratorium on all new social transfers and subsidies. The CBC, for its part, should ensure that the direct credit controls are observed, and consider additional liquidity measures later in the year if credit growth continues to exceed its guidelines.

23. ***Significant further policy adjustment will be needed in 2001 and beyond to meet the challenges of financial and capital market liberalization.*** The gradual capital account liberalization and opening to competition mandated for EU accession will expose the economy and, in particular, the financial sector, to greater volatility and risk. This underscores the urgency of addressing the current macroeconomic imbalance and, more broadly, taking steps to minimize the inevitable risks arising from liberalization.

24. ***The first priority should be to rein in the fiscal deficit and adopt an appropriate medium-term fiscal policy framework.*** The authorities should aim at containing the deficit to around 2–2½ percent of GDP by 2002, and reducing it further in the long term. These targets are not difficult to achieve as higher VAT and excise taxes, which are anyway required for EU accession, will provide significant additional revenue. An appropriate medium-term fiscal policy framework should also aim at increasing the efficiency and fairness of the tax system; increasing flexibility and improving resource allocation in the public sector; introducing means-testing for social benefits, many of which are currently extended indiscriminately with little regard to need; and reforming the budget process by extending the coverage to general government (as in all EU countries), imposing uniform accounting standards, and introducing a rolling, multi-year budget plan. The Ministry of Finance's *Strategic Plan for Fiscal Adjustment* is a good outline of such a medium-term framework,

but it needs to be fleshed out with detailed policies and timetables. Its official endorsement by the government and possibly the House is also necessary to enhance its credibility.

25. ***Financial and capital account liberalization will present new challenges for the Central Bank.*** The current exchange rate system has served Cyprus well, and the central parity is currently in line with fundamentals. However, consistent and coordinated macroeconomic policies are essential for safeguarding the viability of the system. In particular, the ability of the CBC to conduct effective monetary policy needs to be strengthened. Abolition of the interest rate ceiling and the statutory establishment of central bank independence are crucial prerequisites for liberalization. In addition to having the ability to manage liquidity, the central bank must also show that it is willing to do so, including by tightening monetary conditions when necessary. Widening of the fluctuation band for the exchange rate will provide leeway for exchange rate movements to absorb increased capital volatility.

26. ***The authorities should focus on preparing the financial sector for the rigors of a liberalized environment.*** Commercial banks, which appear to be sound and well supervised, are in a strong position to face financial liberalization. Important regulatory and supervisory weaknesses, however, exist in other parts of the financial sector. The prudential and supervisory standards applied to credit cooperatives are very weak; unless this is addressed, cooperatives should not be allowed to engage in the full range of banking business. The strengthening of stock market institutions and regulations currently under way is welcome, and should be completed as soon as possible. The authorities should consider participating in a Financial Sector Stability Program to help them identify remaining weaknesses and appropriate remedies. Finally, vigilance should continue to be exercised in offshore sector supervision.

27. ***Labor market reforms and deregulation are important for ensuring macroeconomic stability, increasing economic efficiency, and raising the potential growth rate.*** The benefits of the COLA in terms of social peace notwithstanding, the price impact of indirect tax increases should be excluded from the indexation formula. The first-best solution, however, would be to move toward forward-looking wage-setting that takes into account productivity and wage developments in Cyprus's trade partners. State intervention in the economy should be reduced, starting with the transformation of all state enterprises into public companies with proper management rules, and the opening up of sectors dominated by state monopolies to competition. This would pave the way for greater private sector participation in the provision of public services and, provided a consensus is reached, the eventual privatization of these state companies. Agricultural protection should be reduced.

28. Cyprus's macroeconomic **statistics are adequate for surveillance**, but there are important shortcomings, particularly in the timeliness of some indicators in the balance of payments and national accounts. Capital account liberalization will necessitate a switch to a settlements-based system for gathering balance of payments statistics, and this will need to be supplemented by surveys of banks and the broader financial system.

29. The next **Article IV consultation with Cyprus** should remain on a 24 month cycle.

Table 1. Cyprus: Selected Indicators

I. Social and Demographic Indicators

Area:	9,251 square kilometers
Population:	663,300 (1999) in government-controlled area
Growth rate:	0.9 percent (1999)
GDP per capita:	\$13,647 (1999) in government-controlled area
Life expectancy:	75 (male), 80 (female) (1996/97)
Infant mortality:	7 per thousand (1998)

II. Economic Indicators

	1993	1994	1995	1996	1997	1998	1999	2000 proj.
(Contributions to annual growth; excludes statistical discrepancy)								
Demand and Supply								
Total aggregate demand	-11.1	11.2	10.1	8.2	1.1	6.6	3.4	11.9
Domestic demand	-10.4	7.3	7.8	6.2	0.6	7.8	-0.2	8.1
Private consumption	-3.0	2.9	6.0	5.1	3.8	5.3	0.2	4.3
Public consumption	-2.7	0.6	0.5	1.8	0.6	1.1	-0.6	2.8
Gross investment	-4.7	3.7	1.3	-0.6	-3.8	1.4	0.3	1.1
Foreign balance	10.6	-0.2	-3.6	-1.7	0.7	-3.7	3.6	-1.5
Exports of goods and services	-0.7	3.9	2.3	2.0	0.5	-1.2	3.5	3.8
Imports of goods and services	11.3	-4.2	-6.0	-3.7	0.2	-2.5	0.0	-5.2
(Annual percentage change)								
Real GDP	0.7	5.9	6.1	1.9	2.4	5.0	4.5	4.8
Industrial production index	-6.4	3.5	1.6	-3.0	-0.3	2.8	1.7	1.8
Tourist arrivals	-7.5	12.4	1.5	-7.1	7.1	6.5	9.5	10.9
Gross domestic investment (percent of GDP)	24.1	25.6	21.9	22.3	19.7	19.6	18.8	19.0
Gross national savings (percent of GDP)	27.6	28.6	23.0	20.0	19.0	16.1	19.0	18.5
Of which: private savings (percent of GDP)	27.2	27.2	21.6	21.1	21.8	19.0	20.3	20.0
Employment and Unemployment								
Labor force growth rate (in percent)	-0.8	2.8	3.1	1.5	0.2	1.4	1.2	0.8
Participation rate (in percent)	45.9	46.4	47.2	47.0	46.7	46.9	46.9	46.9
Unemployment rate (in percent)	2.7	2.7	2.6	3.1	3.4	3.4	3.6	3.5
Prices and Wages								
Consumer prices (percent change, end-period)	3.6	5.6	1.6	2.5	3.9	1.0	3.7	5.5
Consumer prices (percent change, period average)	4.9	4.7	2.6	3.0	3.6	2.2	1.8	5.4
Real wages	3.8	2.6	3.0	2.8	2.7	2.8	2.0	2.2
(In percent of GDP)								
Public Finance								
Consolidated central government 1/								
Revenue	30.3	31.4	31.7	31.8	31.5	31.5	32.2	34.3
Expenditure and net lending	32.6	32.8	32.7	35.3	36.8	37.0	36.3	38.9
Overall balance	-2.4	-1.4	-1.0	-3.4	-5.3	-5.5	-4.1	-4.5
Primary balance	2.6	3.7	4.0	1.9	0.0	0.2	1.7	1.1
(without intragovernmental interest)	0.9	1.9	2.2	-0.1	-2.2	-2.1	-0.7	-1.3
Debt net of intragovernmental debt	58.4	53.5	51.4	52.9	57.2	59.6	60.9	61.6

	1993	1994	1995	1996	1997	1998	1999	2000 proj.
	(Annual percentage change)							
Money and Credit 2/								
Broad money	16.3	12.5	11.4	10.5	11.0	8.3	15.4	12.6
Reserve money	1.6	12.5	-4.3	-8.8	-0.8	16.2	14.1	20.0
Domestic credit	15.3	11.0	14.8	13.7	12.0	11.8	10.3	10.7
Broad money velocity	10.2	1.1	-1.7	-6.2	5.5	-1.2	-7.6	-2.7
Interest rates								
13-week T-bill 3/	6.0	6.0	6.0	6.1	5.4	5.6	5.6	5.5
10-year domestic bonds 3/	8.0	7.0	7.0	7.0	6.9	7.1	7.2	7.4
	(In percent of GDP)							
External Sector								
Trade balance	-24.2	-24.6	-24.7	-25.7	-25.2	-27.5	-26.2	-28.4
Current account	1.5	1.2	-1.9	-5.3	-3.9	-6.7	-2.6	-3.4
Capital account	-1.0	0.0	-0.3	-0.1	2.0	3.5	0.1	1.9
Of which: Direct foreign investment	0.7	0.2	0.5	0.9	0.1	-0.7	-0.3	3.9
Of which: Short-term capital, net	-1.0	1.7	0.2	0.1	-0.5	-0.8	0.9	0.6
	(In millions of U.S. dollars unless otherwise indicated)							
Vulnerability Indicators								
Trade balance	-1,597	-1,826	-2,187	-2,295	-2,141	-2,490	-2,383	-2,473
Current account balance	100	89	-171	-473	-331	-608	-241	-298
Capital account balance	-67	1	-25	-9	174	313	12	166
Of which: Direct foreign investment	46	18	44	81	12	-65	-31	336
Of which: Short-term capital, net	-64	129	15	9	-44	-71	82	55
Official foreign exchange reserves	1,112	1,482	1,837	1,713	1,527	1,513	1,976	1,902
(in months of GNFS imports)	4.4	4.8	5.0	4.3	4.2	3.7	5.5	5.3
Reserve money/reserves (end-period, percent)	134.2	123.6	99.5	94.6	94.1	116.4	88.2	88.3
Broad money/reserves (end-period, ratio)	5.2	4.8	4.5	5.2	5.7	6.6	5.1	5.2
Net international reserves (end-period)	1,346	1,563	2,182	2,250	2,608	2,316	2,959	3,551
Banks' net foreign assets (end-period)	423.4	642.7	389.4	608.6	408.5	191.2	452.7	...
External debt (percent of GDP) 4/	33.0	28.4	24.7	22.2	25.3	28.5	32.8	35.1
(in percent of GNFS exports)	62.8	54.3	47.2	42.5	48.0	57.6	63.4	65.1
Of which: Public sector (percent of total)	58.1	53.5	49.0	44.2	47.1	50.2	52.8	58.5
ST external debt/reserves (in percent)	80.6	84.8	64.2	60.0	51.8	65.3	51.5	38.7
External debt service	181.7	171.4	170.0	132.4	133.6	171.0	172.5	180.9
(in percent of exports GNFS)	5.3	4.4	3.7	2.8	3.0	3.8	3.7	3.8
Exchange Rates								
Pounds per U.S. dollar (end-period) 3/	0.52	0.48	0.46	0.47	0.53	0.50	0.57	0.60
Pounds per euro (end-period) 3/	0.58	0.58	0.59	0.59	0.58	0.59	0.58	0.58
Nominal effective (1995=100) 5/	93.0	96.3	100.0	102.0	102.8	108.3	106.0	102.2
Real effective (CPI, 1995=100) 5/	96.6	99.0	100.0	100.3	100.1	103.3	99.8	97.3
Financial Market Indicators								
Stock market general index 3/	82.3	76.8	90.6	714.0	467.8
Long-term foreign currency debt rating (S&P)	...	AA-	AA-	AA-	AA-	A+	A+	A

1/ Central government (excludes local government); corresponds to the authorities' "consolidated" budget.

2/ Deposit money banks only; does not include credit cooperatives.

3/ Data for 2000 are the latest available, July 5.

4/ Excludes offshore sector, with short-term debt and external debt service estimated by combining B/S and official data.

5/ Data for 2000 are for April.

Table 2. Cyprus: Consolidated Central Government Budget, 1993-2000

(In percent of GDP)

	1993	1994	1995	1996	1997	1998	1999 Est.	2000 Proj.
Revenue	30.3	31.4	31.7	31.8	31.5	31.5	32.2	34.3
Current revenue	30.1	31.3	31.6	31.8	31.4	31.5	32.2	34.3
Tax revenue	24.1	25.5	25.5	25.5	24.6	25.1	26.0	26.7
Direct taxes	7.7	8.3	8.2	8.5	8.6	9.0	10.0	9.9
Indirect taxes	11.8	12.5	12.8	12.2	11.3	11.4	11.4	11.9
Social security contributions	4.7	4.6	4.5	4.8	4.7	4.7	4.6	4.9
Nontax	6.0	5.8	6.1	6.3	6.9	6.3	6.2	7.6
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign grants	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Expenditure	32.6	32.8	32.7	35.3	36.8	37.0	36.3	38.9
Current expenditure	28.9	29.2	28.8	31.7	33.0	33.2	32.3	34.7
Wages and salaries	9.4	9.7	9.4	9.5	9.8	9.8	9.8	10.4
Other goods and services	2.7	2.5	2.4	2.7	3.0	3.0	3.0	3.2
Subsidies	1.2	0.8	0.9	1.1	0.8	0.7	0.8	0.7
Interest payments	5.0	5.1	5.0	5.3	5.3	5.8	5.8	5.7
Social security payments	4.9	4.9	4.8	5.2	5.4	5.4	5.5	6.0
Other transfers	3.8	4.3	4.6	5.1	5.8	6.0	6.3	7.0
Other	2.0	2.0	1.7	2.7	2.9	2.5	1.1	1.8
Capital	3.3	3.5	3.8	3.5	3.7	3.8	3.9	4.1
Investment	2.7	2.7	2.4	2.3	2.5	2.7	2.7	3.0
Transfers	0.6	0.8	1.4	1.1	1.2	1.1	1.2	1.1
Net lending	0.5	0.1	0.1	0.1	0.1	0.0	0.1	0.0
Overall balance	-2.4	-1.4	-1.0	-3.4	-5.3	-5.5	-4.1	-4.5
Primary balance	2.6	3.7	4.0	1.9	0.0	0.2	1.7	1.1
Without intragovernmental interest	0.9	1.9	2.2	-0.1	-2.2	-2.1	-0.7	-1.3

Sources: Ministry of Finance; and Fund staff projections.

Table 3. Cyprus: Balance of Payments, 1993-2000

	1993	1994	1995	1996	1997	1998	1999 Est.	2000 Proj.
(In millions of U.S. dollars)								
Current account balance	100	89	-171	-473	-331	-608	-241	-298
Trade balance	-1,597	-1,826	-2,187	-2,295	-2,141	-2,490	-2,383	-2,473
Exports	779	881	1,128	1,281	1,179	1,006	930	896
Imports	2,376	2,707	3,316	3,576	3,320	3,496	3,313	3,370
Fuel and lubricants	257	252	286	336	306	245	322	458
Services	1,698	1,915	2,016	1,822	1,810	1,882	2,142	2,175
Exports	2,509	2,825	3,172	3,058	2,969	3,097	3,336	3,304
Travel (mostly tourism)	1,405	1,653	1,798	1,679	1,658	1,718	1,905	1,933
Imports	806	898	1,154	1,228	1,173	1,224	1,240	1,208
Investment income, net	-39	-45	-30	-40	-12	-21	-39	-55
Transfers, net	34	34	29	33	26	29	86	134
Capital account 1/	-67	1	-25	-9	174	313	12	166
Short-term capital	-64	129	15	9	-44	-71	82	55
Long-term loans	-48	-144	-82	-97	-92	61	-331	-383
FDI, net	46	18	44	81	12	-65	-31	336
Net errors and omissions	69	44	-49	11	-75	-71	-50	-43
Overall balance	102	134	-245	-471	-232	-366	-278	-174
Change in official reserves	43	273	419	-128	-164	-105	636	-79
(Percentage change)								
Memorandum items:								
Goods exports	-2.4	11.8	17.9	17.0	1.4	-14.2	-3.0	10.3
Goods imports	-20.4	12.6	12.7	11.2	2.2	6.0	-0.6	16.4
Tourism receipts	0.3	16.4	0.0	-3.7	8.7	4.3	16.3	16.1
(In percent of GDP)								
Trade balance	-24.2	-24.6	-24.7	-25.7	-25.2	-27.5	-26.2	-28.4
Current account	1.5	1.2	-1.9	-5.3	-3.9	-6.7	-2.6	-3.4
Capital account	-1.0	0.0	-0.3	-0.1	2.0	3.5	0.1	1.9
Change in official reserves	0.7	3.7	4.7	-1.4	-1.9	-1.2	7.0	-0.9
(In millions of U.S. dollars, end-of-period)								
Gross official reserves	1,163	1,436	1,855	1,727	1,563	1,458	2,094	2,015
In months of imports GS	4.4	4.8	5.0	4.3	4.2	3.7	5.5	5.3
Total gross reserves (includes banks)	2,707	3,181	4,825	4,825	5,079	4,479	5,457	5,721
In months of imports GS	10.2	10.6	13.0	12.1	13.6	11.4	14.4	15.0
(In billions of U.S. dollars)								
Gross domestic product	6.6	7.4	8.9	8.9	8.5	9.1	9.1	8.7

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

1/ Capital and financial account do not conform to the methodology of *Balance of Payments Manual* Fifth Edition.

Table 4. Cyprus: Medium-Term Macroeconomic Scenarios, 1998-2005

	1998	Est. 1999	Projection					
			2000	2001	2002	2003	2004	2005
BASELINE SCENARIO			(Percentage change)					
Real GDP	5.0	4.5	4.8	4.3	4.0	3.8	3.5	3.5
Domestic demand	7.5	-0.2	8.0	5.3	4.3	4.4	3.8	3.6
Private consumption	8.0	0.3	6.5	6.0	4.4	4.9	4.0	3.8
Public consumption	6.4	-3.6	17.6	4.2	4.5	3.5	3.1	3.1
Investment	6.6	1.2	5.5	4.1	3.8	3.7	3.6	3.5
Exports GNFS	-2.4	7.6	7.8	1.2	0.1	0.2	1.0	1.6
Imports GNFS	4.4	-0.1	9.9	1.0	1.1	1.9	1.9	2.1
Consumer Price Inflation (period average)	2.2	1.8	5.4	5.6	5.8	5.7	5.0	4.7
			(In percent of GDP)					
Gross domestic investment	18.5	17.5	17.7	17.7	17.6	17.6	17.6	17.6
Private investment	14.7	13.6	13.5	13.5	13.5	13.5	13.5	13.5
Gross domestic saving	11.8	14.8	14.3	13.9	13.7	13.1	12.7	12.4
Public	-1.7	-0.2	-0.4	-1.5	-1.5	-1.7	-1.8	-2.0
Private	13.5	15.0	14.7	15.4	15.1	14.8	14.5	14.4
Foreign savings (current account deficit)	6.7	2.6	3.4	3.8	4.0	4.5	4.9	5.2
Public finances								
Total revenue	31.5	32.2	34.3	34.8	36.5	37.8	37.8	37.8
Total expenditure and net lending	37.0	36.3	38.9	40.4	42.1	43.6	43.7	43.9
Overall balance	-5.5	-4.1	-4.5	-5.6	-5.6	-5.8	-6.0	-6.1
Primary balance	-2.1	-0.7	-1.3	-1.0	-1.1	-1.4	-1.5	-1.5
Public debt	59.6	60.9	61.6	61.4	61.1	61.2	62.1	63.1
ADJUSTMENT SCENARIO			(Percentage change)					
Real GDP	5.0	4.5	4.8	3.5	3.3	3.5	4.0	4.3
Domestic demand	7.5	-0.2	8.0	3.3	3.1	3.8	4.2	4.3
Private consumption	8.0	0.3	6.7	3.8	3.0	3.8	4.1	4.2
Public consumption	6.4	-3.6	17.6	-1.4	1.6	1.4	1.5	2.0
Investment	6.6	1.2	5.5	5.6	4.6	5.3	6.5	6.0
Exports GNFS	-2.4	7.6	7.8	1.4	0.8	1.5	2.8	3.9
Imports GNFS	4.4	-0.1	9.9	-1.2	0.7	2.2	3.2	3.9
Consumer Price Inflation (period average)	2.2	1.8	5.4	5.4	5.1	4.5	3.4	2.6
			(In percent of GDP)					
Gross domestic investment	18.5	17.5	17.7	18.1	18.4	18.7	19.2	19.6
Private investment	14.7	13.6	13.5	14.0	14.2	14.6	15.1	15.4
Gross domestic saving	11.8	14.8	14.3	15.7	16.6	16.9	17.3	17.8
Public	-1.7	-0.2	-0.4	-0.2	1.6	2.5	3.1	3.5
Private	13.5	15.0	14.7	15.9	15.0	14.4	14.2	14.3
Foreign savings (current account deficit)	6.7	2.6	3.4	2.4	1.7	1.8	1.9	1.8
Public finances								
Total revenue	31.5	32.2	34.3	35.0	36.9	38.2	38.0	38.0
Total expenditure and net lending	37.0	36.3	38.9	39.3	39.4	39.8	39.1	38.7
Overall balance	-5.5	-4.1	-4.5	-4.3	-2.5	-1.6	-1.1	-0.7
Primary balance	-2.1	-0.7	-1.3	0.0	1.4	2.1	2.3	2.4
Public debt	59.6	60.9	61.6	60.6	58.1	55.0	51.9	48.9

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

CYPRUS: FUND RELATIONS
(As of May 31, 2000)

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

II. General Resources Account:	SDR Million	Percent of Quota
Quota	139.60	100.0
Fund holdings of currency	104.25	74.7
Reserve position in Fund	35.36	25.3

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	19.44	100.0
Holdings	0.57	2.9

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

V. **Financial Arrangements:**

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

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

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

VIII. **Article IV Consultation:** The last Article IV consultation discussions were held in April–May 1998 and the staff report (SM/98/175, 7/9/98) was discussed by the Executive Board on July 24, 1998.

IX. **Technical Assistance:**

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

X. **Resident Representative:** None.

CYPRUS: STATISTICAL ISSUES

Cyprus has an open publication policy, and its statistical data are of a high quality and adequate frequency. Weaknesses remain with respect to the requirements of the Special Data Dissemination Standard (SDDS), however, and some series are available with time lags that are longer than desirable. The authorities have decided to postpone a subscription to the SDDS, but intend to continue improving aspects of data collection and publication.

National accounts exist only at an annual frequency. The lack of quarterly national accounts data is one of the major weaknesses of Cypriot economic statistics vis-à-vis the requirements of the SDDS. Monthly indicators of economic activity exist (notably trade flows, tourism arrivals, and industrial production), and, to some extent can substitute for the lack of quarterly national accounts data. However, most such indicators are available only with a lag of several months. As of January 1999, the CPI is produced with the EU definition used to judge compliance with Maastricht treaty requirements.

Balance of payments accounts are not yet up to the standard set in the *IMF Balance of Payments Manual*, fifth edition. The authorities are committed to bringing balance of payments statistics up to this (definitional and coverage) standard, and have requested a long-term technical assistance expert. Trade statistics are available on a monthly basis with a lag of about three to four months; current account statistics are only available on a quarterly basis, and with a long lag.

Fiscal data for the central government are of good quality and coverage. Monthly fiscal data are collected and are generally of high quality, but they are not always published on a timely basis. Local authority data are beginning to be compiled for the largest local authorities and municipalities. Consolidated general government accounts will be needed to produce data comparable to EU countries.

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

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

Cyprus: Core Statistical Indicators
as of July 11, 2000

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	7/11/00	5/31/00	5/31/00	5/31/00	5/31/00	7/11/00	May 2000	May 2000	September 1999	December 1999	1999 estimate	1999
Date Received	7/11/00	7/11/00	6/28/00	6/28/00	6/28/00	7/11/00	6/6/00	7/5/00	5/12/00	5/12/00	5/12/00	5/12/00
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Annual	Semi-annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly/ When requested	When Requested	When Updated	When Requested
Source of Update 1/	Reuters/ Bloomberg	CBC	CBC	CBC	CBC	CBC/ Reuters	CBC/ Reuters	CBC/ Reuters	CBC	MoF	MoF	MoF
Mode of Reporting	Internet/ Electronic	Electronic/ Fax	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic	Internet/ Electronic/ Fax	Fax/ Publication	Fax/ Publication	Fax	Fax
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	When Updated	Semi-annual

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

Statement by the IMF Staff Representative
August 3, 2000

1. This statement updates the staff report (SM/00/173, July 19, 2000) to reflect information that has become available since the issuance of the report. These recent developments do not change the thrust of the staff appraisal.
2. **Fiscal policy.** Recent projections by the Ministry of Finance on the basis of fiscal developments in the first half of the year suggest that, if the trend of higher-than-expected revenues and underspending in certain budget categories (notably defense) continued for the rest of the year, the deficit could be contained to 3.7 percent of GDP in 2000. However, no new fiscal policy initiatives or permanent measures underpinning these projections have been announced to date.
3. **Monetary policy.** In recent days, faced with continued bank credit growth well in excess of its end-year ceiling of 12 percent, the Central Bank of Cyprus announced that it will not penalize banks exceeding the ceiling by up to 20 percent. This measure effectively relaxed its aggregate credit target for 2000 to 14.4 percent. At the same time, in view of the decline in the stock market index, the Bank lifted its ban on lending for stock purchases. The relaxation of the aggregate credit target is not justified by economic fundamentals, and highlights the difficulties facing the Central Bank in maintaining control over domestic liquidity conditions under the interest rate ceiling. These measures also risk giving the wrong signal to market participants at a time of strong domestic demand growth.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 00/67
FOR IMMEDIATE RELEASE
August 22, 2000

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

IMF Concludes Article IV Consultation with Cyprus

On August 3, 2000, the Executive Board concluded the Article IV consultation with Cyprus.¹

Background

Cyprus's economic performance in the past quarter century has been impressive, but as the economy has increasingly come to rely on tourism as the main engine of growth, it has become more vulnerable to external shocks. Per capita GDP has more than tripled since 1974, and is now nearly 80 percent of the EU average, above that in several current EU members. Good economic management has until recently ensured full employment and low inflation. Since the mid-1980s, the fiscal deficit has averaged 4 percent of GDP, the Cyprus pound has been kept within a $\pm 2\frac{1}{4}$ percent band around the central parity with the ECU (the euro since 1999), inflation has averaged 3.5 percent, and the unemployment rate has remained below 4 percent (below 3 percent for most of the 1990s). At the same time, significant distortions remain, including financial and capital market controls, full wage indexation (excluding recent excise tax increases), and extensive government involvement in the economy.

Growth has remained strong in recent years, with 5.0 percent real GDP growth in 1998, 4.5 percent in 1999, and 4.8 percent projected in 2000. Unemployment remains below 4 percent. Wage moderation kept inflation at low levels for most of 1999 (CPI inflation averaged 1.8 percent), but inflation accelerated sharply in late 1999 and early 2000 owing to higher energy and food prices, as well as the depreciation of the euro to which the Cyprus pound is pegged. The hike in the VAT rate from 8 to 10 percent on July 1 will trigger a new round of price increases. In addition, trade data suggest that the composition of demand in 2000 is shifting toward domestic consumption: the value of consumer goods imports rose by nearly 12 percent

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

in the first three months of 2000 compared to the same period in 1999, while that of capital goods rose by less than 3 percent. This consumption possibly stems from wealth effects related to gains on the Cyprus Stock Exchange, which registered explosive growth in 1999, peaking in November before falling sharply.

Following a record 5.5 percent of GDP in 1998, the fiscal deficit was reduced to 4.1 percent of GDP in 1999, thanks to postponements in defense-related outlays and small indirect tax increases. The ratio of consolidated government debt to GDP reached 61 percent at end-1999, up from less than 52 percent in 1995. The long-delayed VAT rate hike took effect in July 2000, but its impact on the fiscal balance this year is to be fully offset by increased social transfers and tax cuts. Slow progress in addressing the fiscal imbalance and the rising debt burden were cited as the main factors behind S&P's December 1999 downgrade of Cyprus's debt rating and Moody's May 2000 shift to a negative ratings outlook, though both ratings remain well within the investment grade range.

Financial market restrictions, including the interest rate ceiling, limit the ability of the Central Bank of Cyprus to manage liquidity. The Central Bank of Cyprus (CBC) in mid-1999 imposed ceilings to slow credit growth toward its 10 percent end-year target. Credit and broad money (M2) continued to grow rapidly in 2000 (20 percent and 18 percent in the year to April, respectively), leading the CBC in May 2000 to again impose credit ceilings for the second half of 2000 (for an aggregate credit growth target of 12 percent during the year) and increase the reserve requirement by 1 percentage point to 8 percent. Moreover, while leaving its official intervention rates unchanged, the CBC has limited refinancing to banks.

Capital and financial market liberalization are planned to be implemented by the time of EU accession. Partial liberalization has taken place for foreign direct investment (FDI) outflows by Cypriots and most FDI inflows and portfolio investments by EU residents. Parliament has approved legislation abolishing the interest rate ceiling as of January 1, 2001, and this would be accompanied by liberalization of foreign borrowing by Cypriots. Complete liberalization of short-term capital flows is to coincide with EU accession, for which the Cypriot authorities plan to be ready by January 1, 2003.

Executive Board Assessment

Executive Directors commended Cyprus's strong record of economic growth, low inflation, and low unemployment over the last 25 years, and welcomed the wide spectrum of reforms underway to prepare its membership of the European Union (EU). Directors noted, however, that limited progress in fiscal consolidation and long-standing structural rigidities, notably backward-looking wage indexation, has contributed to the recent increase in the public debt-to-GDP ratio and to the risk of inflation. They stressed the need for the authorities to take advantage of the current strong cyclical position to reduce the fiscal deficit and adopt an appropriate medium-term fiscal policy framework that will ensure a sustainable reduction in the fiscal deficit and debt-to-GDP ratio. A few Directors noted the lack of domestic political consensus, which made it difficult to achieve further fiscal consolidation at the present time. Maintaining and reinforcing a firm stance of macroeconomic policies over the medium term, in

the context of ongoing structural reforms and efforts to diversify the economy, will also be key to averting balance-of-payments pressures.

Directors noted the authorities' intention to keep the fiscal deficit to no more than 4 percent of GDP in 2000, but stressed that sustainable fiscal consolidation will require more lasting measures. In this context, they regretted that additional revenues from the recent increase in value-added tax (VAT) rates have been offset by higher expenditures. With further rises in VAT and excise taxes required prior to EU entry, Directors viewed the ambitious reduction in the deficit to 2-2.5 percent of GDP by 2002, in line with the Finance Ministry's Strategic Plan, as both desirable and feasible. Directors also noted that formal endorsement of this plan by the Cabinet and by the House of Representatives would greatly enhance its role as a medium-term framework for the conduct of fiscal policy.

Directors welcomed the authorities' commitments to remove the statutory ceiling on interest rates in January 2001 and to gradually relax controls on capital movements prior to EU accession. Abolition of the interest rate ceiling and central bank independence will be crucial to enable the Central Bank of Cyprus to conduct monetary policy more flexibly and effectively. At the same time, they stressed the need to ensure that the financial sector is prepared for interest rate and capital account liberalization. Directors noted that, while the commercial banking sector appears to be strong and well-supervised, the prudential and supervisory standards applied to cooperative credit and savings societies are in need of strengthening, if these institutions are to continue to be engaged in the full range of banking business. They also observed that the recent dramatic increases in volume and volatility in the equity market underline the need to improve regulatory capacity and market infrastructure. Directors encouraged the authorities to request a Financial Sector Assessment Program (FSAP) to identify potential areas of weakness in the domestic financial sector.

Directors viewed the current central parity as being in line with fundamentals and welcomed the authorities' intention to move to a wider exchange rate band in the context of capital account liberalization. While the latter step will help the authorities cope with the likely increase in capital volatility, a wider band should, in the view of most Directors, be combined with increased central bank independence to set interest rates in order to ensure external stability. In this connection, Directors cautioned that the use of indirect controls in 2000 might create a liquidity overhang requiring neutralization through interest rate action after the abolition of the ceiling.

Directors commended the authorities for their efforts to improve the oversight of the offshore financial sector, noting that it is subject to the same overall legal framework as the domestic banks. They welcomed the authorities' commitment to phase out the preferential tax treatment of offshore companies. Noting the positive evaluation recently given to Cyprus for its efforts to guard against money laundering by the Financial Action Task Force, Directors urged the authorities to remain vigilant in protecting the integrity of the financial sector. They welcomed the authorities' intention to seek the Fund's assistance in assessing the supervision of offshore banks.

Although the labor market in Cyprus is relatively flexible, Directors encouraged the authorities to reform the current Cost of Living Allowance (COLA) system by introducing a forward-looking wage-setting system. While welcoming the recent exclusion of excise taxes from the calculation of the COLA, a number of Directors regretted the inclusion of the recent VAT increases in the indexation mechanism, as this risks exacerbating inflation.

Directors noted that macroeconomic statistics are adequate for surveillance in Cyprus, but important shortcomings remain, particularly in the timeliness of some indicators in the publication of national accounts and balance-of-payments statistics. In addition, changes in the collection of balance-of-payments statistics will be necessary as a result of the liberalization of the capital account.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Cyprus is also available.

Cyprus: Selected Economic Indicators

	1995	1996	1997	1998	1999	2000 Proj.
Real economy						
Real GDP	6.1	1.9	2.4	5.0	4.5	4.8
Tourist arrivals	1.5	-7.1	7.1	6.5	9.5	10.9
Gross domestic investment (percent of GDP)	21.9	22.3	19.7	19.6	18.8	19.0
Unemployment rate (in percent)	2.6	3.1	3.4	3.4	3.6	3.5
Consumer prices (percent change, end-period)	1.6	2.5	3.9	1.0	3.7	5.5
Consumer prices (percent change, period average)	2.6	3.0	3.6	2.2	1.8	5.4
Real wages	3.0	2.8	2.7	2.8	2.0	2.2
Public finance						
Consolidated central government 1/						
Overall balance	-1.0	-3.4	-5.3	-5.5	-4.1	-4.5
Debt net of intragovernment debt	51.4	52.9	57.2	59.6	60.9	61.6
Money and Credit 2/						
Broad money	11.4	10.5	11.0	8.3	15.4	12.6
Domestic credit	14.8	13.7	12.0	11.8	10.3	10.7
Interest rates						
13-week T-bill 3/	6.0	6.1	5.4	5.6	5.6	5.5
10-year domestic bonds 3/	7.0	7.0	6.9	7.1	7.2	7.4
Balance of payments						
Trade balance	-24.7	-25.7	-25.2	-27.5	-26.2	-28.4
Current account	-1.9	-5.3	-3.9	-6.7	-2.6	-3.4
Official foreign exchange reserves	1,837	1,713	1,527	1,513	1,976	1,902
(in months of GNFS imports)	5.0	4.3	4.2	3.7	5.5	5.3
Exchange Rates						
Pounds per U.S. dollar (end-period) 3/	0.46	0.47	0.53	0.50	0.57	0.60
Pounds per euro (end-period) 3/	0.59	0.59	0.58	0.59	0.58	0.58
Nominal effective (1995=100) 4/	100.0	102.0	102.8	108.3	106.0	102.2
Real effective (CPI, 1995=100) 4/	100.0	100.3	100.1	103.3	99.8	97.3

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

1/ Central government (excludes local government); corresponds to the authorities' "consolidated" budget; staff projection for 2000 assumes no additional measures are taken as of the time of the consultation discussions.

2/ Deposit money banks only; does not include credit cooperatives.

3/ Data for 2000 are the latest available, July 5.

4/ Data for 2000 are for April.

Statement by J. de Beaufort Wijnholds on Cyprus
August 3, 2000

Cyprus is in the midst of a transition period as it prepares for accession to the European Union. The authorities are making efforts to consolidate macroeconomic performance and are engaging in a wide spectrum of structural reforms poised to transform Cyprus into a modern and well functioning economy. In this regard, the authorities appreciate the staff's useful advice.

Recent Economic Developments and Outlook

Since 1998, the economy of Cyprus has been experiencing an economic boom. Output growth which soared to 5 percent in 1998 slowed modestly in 1999 and is expected to pick up further in 2000, registering a growth of 4.8 percent. To a large extent the strong growth performance has been the result of a boom in the tourism sector which benefited from the solid growth in Europe and the depreciation of the Euro to which the Cyprus pound is linked. The unemployment rate continues to be low compared to European levels (averaging 3 percent of the labor force in the last seven years), reflecting in part the flexibility of the labor market.

Inflation developments have been favorable up until the end of 1999. A number of exogenous factors, however, including higher oil prices, the depreciation of the Euro and a persistent drought has led to an acceleration of inflation at end 1999 to 3.7 percent from 1 percent at end 1998. The authorities and the staff have somewhat different views as regards the 2000 inflation outlook. The staff expects inflation to average around 5.4 percent while the authorities' updated forecasts point to an average inflation of around 4.5 percent. Both estimates point, of course, to an acceleration of inflation in 2000 relative to 1999. This development is, to a large extent, the result of the increase in the VAT rate from 8 to 10 percent. The different assessments as regards the size of the expected increase in inflation is due primarily to different expectations concerning the rate of growth of domestic demand. The staff, as noted in paragraph 9, expects domestic demand to accelerate over the course of 2000 and to outweigh any beneficial effects arising from the reversal of oil prices or the exchange rate. The authorities, on the other hand, believe that as a result of the sharp correction in the stock market during the first half of the year, domestic demand will slow down in the remainder of the year. In fact, they note that during the first half of the year inflation averaged 4.5 percent, and in light of the expected slowdown in domestic demand in the second half of the year, average inflation is not expected to be significantly different from 4.5 percent for the year as a whole.

As regards external developments, there was a sharp improvement in the current account in 1999 reflecting the strong performance of tourism and a marginal decline in imports reflecting subdued domestic demand. In 2000 as a result of a pick up of domestic demand in the early part of the year, the current account deficit is expected to rise modestly. Again, there is some discrepancy between the staff's and the authorities' projections (albeit

of smaller magnitude). The staff projects the current account deficit to rise to 3.4 percent of GDP while the authorities expect the current account to rise to 3.1 percent from 2.6 percent in 1999. The different assessments emanate again from different expectations as regards the rate of growth of domestic demand. The authorities' forecast was based on conservative assumptions, namely that there would be no VAT increases (which may constrain the growth of domestic demand), and that defense expenditure would rise considerably (which may not materialize). In light of these factors, it is not expected that the current account deficit will worsen significantly this year.

Policy Mix over the Near Term

In view of the deterioration of the inflation and the current account outlook, the focus of economic policy has been on reversing the emerging macroeconomic imbalances. In doing so, the authorities have been operating under binding constraints. As regards fiscal policy, the government does not have a parliamentary majority and its ability to pass appropriate fiscal measures that would reduce the fiscal deficit in a more determined fashion is currently limited. On the monetary policy front, the Central Bank of Cyprus (CBC) is constrained by institutional rigidities (e.g., the interest rate ceiling) which force it to rely on indirect mechanisms as a means of conducting its monetary policy. In light of the strong political consensus toward EU accession, it is expected that the fiscal constraints will ease over time. On the monetary policy side, the abolition of the interest rate ceiling as of January 1, 2001 is expected to provide more flexibility to the CBC in its conduct of monetary policy.

The authorities are in general agreement with the staff recommendations as regards the direction of policies. In particular they share the staff assessment that fiscal and monetary policies need to be tightened relative to 1999. They have somewhat different views however about the size of the adjustment effort needed in the near term. These disparities stem (as noted above) from the somewhat different assessment of the inflation and external current account outlook. As a result, while a more ambitious fiscal tightening may be appropriate to consolidate public finances in preparation for the medium term challenges facing the economy, it may not be necessary if the objective is to contain inflationary pressures and the current account deficit over the near term.

The distinct estimates of the size of the fiscal adjustment needed over the near term stem in part from differences in the outlook for public finances in 2000. The staff expects the fiscal deficit to deteriorate in 2000 to 4.5 percent if no additional measures are taken (paragraph 9). It acknowledges, however, that the fiscal deficit may in fact be reduced marginally in 2000. On the other hand, the authorities' updated projections point to a reduction in the fiscal deficit to 3.7 percent in 2000, compared with a deficit of 4.1 percent in 1999.

The authorities' improved forecast for 2000 is based on better than expected revenue performance, reflecting the incentive which public firms now have to accurately report their profits so as to support their share valuation. In the first half of 2000 gross income tax collections soared by 28 percent while VAT proceeds rose by 19 percent. In the second half

of the year, revenues will be boosted further as a result of the increase in the VAT rate. On the expenditure side, the fiscal accounts will be aided by a continued restraint on defense expenditure which is not expected to exceed 1999 levels. Despite the higher transfer payments which were necessitated for the passage of the VAT increase by the Parliament, the ratio of expenditure as a percent of GDP is expected to remain constant in 2000.

The authorities thus do not consider the improved fiscal outlook to be solely the result of a postponement of certain outlays, as pointed out by the staff. They note in particular a number of policy measures that they have taken to bring about the improved fiscal outlook, including better tax administration, the imposition of a tax on stock market transactions, the imposition of a capital gains tax for 1999 (to be collected beginning in 2000), restrictions in employment growth in the civil service and the abolition of grants (current transfers) to the Cyprus Tourism Organization.

The staff projections regarding the fiscal deficit fail to take these developments into account and instead rely on projections based on budgeted amounts. This approach does not take into account the fact that traditionally the budget in Cyprus is formulated on the basis of conservative assumptions and as a result actual outlays for certain categories of expenditure customarily fall short of the budgeted amounts.

As a result of the projected reduction in the fiscal deficit, public debt is expected to increase marginally in 2000 to 61 percent of GDP. This level of public debt is certainly high and the authorities intend to reduce it over the medium term in accordance with their medium term program of fiscal consolidation. Foreign debt accounts for 17.8 percent of GDP. All foreign borrowing is medium and long term and it does not pose any near term risk of financing difficulties. As pointed out by the staff, Cyprus continues to benefit from strong credit ratings and the authorities intend to take all necessary measures to safeguard these in the future.

Monetary policy has been tightened in 2000 but its effectiveness is restricted by existing institutional rigidities. The CBC took a number of measures to reduce credit growth. Beginning 2000, it imposed a ceiling on personal loans and raised margin requirements to 100 percent in an effort to slow down credit associated with stock market investments, the driving force behind the overall acceleration of credit growth in 1999. Furthermore, it stiffened considerably the penalties for violating its directives linking the payment of interest on bank reserves to the observance of its guidelines. The CBC decided to increase reserve requirements by one percentage point as of July (to stave off any excess reserves by year end). Credit ceilings, which were reintroduced as of June, would have to be observed on a continuous basis as of July rather than on a quarterly basis as was the case in the past.

Given these additional measures (which were not incorporated in the staff's assessment) as well as the sharp correction in the stock market in 2000 (from 714 at the end of 1999 to 402 today) which is likely to reduce the demand for stock market loans, it is likely that the credit targets for 2000 will be attained. At any rate, in light of the above noted developments, credit growth in 2000 is expected to decelerate relative to 1999.

All in all, the lower fiscal deficit, the stock market correction which is expected to dampen domestic demand, the recent appreciation of the Euro relative to the dollar, lower oil prices and more favorable agricultural product prices imply that the current policy mix is sufficient to address risks in the near term. In fact, late last week, and in response to the sharp correction in the stock exchange, the CBC lifted its restrictions on loans for stock market purchases. This does not represent a change in the CBC's monetary stance but merely a recognition that the stock market speculation which was a cause of concern in the past, ceased to pose a serious threat under the present circumstances. The existing credit ceilings applicable to banks remain unchanged (although penalties would apply if the divergence from the target was more than 20 percent so as to discourage banks from lending at any rate once they exceeded the ceiling).

Clearly, the authorities do not share the staff's characterization of the policy mix as insufficient to address near term risks because the staff's assessment is based on an inflated assessment of the risks (i.e., higher inflation and current account deficit) and an underrated assessment of policies (i.e., fiscal outcome, additional measures adopted by CBC).

To conclude, while a more ambitious (fiscal) tightening might have been appropriate as a means of preparing the economy for its long term challenges, it is currently politically unfeasible. From the near term point of view, the authorities believe that even a more modest tightening is sufficient to address near term risks.

Medium Term Challenges: Capital Account Liberalization

In preparing for the liberalization of capital controls the authorities have adopted a careful and well sequenced plan. The authorities are aware that capital account liberalization and the potential exposure of the economy to more volatility will require a strengthening of the underlying macroeconomic indicators through the implementation of consistent macroeconomic policies. In the area of fiscal policy, the government has been working on a medium term program which provides for a gradual fiscal tightening. In the area of monetary policy, the CBC is prepared to use its new powers made possible by the lifting of the interest rate ceiling to enhance interest rate flexibility. The authorities also intend to widen the exchange rate bands to allow more flexibility in the exchange rate in the event of unusually large swings in capital flows. At the same time, they plan to maintain an inner band within the wider exchange rate band to provide a nominal anchor. In addition to these measures, the authorities are engaging in a number of structural reforms (see section below) to increase productivity and competitiveness. Of particular importance, is the preparation of new legislation, currently underway, which safeguards the independence of the central bank in accordance with EU directives. The CBC is also in the process of setting up a mechanism for intervening in the foreign exchange market.

Aside from these macro considerations, the authorities are stepping up their efforts in the supervisory area. The Cypriot banking system is already based on a modern legal framework and has adopted prudential standards that are in line with EU directives and best international practices (e.g., BIS standards). A large part of the banking system (about 75 percent) is already exposed to a liberalized capital environment through their operations abroad. The CBC raised minimum capital requirements to 9 percent in July 2000 and will

raise them to 10 percent in January 2001 in anticipation of a possible increase in the riskiness of lending following liberalization.

The supervisory framework that applies to credit cooperatives needs, however, significant improvements. It should be noted however that most of the activities of coops involve small collateralized lending to members which is not risky. Furthermore, while there are no minimum capital requirements, credit cooperatives are in general required to transfer a minimum of 25 percent of any surpluses to their reserves. At any rate, the fate of coops will be decided in the context of the EU negotiations and depending on its outcome, either coops will be treated as banks and allowed to operate as fully fledged financial institutions subject to the same regulatory and supervisory standards that apply to banks or will be considered institutions of special character and may thus be subject to a different set of regulatory norms.

The authorities have also maintained a strong supervisory framework for the international banking units, which are subject to the same regulatory standards as domestic banks. A strong regulatory framework for international banking units has been in place since 1986 and a modern anti-money laundering legislation has been introduced in 1996. Cyprus has a good record of implementation and cooperation with other national supervisors and examinations by the FATF and the Council of Europe have resulted in positive evaluations. In June 2000, after a detailed assessment, the FATF concluded that Cyprus had a comprehensive anti-money laundering system and that it was cooperating in the international fight against money laundering. In this regard, the authorities were surprised by the recent listing by the FSF which put Cyprus in the third group of countries seen as having low quality of supervision and/or cooperation with other supervisory bodies. As a further demonstration of its commitment to cooperate with international organizations, Cyprus has agreed to phase out the preferential tax treatment of offshore companies by the end of 2005 not withstanding potential adverse consequences on its balance of payments.

Structural Reforms

In many ways the pace of structural reform agenda is mandated by efforts to harmonize legislation and business practices with those prevailing in the EU. The authorities are proceeding with the partial privatization of Cyprus Airways and have agreed to liberalize the air transportation sector by the end of 2002, one year earlier than anticipated. The telecommunications sector is to be liberalized by January 1, 2003 and the authorities intend to transform the telecommunications company into a joint stock company (while at the same time reducing the government's participation). Currently, legislation is being prepared that will enable the telecom authority to function as a regulator and enforce competition rules in accordance with European directives. The new regime is expected to be implemented by the end of 2001. The authorities also intend to sell their entire stake in a number of small businesses in which they currently participate.

The authorities consider the staff claims that the government has full or majority ownership in many businesses to be inaccurate. The government has majority share ownership in just six enterprises. More importantly, the value of the government's equity

holdings in these companies is just under one percent of GDP. More broadly, the central government, local authorities and semi-government organizations together account for around 24 percent of GDP, which is a much lower figure than in a number of EU countries.

The government is also making efforts to diversify the economy away from tourism. Given its highly educated labor force, efforts are made to promote the use of new technology in the economy and to support the non-tourist services sector (consultancy services, banking, education). Non-tourist services such as finance, communications, distribution and transit trade have in fact registered strong growth in recent years and have helped the economy reduce its dependence on tourism.

In the banking sector, the authorities are introducing a deposit insurance scheme which is to take effect on September 1, 2000. Legislation is also being prepared to ensure the independence of the central bank as prescribed by the EU. The new legislation, which will require an amendment of the constitution, is expected to be in place by June 2002.

As regards the issue of the Cost of Living Allowance (COLA), this mechanism has been in place for decades and efforts to abolish it appear slim, at least at this stage. Despite these difficulties, the authorities, for the first time ever, have managed to modify the existing system. As a result, excise taxes are no longer included in the calculation of COLA and hence, the current system is not one of full indexation, as noted by the staff. There is widespread consensus in Cyprus among the labor movement that COLA has contributed to the maintenance of social peace and has reduced the costs of renegotiating contracts. From this point of view, COLA not only has costs but also benefits, something which has been recognized by the staff as well.

As regards the Cyprus Stock Exchange, there has been progress since the last staff visit. Legislation for mutual funds has been approved by the Council of Ministers (in line with EU directives) while the bill on financial services is with the Attorney General's Office for evaluation before being submitted to the Parliament.

Conclusion

The Cypriot authorities are determined to take the necessary action to ensure macroeconomic stability, both in the short term and medium term. They are also committed to undertaking the necessary reforms required for EU accession, including in the area of capital account liberalization, in which they are proceeding steadily but cautiously.