



CYPRUS

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

October 2014

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on October 20, 2014, following discussions that ended on July 30, 2014, 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 October 3, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Staff Supplement** of October 17, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its October 20, 2014 consideration of the staff report that concluded the Article IV consultation with Cyprus.
- A **Statement by the Executive Director** for Cyprus.

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

Selected Issues Paper

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



CYPRUS

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

October 3, 2014

KEY ISSUES

Background: The large imbalances that accumulated prior to the global financial crisis culminated in a collapse of the banking sector in early 2013. In response, the authorities took unprecedented measures and adopted an economic adjustment program, supported by official financing, aimed at securing financial stability and fiscal sustainability.

Recent developments and outlook: GDP contracted sharply in 2013. Wages and prices also declined, and unemployment increased. While bank deposit outflows have slowed, non-performing loans have risen sharply, and credit remains impaired. The outlook is difficult, with the recession expected to continue this year, followed by a modest recovery starting next year. Risks remain tilted to the downside.

Reform agenda: The authorities need to overcome recent delays in the implementation of their adjustment program. A key priority is addressing high non-performing loans, which requires putting in place a strong private-sector debt-restructuring framework, including legislation to facilitate foreclosures, complemented by a modernized insolvency regime. Banks should continue to restructure and build strong capital buffers. Removal of external-payment restrictions must proceed prudently. Continued fiscal consolidation is required to ensure long-run sustainability, complemented by firm implementation of structural reforms.

Approved By
**Philip Gerson and
 Mark Flanagan**

Discussions took place in Nicosia during July 14–30. The mission met with the Minister of Finance, the Governor of the Central Bank of Cyprus, other Cabinet Ministers, members of Parliament, leaders of the main political parties, union representatives, and other representatives of the private sector. The team comprised D. Velculescu (head), R. Agarwal, A. Hajdenberg, Y. Lu, J. Menkulasi, N. Rendak, P. Sharma, A. Simone, M. Vasquez, and O. Wuensch. V. Guzzo and M. Heracleous (IMF resident representative office) assisted the mission. Ms. Myaing and Cheptea and Mr. Velazquez-Romero provided assistance from headquarters. Mr. Kanaris (OED) attended some of the meetings.

CONTENTS

BACKGROUND	4
A. Crisis and Immediate Policy Response	4
B. Recent Economic Developments	7
C. Context for the Discussions	15
POLICY DISCUSSIONS	18
A. Outlook and Risks	18
B. Public Debt and External Sustainability	20
C. Financial Sector Policy	21
D. Fiscal Policy	26
E. Structural Reforms	28
STAFF APPRAISAL	31
BOXES	
1. Addressing the Banking Crisis	6
FIGURES	
1. From Boom to Bust	5
2. High Frequency Indicators	8
3. Labor Market and Price Developments	10
4. Private Sector Balance Sheet Developments	11
5. External Indicators	12
6. Recent Fiscal Developments	13

7. Non-Performing Loans _____	16
8. Main Reform Initiatives since the 2011 Article IV Consultation _____	17

TABLES

1. Selected Economic Indicators, 2008–20 _____	33
2. Fiscal Developments and Projections, 2008–20 _____	34
3. Balance of Payments, 2008–20 _____	35
4. Monetary Survey, 2008–20 _____	36
5. Financial Soundness Indicators, 2010–14 _____	37

ANNEXES

1. Risk Assessment Matrix _____	38
2. Public Sector Debt Sustainability Analysis _____	39
3. External Debt Sustainability and Real Exchange Rate Assessment _____	47

ANNEX FIGURES

A2.1. Public Debt Sustainability Analysis—Risk Assessment _____	42
A2.2. Public Debt Sustainability Analysis—Realism of Baseline Assumptions _____	43
A2.3. Public Debt Sustainability Analysis—Baseline Scenario _____	44
A2.4. Public Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios _____	45
A2.5. Public Debt Sustainability Analysis—Stress Test _____	46
A3.1. External Debt Sustainability—Bound Tests _____	49

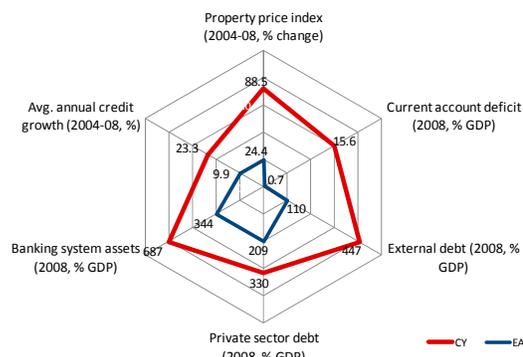
ANNEX TABLE

A3.1. External Debt Sustainability Framework, 2009–21 _____	50
---	----

BACKGROUND

A. Crisis and Immediate Policy Response

1. Cyprus accumulated large imbalances in the run-up to the 2008 global crisis. An annual growth rate of 4 percent in the decade preceding the crisis masked the build-up of unsustainable imbalances and vulnerabilities. Following EU entry and the removal of capital account restrictions in 2004, significant foreign inflows led to a rapid expansion of the banking sector to seven times GDP. Easy credit fuelled a housing boom and an increase in private-sector indebtedness¹ to over 300 percent of GDP by 2008, one of the highest levels in the euro-area. The financial sector became deeply interlinked with that of neighboring Greece, accumulating significant Greek loans and sovereign debt. Surging imports and an erosion of external competitiveness as wage growth exceeded productivity led to a widening of the current-account deficit to about 16 percent of GDP at end-2008.



2. The imbalances eventually culminated in a banking-sector collapse (Figure 1). As foreign inflows slowed and bank credit growth shrunk, the housing boom turned to bust, and output fell in 2009. In response, fiscal policy was loosened, which led to a rapid deterioration in the budget balance and public debt. Domestic weaknesses, compounded by tight sovereign-bank links and an intensification of the Greek crisis, resulted in a loss of market access in May 2011. The explosion of Cyprus's main power station in July added to the economic distress. And the decision to restructure Greek sovereign debt in late 2011 dealt a severe blow to the two largest Cypriot banks, which lost a combined 25 percent of GDP. As a result, one bank had to be recapitalized through state support (10 percent of GDP) in 2012. Deposit outflows intensified, and reliance on Emergency Liquidity Assistance (ELA) rose to 60 percent of GDP by end-2012.

3. In March 2013, the authorities took unprecedented measures to stem the crisis. Cyprus requested official assistance from the EU/IMF in mid-2012. However, negotiations were protracted, due to difficulties in addressing the large capital needs of the banking sector—estimated at about 60 percent of GDP—without endangering debt sustainability (Box 1), as well as to the impending presidential election in early 2013. Following the elections, the new government moved aggressively, resolving the two systemic and by-then economically insolvent banks², recapitalizing the resulting institution at no fiscal cost through bail-in of bank creditors (including uninsured depositors) and selling the banks' Greek operations. Domestic and external payment restrictions were imposed (the latter comprising both capital controls and some exchange restrictions) to prevent a bank run.

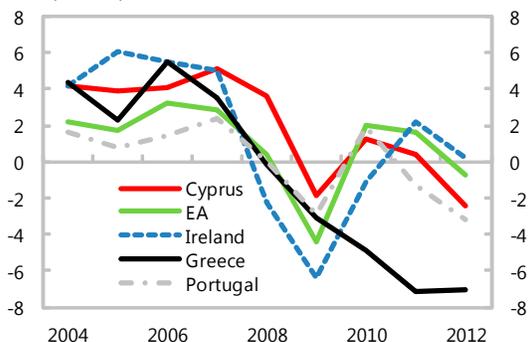
¹ Private sector indebtedness indicators include brass plates.

² Economically insolvent institutions are defined here as those institutions identified by the independent due-diligence exercise as having negative capital under the forward-looking baseline and stress scenarios.

Figure 1. Cyprus: From Boom to Bust

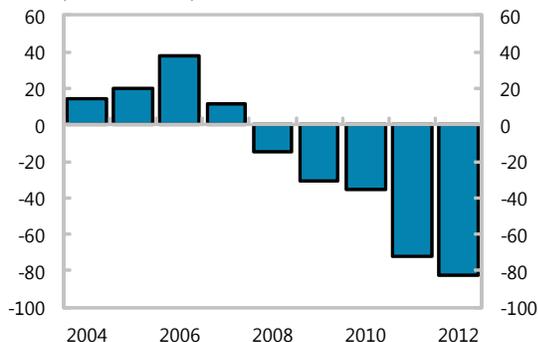
The high growth following EU accession dissipated with the global financial crisis.

Real GDP growth
(Percent)



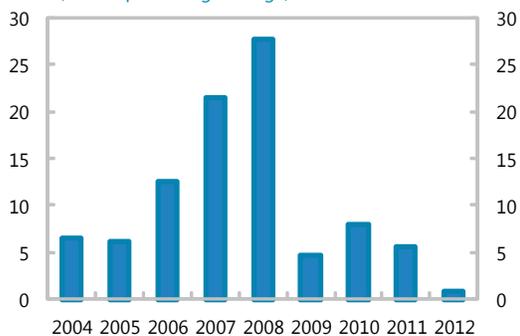
Cyprus's growth was financed by large external inflows...

Net International Investment Position
(Percent of GDP)



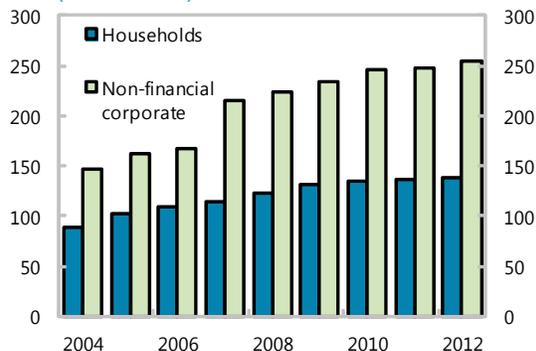
...which financed a credit boom...

Credit to the non-financial private sector
(Annual percentage change)



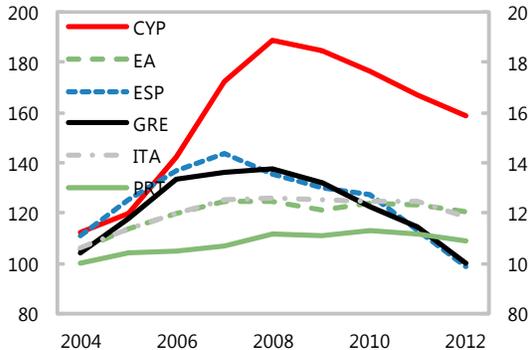
...resulting in high private sector indebtedness...

Private sector debt
(Percent of GDP)



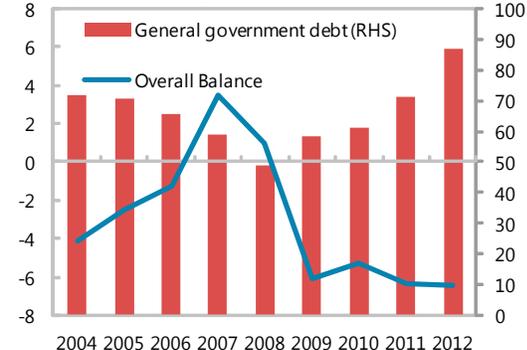
...and a real estate bubble, which burst in 2008.

Housing prices
(Index, 2004Q1=100)



The economic slowdown, loose fiscal policies, and banking sector support after 2008 resulted in large public deficits and high public debt.

Public finances
(Percent of GDP)

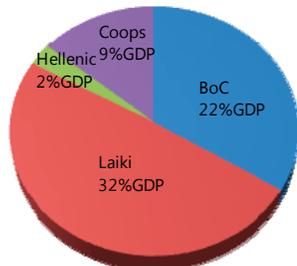


Sources: Cystat, CBC, OECD, Ministry of Finance; and IMF staff estimates.

Box 1. Addressing the Banking Crisis

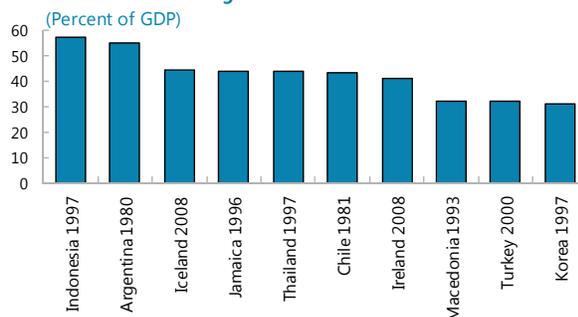
Huge challenges... Cyprus had an outsized banking sector, which was found severely undercapitalized, with the two largest banks found economically insolvent. Capital needs (excluding the 2012 recapitalization bond and after bail in of junior debt) were initially estimated by PIMCO at just over €10 billion, large not only relative to Cyprus's GDP but also in historical comparison.

Capital needs as of February 2013
(percent of GDP)



Source: PIMCO and IMF staff estimates.

Fiscal cost of banking crises



Source: Laeven and Valencia, "Systemic Banking Crises Database: an Update", 2012.

...and limited options... Bank recapitalization with public funds would have rendered public debt—already close to 90 percent of GDP at end-2012—unsustainable. Moreover, rather than addressing the problem at its root by dealing with economic insolvency in the largest two banks, this would have shifted the burden to the public-sector balance sheet, putting a daunting burden on the Cypriot taxpayer. Given the significant share of public debt held by the official sector and banks, debt restructuring was also not feasible. Direct bank support by the ESM could have minimized fiscal costs and reduced sovereign-bank links, but was not available.

Bail-in Amounts
(Billions of euros)

	BoC	Laiki	Total
Uninsured deposits	3.9	4	7.9
Senior debt	0	0.1	0.1
Subordinated debt	0.6	0.8	1.4
Total	4.5	4.9	9.4

Source: CBC.

...led to an unprecedented policy response in March 2013.^{1,2} A first attempt to recapitalize the banking sector through the imposition of a levy on all bank deposits (equivalent to around two years of interest earnings, and differentiated by size) was rejected by parliament on March 19 and was followed by a bank run, as the proposal was perceived to violate deposit insurance. With financial stability endangered, the authorities imposed a bank holiday, and on March 25 intervened the two economically insolvent banks. Following a purchase-and-assumption transaction, the resulting institution was recapitalized at no fiscal cost, through bail in of bank creditors, including uninsured deposits, which were converted into equity. Following the bank holiday, the authorities imposed restrictions on domestic and external payment flows.

Cyprus's response to the crisis entailed difficult but unavoidable decisions. Bank economic insolvency was addressed upfront and debt sustainability was protected, thus limiting the burden on the Cypriot taxpayer.

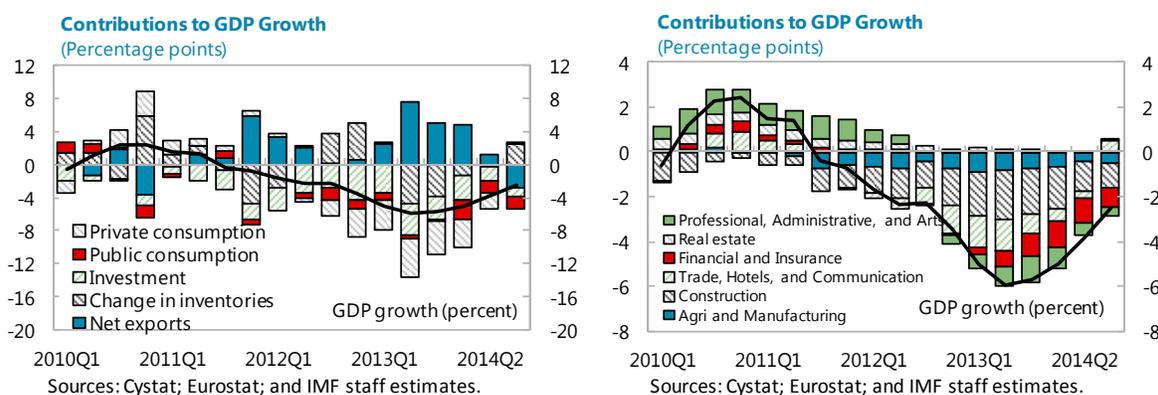
¹ See Box 1 in [Country Report No. 13/125](#).

² Also see Section I of Selected Issues Paper "Cyprus's Banking Sector: The Crisis and its Aftermath."

4. This paved the way for an agreement on an adjustment program supported by official financing. The three-year program—underpinned by financial support of €10 billion (60 percent of Cyprus’s GDP) from European partners and the IMF—aimed at stabilizing the financial sector and ensuring sustainable public finances. The financial sector strategy focused on: (i) completing the recapitalization and restructuring of the banking sector, including the cooperative credit (coop) sector; (ii) implementing a debt-restructuring framework to address rising non-performing loans (NPLs) and private indebtedness; (iii) developing a roadmap for the gradual relaxation of payment restrictions; and (iv) strengthening bank regulation and supervision and the implementation of the AML/CFT framework. Fiscal policy aimed to achieve an ambitious yet well-paced consolidation, balancing short-term cyclical and longer-term sustainability concerns, complemented by comprehensive structural reforms.

B. Recent Economic Developments

5. The correction of imbalances resulted in a deep but unavoidable recession. Output declined by 5.4 percent in 2013, as high macroeconomic uncertainty, the large shock to income and wealth, and ongoing fiscal consolidation depressed consumption and investment. All sectors contracted, with construction and financial services—which had expanded rapidly before the crisis—declining sharply. Nevertheless, the recession was less deep than that projected at the onset of the program (8.7 percent), as households used savings to smooth consumption. In the first half of 2014, output contracted by a further 3.2 percent year-on-year, with private consumption stabilizing in the second quarter, and the tourism and trade sectors growing (Figure 2).



6. The downturn has been partially mitigated by price and wage flexibility (Figure 3). Prices declined in the second half of 2013 and early 2014, with inflation averaging -0.3 percent in the first eight months of 2014. Wages also adjusted, due to public-sector wage cuts and a renegotiation of contracts in the private sector. This helped contain the rise in unemployment, which peaked at about 16 percent in 2013 before moderating slightly due to a decline in labor-force participation.

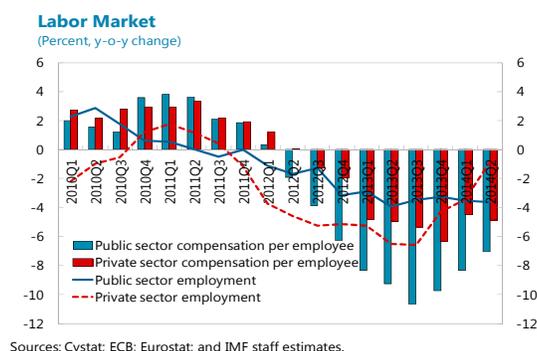
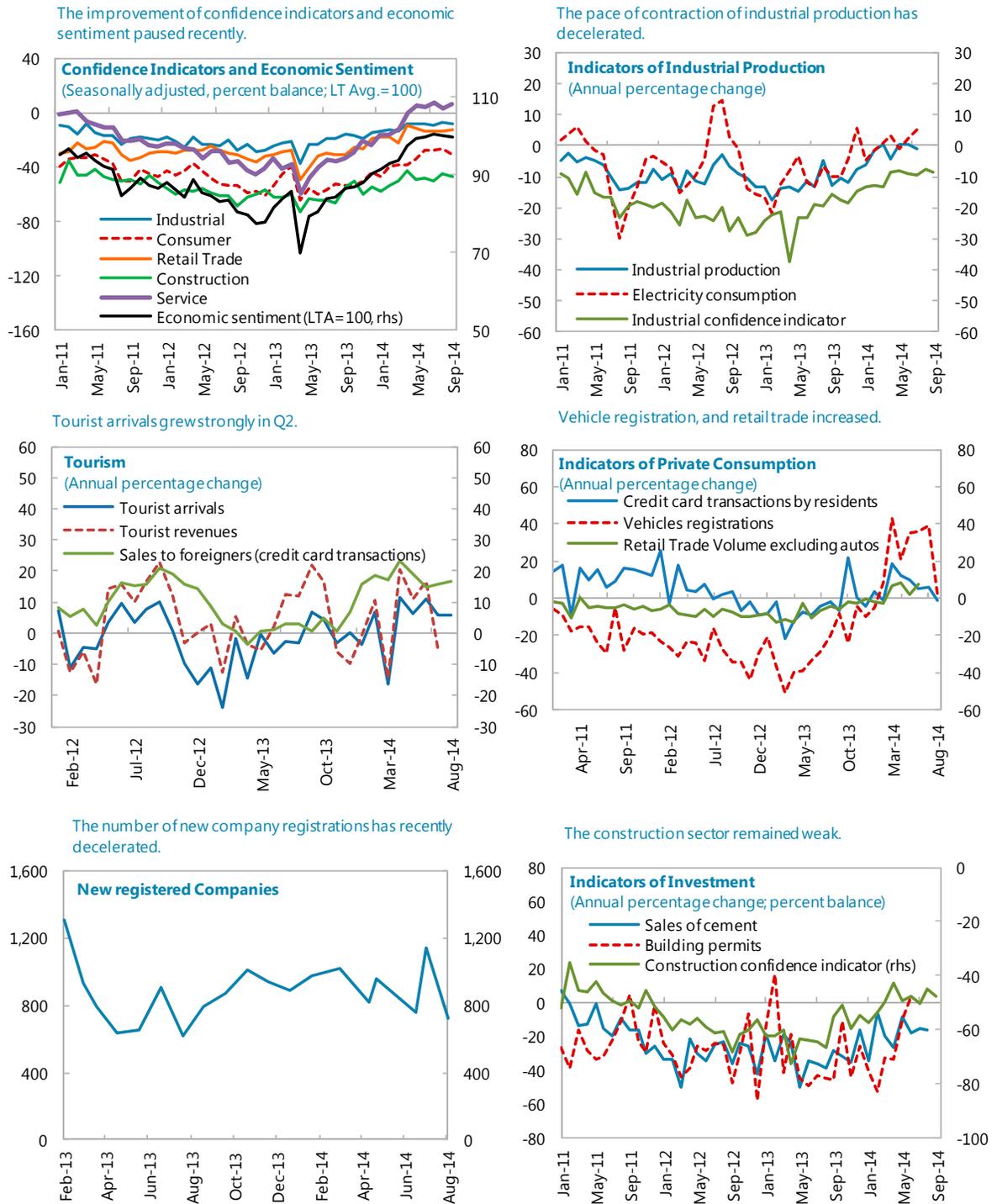


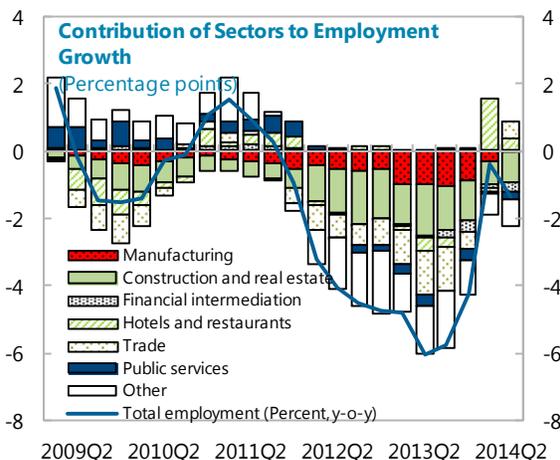
Figure 2. Cyprus: High Frequency Indicators



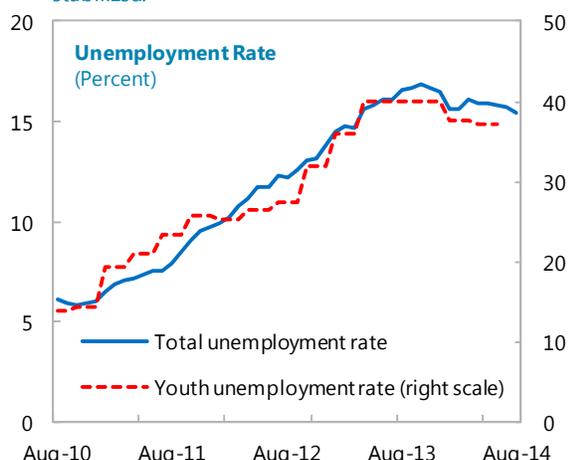
Sources: Cystat; Eurostat; MoF; and IMF staff estimates.

Figure 3. Cyprus: Labor Market and Price Developments

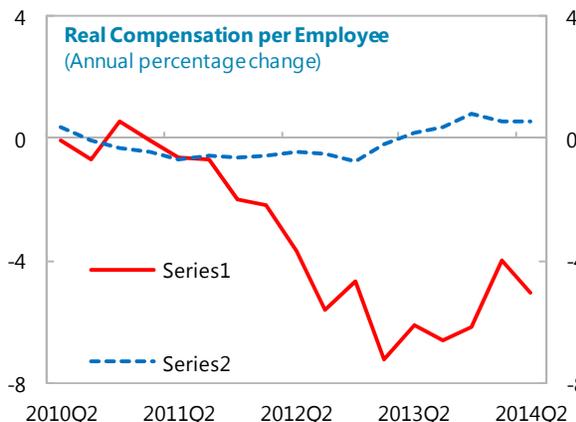
The decline of employment moderated.



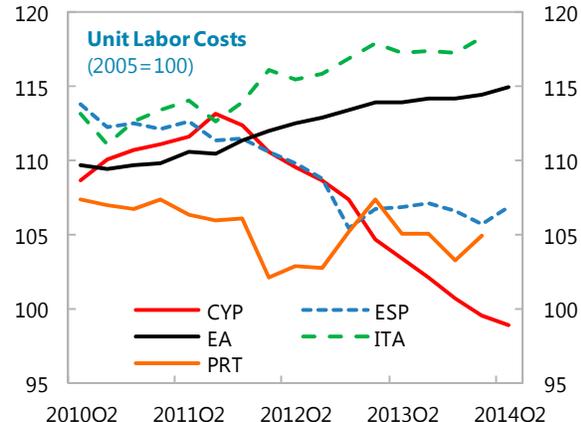
Unemployment increased sharply, but has recently stabilized.



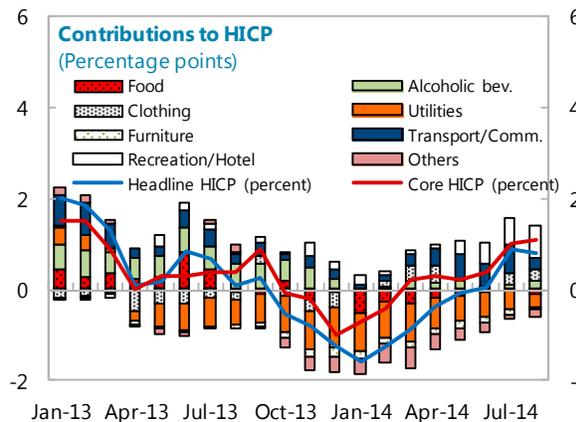
Compensation of employees has declined...



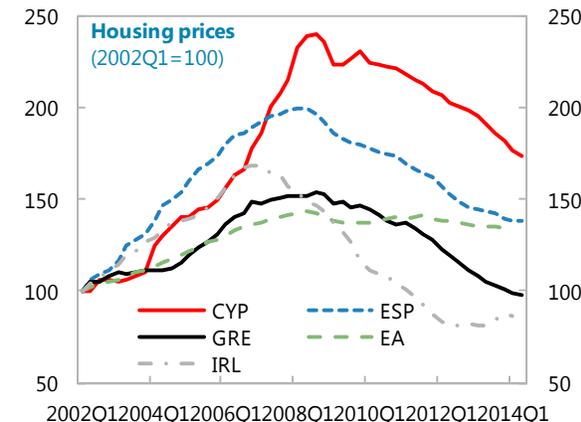
...pushing unit labor costs down.



Inflation turned negative during 2013, but has returned to positive territory.



Housing prices have declined from their peak, but remain significantly above pre-boom levels.

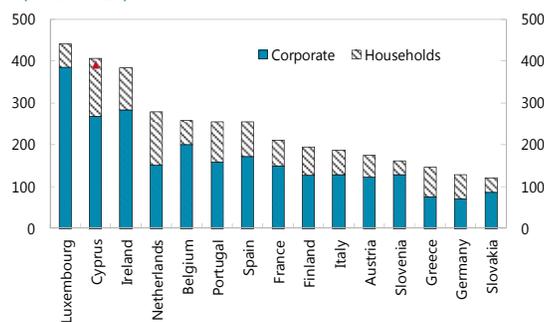


Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

7. Private sector deleveraging has been slow

(Figure 4). Bank credit to the domestic private sector fell by 5.4 percent in 2013, and by a further 1 percent y-o-y by end-August 2014. Private-sector debt remains among the highest in Europe, at 410 percent of GDP at end-2013. Nevertheless, households’ net financial-asset position has declined but remains large and positive (140 percent of GDP), while that of corporates is large and negative (-200 percent of GDP). Housing prices continued to adjust in 2013–14, and are now 25 percent below their 2008 peak, pointing to a large deterioration in the private sector’s non-financial asset position.

Private Sector Indebtedness, 2013
(Percent of GDP)

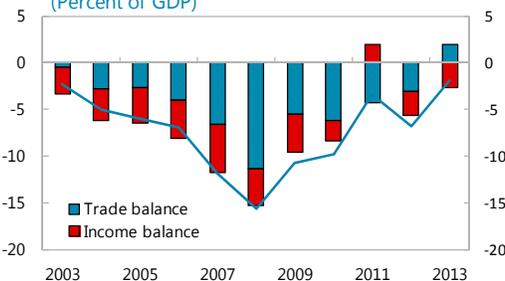


Sources: Haver, and IMF staff estimates. Mark is for the overall level in 2012.

8. The external current account has adjusted

(Figure 5). The current account deficit declined to about 2 percent of GDP in 2013 from a peak of 15.6 percent of GDP in 2008. The trade balance registered a 2 percent-of-GDP surplus, driven by contracting imports, which more than offset falling exports. The income balance remained in deficit, reflecting the large negative international investment position (-86 percent of GDP at end-2013). Import growth turned positive in mid-2014, and goods exports and tourist arrivals have risen.

Current Account
(Percent of GDP)

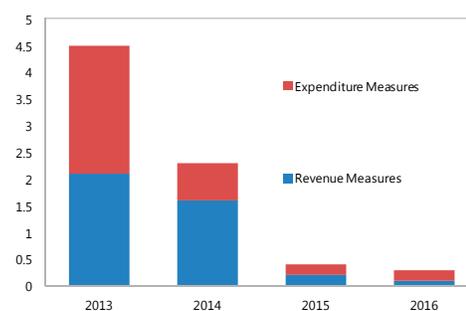


Source: Central Bank of Cyprus.

9. The fiscal deficit has declined on the back of an ambitious consolidation (Figure 6). The

authorities implemented 4.5 percent of GDP of adjustment measures in 2013. These helped reduce the primary deficit to 2 percent of GDP in 2013 from 3.2 percent of GDP a year earlier, despite the deep recession. The 2014 budget included additional adjustment measures of 2.3 percent of GDP. In July, the cumulative primary surplus reached 2.1 percent of GDP relative to an expected balance, reflecting both lower primary spending and better-than-expected revenues, although the latter was partly affected by seasonality related to corporate-tax payments. Preliminary August figures point to continued overperformance.

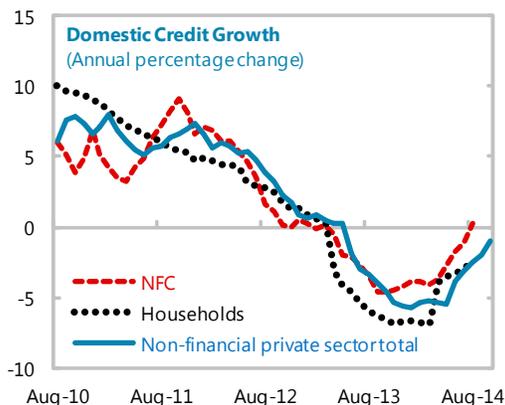
Estimated Yield of Implemented Program Fiscal Measures (2013-16)
(Percent of GDP)



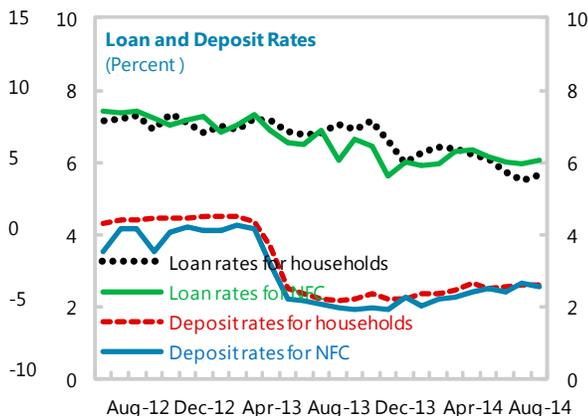
Source: IMF Staff Estimates

Figure 4. Cyprus: Private Sector Balance Sheet Developments

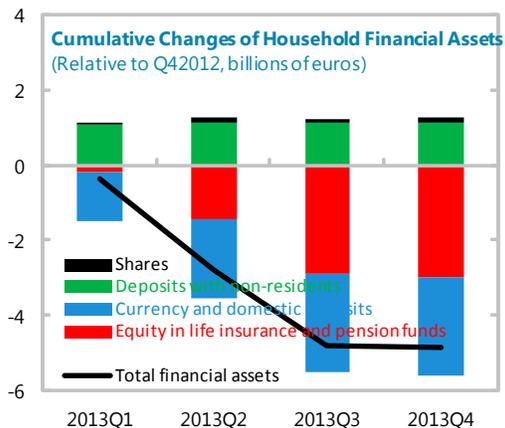
The pace of domestic credit contraction has moderated.



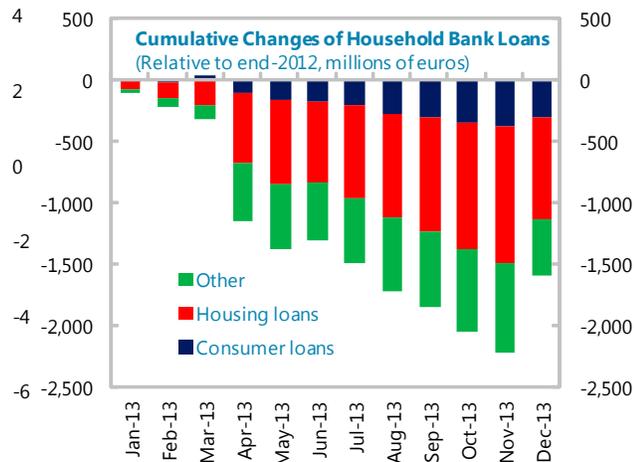
Loan and deposit rates remain high.



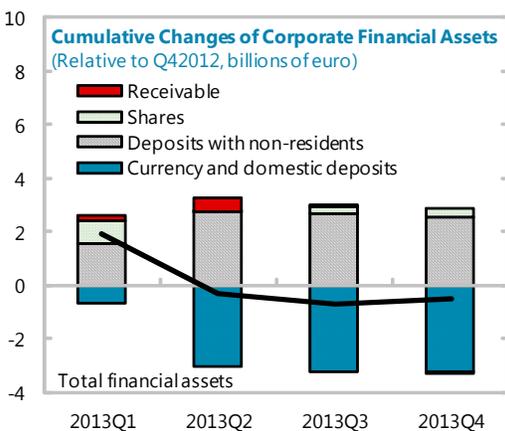
Household financial assets declined sharply in 2013...



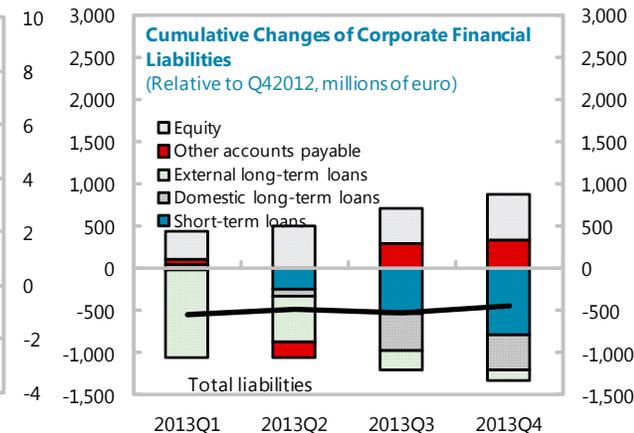
...but so did liabilities, mainly related to housing loans.



Corporate financial assets fell modestly in 2013...

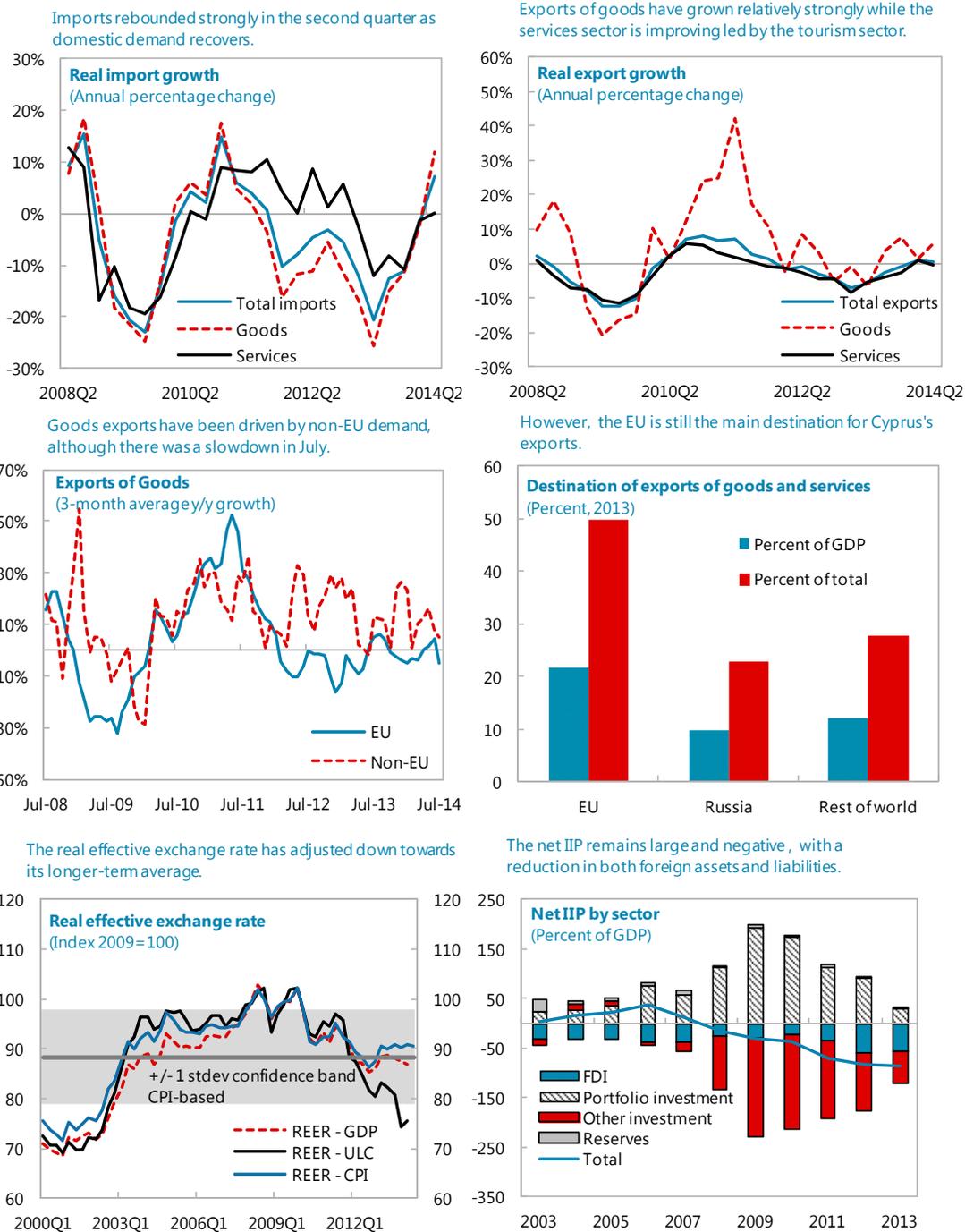


...while the decline in liabilities was partly compensated by an increase in equity and other accounts payable.



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

Figure 5. Cyprus: External Indicators

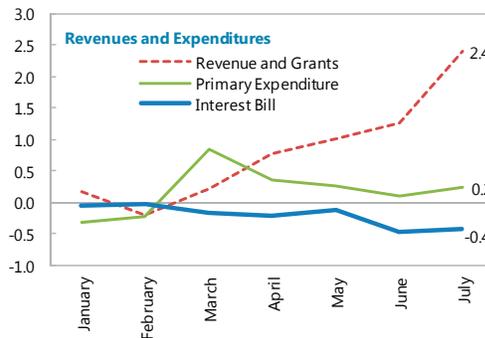
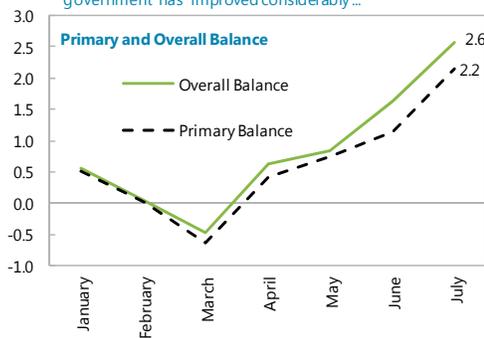


Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

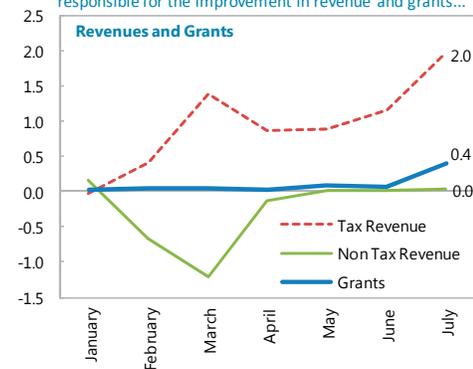
Figure 6. Cyprus: Recent Fiscal Developments 1/

(Cumulative percent of GDP difference relative to previous year)

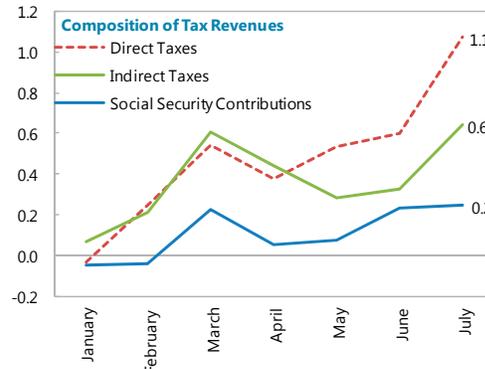
The primary cash balance of the consolidated central government has improved considerably ...



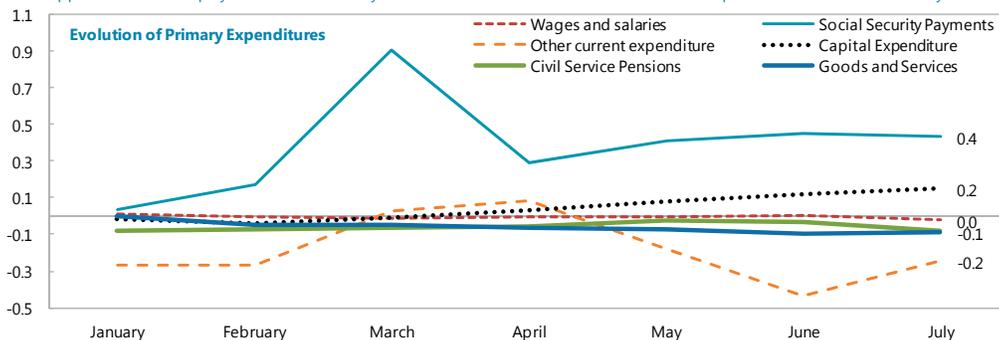
Increasing tax revenues as a share of GDP are mainly responsible for the improvement in revenue and grants...



... primarily due to improved direct and indirect tax revenue.



The increase in primary spending has been mainly due to higher levels of social security payments due to an accelerated processing of applications of unemployment and redundancy benefits. Goods and services and other current expenditure were lower than last year.

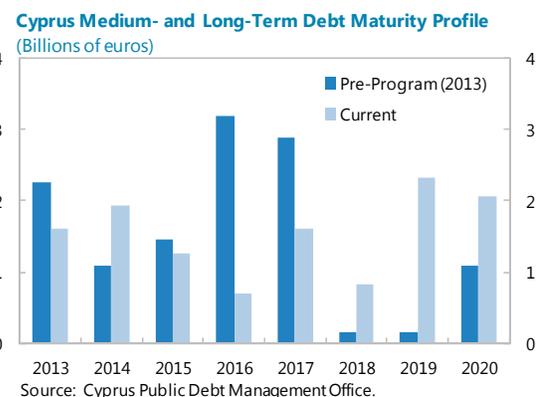
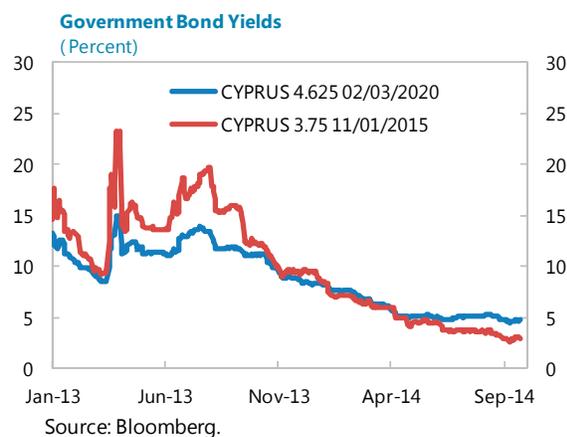


Sources: Ministry of Finance; and IMF staff estimates.

1/Based on cash data and the national classification, which unlike ESA do not cover local governments and semi-government entities.

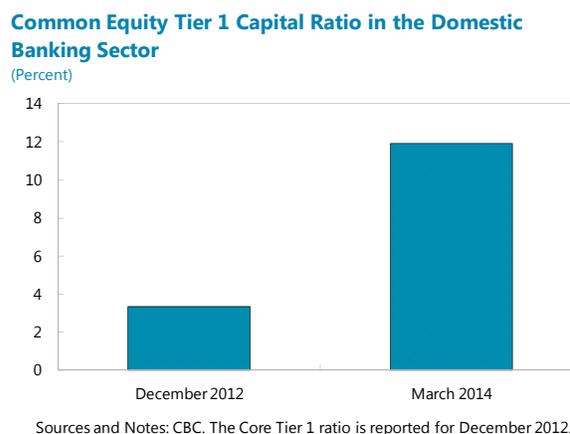
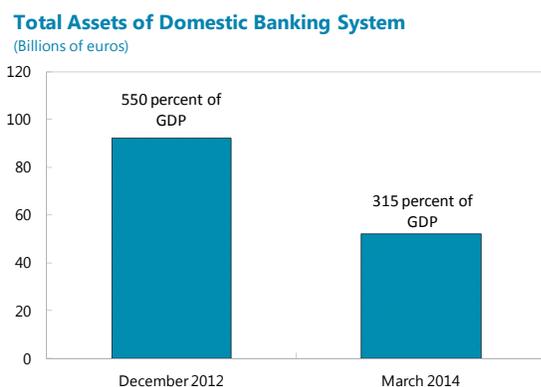
10. Cyprus returned to the sovereign-bond market in mid-2014 after a three-year hiatus.

Due to improved market sentiment in the region, but also to progress in addressing the crisis, Cypriot bond yields declined from close to 25 percent in March 2013 to under 5 percent in September 2014. In June 2014, Cyprus issued a five-year €750 million Eurobond. The proceeds were used to repay part of the 2012 recapitalization bond held by BoC. This helped smooth the debt-maturity profile, complementing measures taken in 2013 to extend the maturity of €1 billion of domestic debt and restructure a bilateral Russian loan maturing in 2016.



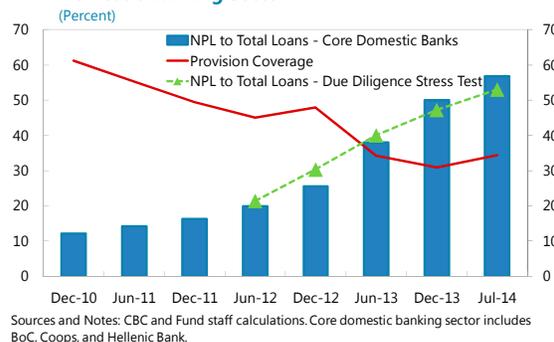
11. The core domestic financial sector has been downsized, recapitalized, and restructured.

Following the March 2013 measures, the disposal of non-core bank assets, and further loan-book deleveraging, the domestic banking sector declined to 315 percent of GDP in March 2014 from 550 percent at end-2012 (foreign banks add another 160 percent of GDP). Its CET1 capital ratio is estimated to have increased to close to 14 percent of risk-weighted assets at end-August 2014 (from 3.5 percent at end-2012), as a result of: (i) BoC's recapitalization at no fiscal cost in 2013 and an additional private placement of €1 billion completed in September 2014, (ii) the recapitalization of Hellenic Bank through private funds in late 2013; and (iii) the injection of public funds (€1.5 billion) in the coop sector in early 2014. The latter was also consolidated from 93 entities into 18.



12. NPLs, however, have risen to very high levels (Figure 7). Although the recession has been less deep than expected, the NPL ratio of the core domestic sector increased sharply from 20 percent at end-2012 to 57 percent at end-July, broadly in line with the due-diligence projections under the stress scenario. Corporate NPLs stood at 50 percent and were highly concentrated, with construction NPLs now at over 73 percent. NPLs on primary-residence mortgages are around 40 percent. Provision coverage remains relatively low, at 34 percent compared to the European average of 46 percent.

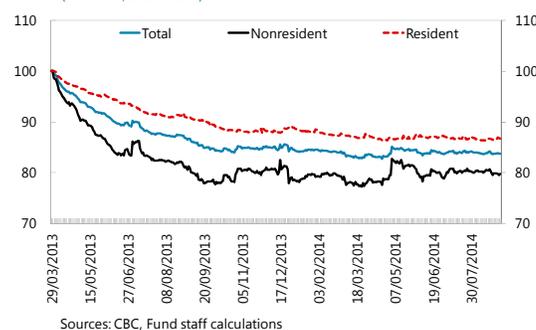
Nonperforming Loans and Provisions in Core Domestic Banking Sector



13. Deposit outflows have slowed, and domestic payment restrictions were fully eliminated.

After falling by about 16 percent (excluding bailed-in amounts) during March-December 2013, system-wide deposits declined by a further 1.4 percent in the first eight months of 2014. The authorities gradually relaxed domestic payment restrictions, which were fully eliminated in May, and unfroze BoC's uninsured deposits. External payment restrictions remain in place, given still tight bank liquidity, with BoC's reliance on short-term central bank and ECB funding at about 55 percent of GDP and limited collateral buffers as asset quality deteriorates.

Total Deposits in Banking System
(March 29, 2013 = 100)



C. Context for the Discussions

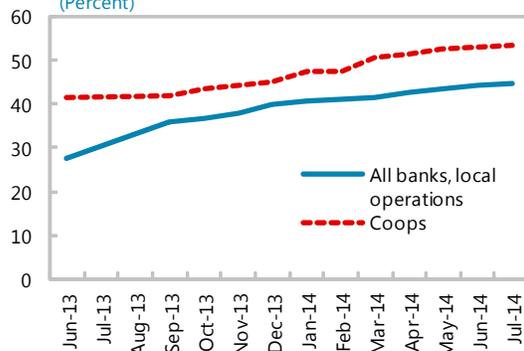
14. In the context of their adjustment program, the authorities have implemented an ambitious package of reforms (Figure 8). Policy recommendations included in the last Article IV consultation have been adopted, although some only after the crisis hit. These include an ambitious fiscal consolidation during 2012–14, measures to shore up the banking sector and strengthen supervision, and reforms of the public-sector wage-indexation mechanism (COLA) and the pension system. The authorities went beyond these to also reform the welfare system and the revenue administration, and introduce a new privatization framework, among others.

15. Delays in program implementation have recently emerged. Following the break-up of the governing coalition in February 2014, the government lost its majority in parliament. Since then, political opposition to the program has risen, signs of reform fatigue have emerged, and vested interests have been gaining traction. As a result, the authorities have encountered difficulties in implementing key elements of the debt-restructuring legal framework to address NPLs, with parliament having approved foreclosure legislation that is not in line with program objectives (some of the bills were subsequently referred to the Supreme Court for a decision on their constitutionality, expected later in October). In light of these developments and ensuing legal uncertainty, the completion of the fifth review has been delayed.

Figure 7. Cyprus: Non-Performing Loans

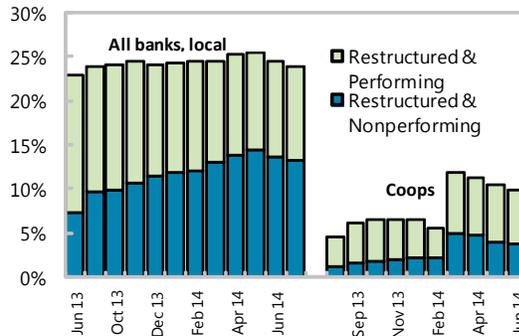
NPLs have reached very high levels.

Nonperforming Loans in Banks and Coops (Percent)



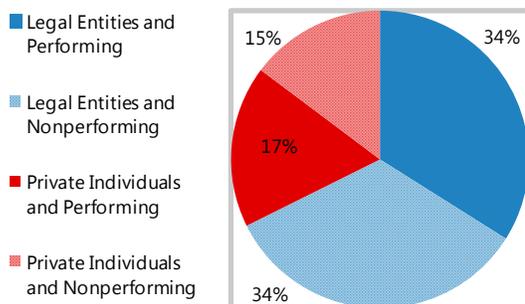
They are also high within already restructured loans.

NPLs and Restructured Facilities in Banks and Coops: (Percent of Total Credit Facilities)



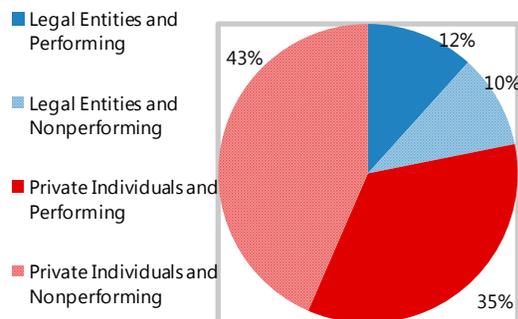
Banks have larger concentration of loans to corporates, where NPLs are 50 percent.

Composition of Loans in the Banks (Percent of total credit facilities, end-July 2014)



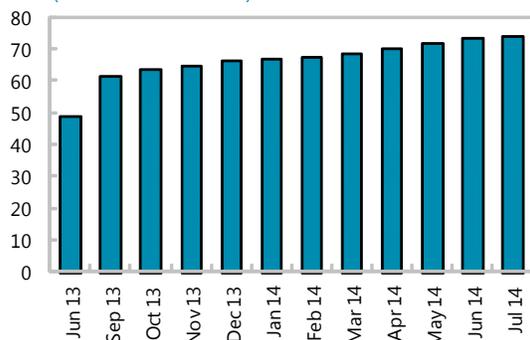
While coops have higher concentration on households, where NPLs are 55 percent.

Composition of Loans in Coops (Percent of total credit facilities, end-July 2014)



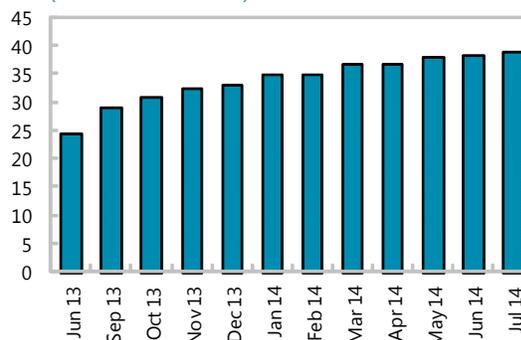
The construction sector has been the hardest hit.

NPL Ratio in the Construction Sector (Percent of Total Loans)



A large share of home mortgages are non-performing.

NPL Ratio of Owner Occupied Properties (Percent of Total Loans)



Source: Central Bank of Cyprus, and IMF staff estimates.

Notes: The "all banks, local operations" category includes Cyprus operations only, i.e. it excludes overseas operations (branches and subsidiaries situated abroad) of the Cyprus-based banking groups.

Figure 8. Main Reform Initiatives since the 2011 Article IV Consultation

Article IV Recommendations	Policy Actions
Restoring sound public finances	
<ul style="list-style-type: none"> • Reverse widening deficits and put public debt on a downward path • Measures should focus on expenditure reductions: (i.e. containment of public sector wages and benefits and further improvements in the targeting of social transfers) and a moderate increase in VAT rates 	<ul style="list-style-type: none"> • Adjustment measures of 2.5% of GDP in 2012 • Adjustment measures of 7.5% GDP implemented (2013-16), including: (i) public wage cuts of 9-15%; (ii) freeze of public sector wages until 2016; (iii) reduction in public sector employment by 4,500; (iv) streamlining social transfers and public employee allowances; (v) standard VAT rate increase of 2%; and (vi) increase in contributions on earnings and pensions and increases in CIT, withholding, property and excise taxes
Implementing structural reforms	
<ul style="list-style-type: none"> • Improve flexibility of labor markets, including by reforming the cost-of-living allowance mechanism (COLA) • Reform the national and government pension scheme • Reform budget institutions by introducing medium-term budgetary framework and fully implementing the EU fiscal framework directives, including the introduction of fiscal rules 	<ul style="list-style-type: none"> • Reform of COLA indexation (2012) • Reform of General Social Insurance Scheme and Government Pension Scheme (2013) • Adoption of Fiscal Responsibility and Budget Systems Law (2013), introducing medium-term budget framework, fiscal rules, and fiscal-risk management framework • Also legislated a reform of the social welfare system (2014), a privatization law (2014), and a reform of revenue administration, including strengthening its enforcement powers (2014)
Strengthening the financial sector	
<ul style="list-style-type: none"> • Heightened vigilance and contingency planning • Ensure bank capital ratios are in line with EBA requirements; address liquidity needs; take prompt corrective action to recapitalize or resolve banks; revamp the bank framework law; strengthen and bring supervision and regulation of coops in line with those for banks 	<ul style="list-style-type: none"> • Insolvent banks were resolved and recapitalized while maintaining fiscal sustainability (2013) • Other banks and the coops sector were recapitalized (2013-14) • Modern bank-resolution framework implemented (2013-14) • Supervision and regulation of the financial system strengthened, including by unifying supervision of banks and coops (2013-14) • Also strengthened the AML/CFT framework (2013-14)

16. European policies remain broadly supportive. Since the crisis, key policy initiatives have been put in place at the euro-area level, which Cyprus is expected to benefit from. The upcoming transition to the Single-Supervisory Mechanism (SSM) will harmonize supervisory and regulatory standards across the region, and the possibility of direct ESM support to banks could help limit sovereign-bank links. The ECB's recent policy rate cut is in line with Cyprus's cyclical position, although deposit rates in Cyprus remain elevated, reflecting a still-high risk premium. The new TLTRO and asset-purchase schemes to support lending are also welcome, although to achieve more than a limited effect in Cyprus, where asset quality has been deteriorating, the ECB would have to further relax its requirements. Further progress with completing the monetary and fiscal union could help support Cyprus's efforts to normalize bank-funding conditions, remove external-payment restrictions, and preserve fiscal sustainability.

POLICY DISCUSSIONS

17. Discussions focused on the policy agenda to support the recovery. They covered three main areas: (i) macroeconomic fundamentals—including an assessment of consumption-saving dynamics, housing prices, competitiveness, and long-term potential growth—and risks; (ii) financial sector policies to address high NPLs and establish conditions to revive lending and normalize external payment flows; and (iii) fiscal and structural policies for sustainable public finances. Discussions highlighted the importance of an appropriate policy mix to support the recovery through a gradual fiscal adjustment minimizing the negative fiscal impulse together with financial policies reducing NPLs, facilitating private-debt restructuring, and strengthening bank capital and liquidity to revive lending. Over the medium-term, boosting depositor confidence and gradually lifting external payment restrictions, together with lowering public debt, are essential to restoring external stability.

A. Outlook and Risks

18. The recession is expected to continue this year. Output is projected to fall by a further 3.2 percent in 2014 (somewhat better than the fourth program review projection), bringing the 2013–14 recession to a cumulative 8.6 percent. This is 4 percentage points less than initially projected,

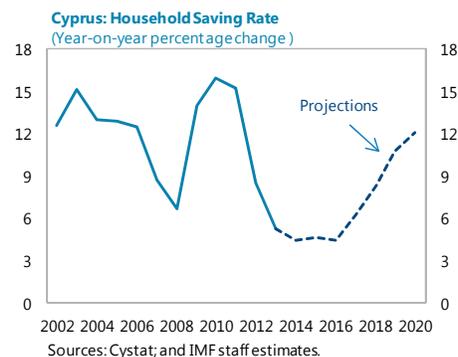
Selected Economic Indicators

	2013	2014	2015	2016	2017	2018
		Projection				
		(Percent change, unless otherwise indicated)				
Real GDP	-5.4	-3.2	0.4	1.6	2.0	2.2
Consumption	-5.6	-2.9	-0.6	0.5	1.3	1.5
Private consumption	-5.7	-2.4	-0.1	1.5	1.7	1.9
Public consumption	-5.0	-4.7	-2.1	-3.2	-0.6	-0.3
Fixed investment	-21.6	-13.4	1.3	3.9	4.6	4.9
Inventory accumulation 1/	-2.4	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	5.0	1.0	0.8	0.7	0.4	0.3
HICP (period average)	0.4	0.0	0.7	1.3	1.5	1.7
Unemployment rate EU stand. (percent)	15.9	16.6	16.1	15.0	13.7	12.5

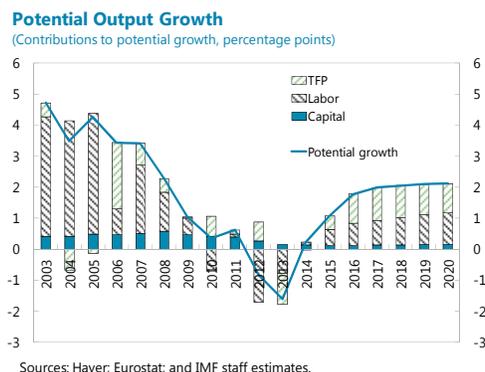
Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth.

reflecting consumption smoothing and more gradual deleveraging.³ Private consumption and investment are projected to further decline, albeit at lower rates, as deleveraging continues and the housing market adjusts. Unemployment is projected to reach 16.6 percent, and the price level to stabilize. The macroeconomic baseline is predicated on rapidly overcoming delays in program implementation.

19. A modest recovery is expected next year. Output is projected to grow by 0.4 percent and expand gradually thereafter. Private consumption will remain subdued, as households reduce debt, rebuild financial wealth, and adjust to lower non-financial wealth (house prices are projected to fall by a further 5–15 percent before reaching equilibrium).⁴ The household-saving rate is expected to further fall before rising to over 10 percent over the medium term.⁵ Given the large deleveraging needs of the corporate sector (30–60 percent of GDP), investment will recover only gradually. The recovery is expected to be credit-less and led by service sectors less dependent on credit, such as tourism and non-financial business services.⁶ Inflation will remain subdued relative to trading partners, facilitating a further modest depreciation of the real-exchange rate and an improvement in competitiveness.



20. Over the medium term, potential growth is expected to remain well below pre-crisis levels.⁷ The crisis will likely have a long-lasting impact on Cyprus's potential growth, due to physical capital becoming idle and eventually obsolete, human capital shortfalls owing to hysteresis effects, and to individuals leaving the labor force after long unemployment spells. As a result, long-term potential growth is estimated at 2 percent, half its pre-crisis level, driven by modest growth in the labor force—underpinned by long-term demographic trends—and education-led productivity improvements, while capital accumulation remains subdued, as resources shift away from construction toward tourism and non-financial services, where Cyprus has a comparative advantage.



³ See Box 4 of [Country Report No. 13/125](#) for an initial analysis of the potential impact of the crisis on economic activity.

⁴ See the companion Selected Issues Papers, “The Housing Market in Cyprus: From Boom to Bust”.

⁵ See the companion Selected Issues Papers, “The Cypriot Household Saving Rate”.

⁶ See [Country Report No. 13/374](#) for an analysis of private sector balance sheet deleveraging on growth (Box 1) and [Country Report No. 14/92](#) for a sectoral analysis of the expected credit-less recovery in Cyprus (Box 1).

⁷ See the companion Selected Issues Paper, “Estimating Cyprus’s Potential Output Growth”.

21. Risks to the medium-term outlook are tilted to the downside (Annex 1).

- **Domestic risks:** Prolonged delays in program implementation due to political tensions could have adverse implications for confidence and the recovery. Specifically, difficulties in addressing NPLs, including as a result of an inadequate debt-restructuring legal framework, and delays in meeting potential bank-capital needs following the comprehensive assessment could reignite negative bank-sovereign-real-sector feedback loops. Moreover, on the fiscal front, resistance to consolidation and reform fatigue could compromise debt sustainability. Even if the authorities manage to put the program back on track, deeper and more prolonged private sector deleveraging, exacerbated by the impact of persistently low inflation on indebtedness, could weigh on domestic demand and endanger debt sustainability (Annex 2). Long lasting external-payment restrictions could damage confidence and FDI, while a too rapid relaxation may exhaust liquidity buffers and endanger financial stability.
- **External risks:** Weaker euro-area recovery would hurt Cyprus's exports. Relatively lower euro-area inflation could hinder the envisaged improvement in competitiveness (Annex 3). An increase in world oil prices due to geopolitical tensions would boost imports and intermediate costs, dampening activity. While spillovers from the conflict in Ukraine have not been observed so far, a further escalation of sanctions and retaliatory measures could negatively affect Cyprus through three channels: (i) trade could suffer, given that service exports to Russia account for over 20 percent of Cyprus' total exports (mostly tourism); (ii) the service sector could be hit by a departure of Russian companies registered in Cyprus, which make use of Cypriot business services; and (iii) fiscal revenues would decline if off-shore companies leave Cyprus (they contribute 1–2 percent of GDP in corporate income-tax revenue).
- **Mitigating factors:** A continuation of gradually improving quarterly national-accounts trends could result in higher growth this year, while investment associated with the exploitation of natural gas could boost growth over the medium term.

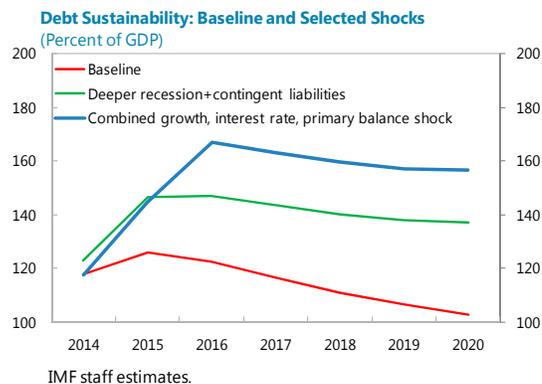
22. The authorities broadly concurred with the outlook and saw some upside potential.

They argued that households may save less, given still low confidence in the banking sector, which could boost consumption in the medium term. Regarding the housing market, they considered that prices are bottoming out and could modestly increase by next year, given emerging signs of renewed domestic and foreign demand. Finally, they saw upside to medium-term output, including due to the recent gas discoveries. The authorities agreed that a prolonged delay in program implementation could have adverse implications for the macroeconomic framework and concurred with staff's views on external risks.

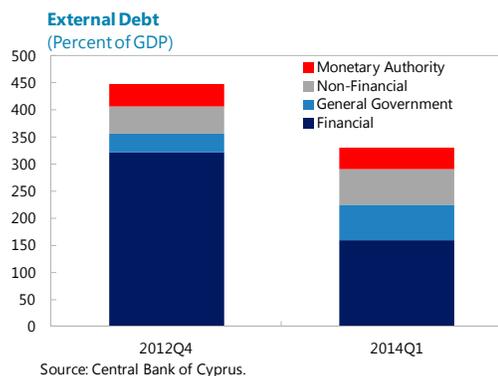
B. Public Debt and External Sustainability

23. Public debt is high and vulnerable to shocks (Annex 2). Public debt rose to 112 percent of GDP at end-2013, due to the large official financing and the sharp fall in output. Debt is projected to peak at about 126 percent of GDP in 2015 and to decline gradually thereafter toward 100 percent by 2020. Contingent liabilities associated with government guarantees on bank loans (20 percent of

GDP) and still-large implicit liabilities associated with the banks' reliance on central bank financing (55 percent of GDP) increase its vulnerability to shocks. In particular, a growth/interest rate/primary-balance shock or a shock to growth combined with a materialization of contingent liabilities could push debt to very high levels. In these cases, additional financing measures and commitments from European partners would be needed to protect debt sustainability.



24. Cyprus's external position is also highly vulnerable (Annex 3). Although external debt has declined, it remains high, at 350 percent of GDP at end-2013. Financial-sector liabilities—mainly non-resident deposits—are large and unstable, requiring the maintenance of external-payment restrictions. Reliance on official financing is high and rising, while external liabilities of the central bank with the Euro-system remain significant. The external net international-investment position (-86 percent of GDP at end-2013) is significantly weaker than that consistent with medium-term fundamentals. Restoring external stability critically hinges on a restoration of the health of the financial sector and a reduction in public debt, which are expected to take time. But it would also likely require a more depreciated real-exchange rate (REER) over the medium term, a little beyond the 0-8 percent adjustment implied by standard fundamentals-based models.



25. The authorities broadly agreed with the risks posed by public and external debt. Nevertheless, they considered that public sector debt projections remain conservative, given the assumption of full disbursement of the program buffer and the stringent growth and inflation projections. They also noted that expected upward revisions to the output level later this year (to conform to ESA2010 standards) will bring down the debt-to-GDP ratio. They concurred with the external stability assessment, including the need for moderate medium-term REER adjustment.

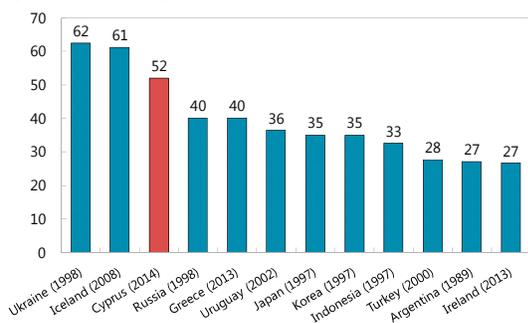
C. Financial Sector Policy

26. While the authorities took decisive action to address the crisis, important challenges remain. The banking sector is now smaller and better capitalized, domestic payment restrictions have been eliminated, and deposits have broadly stabilized. However, left unaddressed, high and rising NPLs would pose a threat to the banking system's long-term viability and the economic recovery. Capital buffers in some banks are limited, and bank restructuring remains incomplete, hampering the resumption of credit and growth. Narrow liquidity buffers and still-large ELA exposure require the maintenance of external payment restrictions. Finally, the authorities need to further enhance bank supervision ahead of the transition to the SSM and strengthen the implementation of the AML/CFT framework.

Challenge 1: Addressing NPLs

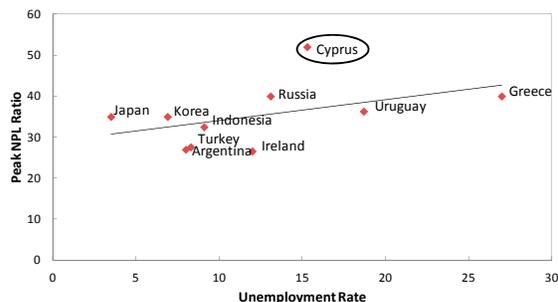
27. Early policy initiatives have not managed to curb the rising NPL trend. NPLs are very high both in a historical and cross-country context. This reflects not only the severe recession, but also increasing strategic default. Indeed, NPLs exceed what could be explained by unemployment, especially given the large and positive asset position of households. To facilitate the restructuring of troubled loans, banks have put in place restructuring units. (A state-backed asset-management company (AMC) was not created given debt-sustainability concerns limiting the ability to provide either direct state funding or government guarantees.⁸) The Central Bank of Cyprus (CBC) published an arrears-management framework (AMF) and Code of Conduct (CoC) to guide the loan-restructuring process and developed a supervisory framework to monitor banks' capacity and progress against operational and restructuring indicators. Still, progress has been slow, as incentives are lacking, and banks need time to build capacity to handle the many NPLs.

Peak NPL Ratios
(Percent of Total Loans)



Sources: IMF, Laeven and Valencia (2013)

Peak NPL Ratios and Unemployment Rates in Select Episodes
(Percent)



Sources: IMF staff estimates.

28. Reforming the debt-restructuring legal framework is urgent. The inability to reach restructuring solutions is largely due to a lack of incentives for borrowers and lenders to negotiate, including a foreclosure process that takes 10–15 years and outdated corporate-restructuring and personal-bankruptcy procedures. In this regard:

- **Foreclosure:** The authorities need to implement without delay foreclosure legislation allowing for a balanced but swift process without interference from government agencies. While a recently adopted legislative package includes important elements, it also introduces a number of new obstacles, including processes to delay foreclosures, moratoria, and debt-write-offs irrespective of viability considerations. These obstacles should be removed to protect the payment culture and provide incentives for debt restructuring. Indeed, banks are expected to use the law sparingly and mainly as a negotiation tool, as potentially declining collateral values due

⁸ Moreover, commercial real-estate related NPLs which are the prime candidate for transfers to an AMC are concentrated in one bank, limiting the potential benefits of an AMC to achieve economies of scale. For a discussion of cross-country experience with AMCs, see Section IIA of Selected Issues Paper "Cyprus's Banking Sector: The Crisis and its Aftermath".

to foreclosures would affect their capital. To protect vulnerable groups, implementation of the foreclosure law for primary residences should be aligned with the new personal-bankruptcy legislation, and the authorities should ensure adequate implementation of the new safety-net reform protecting those most in need.

- **Insolvency:** The foreclosure law will need to be complemented by a modernized corporate and personal-insolvency legal framework facilitating debt restructuring for viable debtors, and allowing for speedy liquidation of non-viable companies and for a “fresh start” for individuals without capacity to repay.

29. Supervisory tools also need to be strengthened. Banks need stronger capacity and better incentives and tools to proactively restructure NPLs to spearhead the recovery. The CBC needs to follow up on its review of banks’ operational capacity and ensure that remaining deficiencies are being addressed. Moreover, the new voluntary Arrears-Management Framework and Code of Conduct will need to be further refined and their implementation monitored and enforced through supervisory action. The authorities should also further leverage the supervisory bank-monitoring framework as a tool to encourage banks to restructure NPLs. Finally, to facilitate the disposal and workout of NPLs, the authorities could consider other measures to address legal and other barriers hampering the sale and servicing of bank loans by third parties.

30. The authorities recognized the importance of addressing NPLs, but emphasized the need for adequate safeguards for households. They agreed that the insolvency and foreclosure legal framework needs strengthening, but stressed that the process should be balanced and vulnerable groups adequately protected. They also noted risks from potential sharp declines in property prices as a result of foreclosures. They agreed to further refine the AMF and CoC to better standardize restructuring processes and tools, emphasizing the importance of adequate supervisory enforcement of the framework.

Challenge 2: Putting in place the conditions to revive lending

31. The financial sector needs to maintain strong capital buffers. While banks have been recapitalized under conservative assumptions (including for housing prices, which were projected to further fall broadly in line with staff’s baseline scenario) given lingering downside risks and low provisions, stronger capital buffers would help deal with potential shocks, address high NPLs proactively, and allow for new lending to support viable investment. Moreover, Cypriot banks need to ensure adequate buffers in light of the pan-European comprehensive assessment, whose methodological assumptions and stress-test scenario are somewhat more stringent than those underlying the banks’ initial recapitalization. The recent market recapitalization of BoC, which boosted its CET1 capital ratio to 15 percent, is a welcome step, and the bank should ensure that any additional needs can be covered through market sources, if necessary. Hellenic Bank also indicated its intention to proactively increase its share capital. The authorities should stand ready to provide additional support to the coop sector, if needed, in line with the program envelope. Commercial banks’ renewed access to markets, the availability of ESM direct bank recapitalization support (albeit

under stringent conditions), and the program buffer (in excess of 10 percent of GDP) can help mitigate risks.

32. Bank restructuring should continue. Banks and coops are progressing with the implementation of their restructuring plans. They cut their cost-to-income ratios to 40 and 50 percent, respectively, well below the European average (60 percent). BoC finalized its operational integration with Laiki and disposed of non-core activities abroad. Looking forward, given that BoC's operational restructuring plan is broadly on track, the bank's efforts need to focus on continuing overseas deleveraging and normalizing funding. Regarding the coops, with the new organizational structure in place, efforts should focus on ensuring efficient and consistent management of information, processes, and risks across the sector, including by centralizing the management of NPLs and early arrears and by further strengthening governance arrangements.

33. The authorities agreed that strong capital buffers and progress with restructuring are key to reviving lending. They noted that high bank-funding costs—reflecting an elevated risk premium due to still-low depositor confidence—hamper the resumption of credit. They agreed that the normalization of funding conditions and lending rates requires further efforts to bolster confidence, including by expeditiously addressing any capital shortfalls identified by the comprehensive assessment. Regarding the restructuring of coops, while they concurred with the need to strengthen and unify management practices across the sector, they noted that excessive centralization could jeopardize the sector's franchise and business model.

Challenge 3: Normalizing external flows

34. Safeguarding financial stability requires prudent management of payment restrictions. Domestic payment restrictions imposed during the crisis have been gradually and successfully relaxed on the basis of the authorities' published roadmap, as key milestones in the bank recapitalization and restructuring strategy were achieved. However, owing to the short deposit-maturity structure, significant foreign deposits (close to 40 percent of the total), large reliance of BoC on ELA, and the lack of other market funding, external restrictions remain in place. While restrictions

Restrictive Measures as of End-September 2014 (Euros)

Cashless payments/transfers w/o justification to institutions abroad (per day per account)	
Transactions within normal business w/o Committee's approval	1,000,000
Living expenses per quarter as tuition fees	5,000
Payments via debit or credit card (per month)	No limit
Exports of euro notes or foreign currency per person per journey	3,000
Monthly transfer of deposits/funds abroad regardless of the purpose	5,000

Source: Central Bank of Cyprus / Ministry of Finance Cyprus

do not apply to fresh foreign inflows into Cyprus, they limit outflows, hampering trade credit and affecting overall confidence.

35. The authorities should relax external restrictions gradually, paying attention to shifts in both depositor confidence and bank liquidity. A gradual approach is needed to manage restrictions in line with the banks' ability to normalize funding conditions, taking into account the need to maintain depositor confidence, in particular given delays in program implementation. The approach needs to be underpinned by careful analysis of deposit and liquidity trends and be clearly communicated to provide for a transparent and predictable process. In the meantime, the CBC will need to carefully monitor the effectiveness of restrictions through supervisory monitoring and inspections.

36. Strengthening bank liquidity will be critical to the eventual exit from external payment restrictions. BoC's recent capital increase has helped improve its liquidity position and boost depositor confidence. And the disposal of foreign operations and partial redemption of the Laiki recapitalization bond have allowed a reduction in ELA. Still, it will take significant time to fully normalize BoC's funding. Efforts to accelerate the resolution of NPLs and to further deleverage operations abroad can help improve the quality of collateral and generate additional cash flow. BoC could also seek market (junior) funding, which can further boost confidence, although it will need to ensure that this funding does not come at an excessive cost. Further Euro-system support to ensure adequate access to liquidity and a normalization of funding remains essential.

37. The authorities agreed with the need to manage remaining restrictions cautiously. Given heightened uncertainty associated with the comprehensive assessment, they extended existing restrictions until after the successful completion of the assessment and transition to the SSM.⁹ They agreed that subsequent relaxations need to be gradual and based on data analysis, but stressed the difficulty of assessing and predicting deposit behavior. They remained optimistic that relaxations could be achieved within a reasonable timeframe.

Challenge 4: Ensuring adequate prudential and AML/CFT supervision

38. The authorities have taken steps to address weaknesses in the bank supervision and AML/CFT frameworks. Relaxed supervisory standards before the crisis allowed for excessive credit growth, weak bank governance and risk-management practices, and fragmented standards across banks and coops. Moreover, weaknesses in the implementation of the AML/CFT framework may have contributed to the unsustainable growth of the financial sector. The authorities took steps to address supervisory shortcomings, including by issuing new directives on provisioning, NPL disclosure, and loan origination, putting in place a country-wide credit register, unifying the supervision of banks and coops, and strengthening the resolution authority. They also revised the

⁹ The Executive Board has recently approved retention of the existing exchange restrictions for twelve months.

AML/CFT legal framework to improve compliance with international standards, strengthened the CBC's AML/CFT supervisory resources, and developed risk-based tools.

39. Efforts must continue to further strengthen bank supervision and the implementation of the AML/CFT framework:

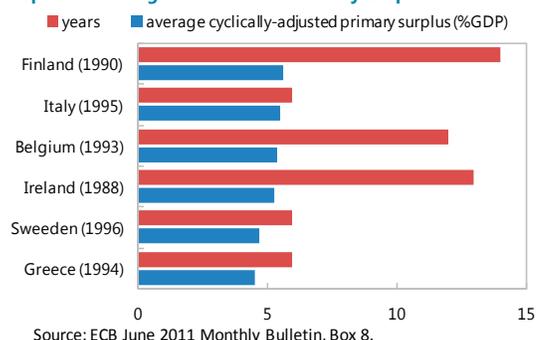
- **Supervision:** The two largest Cypriot banks and the coops, representing 80 percent of the sector, will come under the supervision of the SSM in November. Although the transition to the SSM, including the ongoing comprehensive assessment, are putting strains on the CBC's capacity, the CBC should ensure adequate supervision while the banking sector is in a critical restructuring phase. Future supervisory priorities will need to be coordinated within the SSM, and Cypriot ownership will be key to ensuring an effective oversight of the sector.
- **AML/CFT:** The authorities need to build on progress to date to step up implementation of the risk-based framework for AML/CFT supervision for banks and service providers, including by: (i) further enhancing institutional and staff capacity, (ii) improving coordination with prudential bank supervision, (iii) strengthening inspection processes, risk-based tools, and the quality of reports, and (iv) improving enforcement, including by applying appropriate sanctions as needed. The CBC also needs to complete its AML/CFT investigation of FBME branch operating in Cyprus, which was intervened in July following the bank's designation by the U.S. Treasury as an institution of primary money-laundering concern.

40. The authorities agreed with the need to strengthen prudential and AML/CFT supervision. While they looked forward to enhancing coordination of overall policies and bank-specific supervisory work with European practices, they noted that the practical details of the integration with the SSM still need to be clarified and implemented, which could take time and resources. While they considered that their AML/CFT framework is at least comparable to that of other countries, they agreed with the need to further strengthen its implementation, especially with respect to banks and service providers, as a way to rebuild Cyprus's reputation as a strong and sustainable financial and business center.

D. Fiscal Policy

41. The policy objective is to unwind the imbalances accumulated before the crisis and put public debt on a firmly downward path. The loose fiscal policies initiated in 2008, unwinding of the property-market boom, and deep recession dealt a severe blow to the fiscal balance, which went from an overall surplus of 1 percent of GDP in 2008 to average annual deficits of 6 percent of GDP during 2009–12. This, together with the 2012 public support to Laiki bank, led to an almost doubling of public debt during this period. The authorities aim to achieve a primary

Episodes of Large and Sustained Primary Surpluses

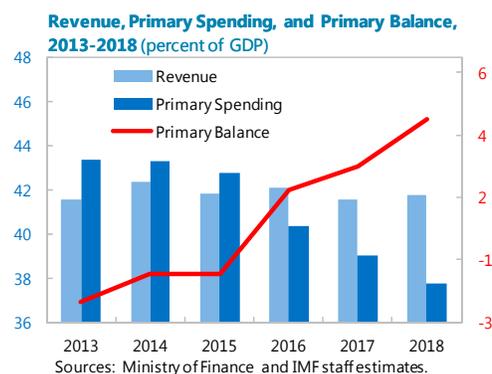


surplus of 4 percent of GDP by 2018—similar to the level reached in 2008—to lower public debt to around 100 percent of GDP by 2020. Primary surpluses will need to be maintained beyond 2020 to bring debt to its pre-crisis level (50–60 percent of GDP). While achieving and sustaining primary surpluses of such magnitude can be challenging, a number of countries have done so successfully.¹⁰

42. The challenge is to achieve a credible but balanced fiscal adjustment over time. The

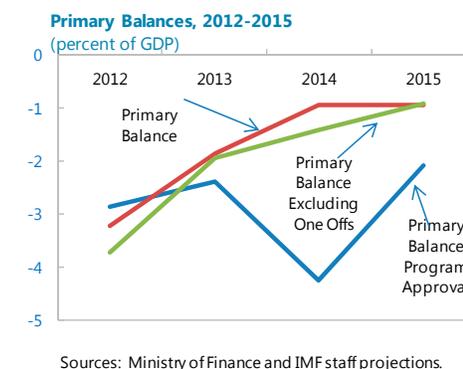
authorities aim for a gradual improvement in the primary balance, taking into account short-term cyclical and long-term sustainability concerns. The 7 percent of GDP of measures implemented in 2013–14 are expected to help unwind some of the spending increases undertaken before the crisis (e.g. on public-sector wages and social transfers), and partially compensate for the loss of real-estate revenue following the housing-market bust, while ensuring that the negative fiscal impulse remains manageable.¹¹

However, to attain the primary-surplus target of 4 percent of GDP by 2018, additional measures of about 3.4 percent of GDP will be needed under the current macroeconomic baseline.



43. Given the consolidation to date, the primary deficit is projected to decline to about 1 percent of GDP this year. This represents one-third of the 2012 level and is better than expected at the onset of the program by about 3 percent of GDP.

While the level of spending has been largely as anticipated, revenues have over-performed due to the better-than-projected macroeconomic outcome, lower-than-expected elasticities, but also some one-off factors. Consequently, the fiscal impulse resulting from the lower deficit is not thought to have negatively affected the economy beyond what was expected at the start of the program. The projected primary deficit is well within the authorities' program target established during the 4th review (1.6 percent of GDP).



44. In 2015, the primary deficit is projected to remain around at 1 percent of GDP. This represents a modest improvement in the primary balance net of one-offs, given the over-performance in 2013–14 and the weak expected recovery in 2015. To ensure the fiscal neutrality of the new welfare reform, the authorities need to implement permanent measures of 0.3 percent of GDP, which should be focused on improving the targeting and rationalization of other social benefits. Should costs of the welfare reform turn out to be higher than expected, the authorities should be prepared to offset these during 2015 with high-quality measures. However, if

¹⁰ See Box 8 of ECB Monthly Bulletin, June 2011.

¹¹ See Box 4 of [IMF Country Report No.13/374](#).

macroeconomic outcomes deteriorate beyond expectations, automatic stabilizers should be allowed to operate.

45. Additional adjustment measures are needed over the medium term to ensure fiscal sustainability. The adjustment should start in 2016, be growth-friendly and balanced over time, and focus on reversing the statutory spending increases that took place before the crisis.¹² To prevent a rapid rise in public-sector wages following their expected unfreezing after the program period, the wage bill needs to be further rationalized, including by revising current wage levels and pay scales, eliminating automatic increases, reducing employment in overstuffed areas (i.e. education), and rationalizing public-pension lump-sum payments.¹³ The authorities could also review social benefits increased during 2008–12 and improve the targeting of education subsidies, while increasing tertiary-education fees.

Public Sector Compensation of Employees, Euro Area Countries, end-2013 1/ (Percent of GDP)



Source: Eurostat.

1/ Cyprus compensation of employees is divided by the 2012 GDP given the unusually low 2013 GDP due to the crisis.

46. The authorities had a more favorable view of fiscal prospects. They expected a better fiscal outturn in 2014 and considered that a more modest fiscal effort will be required to attain the 2018 primary-surplus target, given the over-performance to date and a likely stronger economic recovery. While they saw merit in reforming the public wage-setting framework to better link wages with productivity, they did not agree with further reducing wage levels. They saw scope for further rationalization of social benefits, pension gratuities, and education spending, but were reluctant to consider specific measures beyond those required to ensure fiscal neutrality of the welfare reform.

E. Structural Reforms

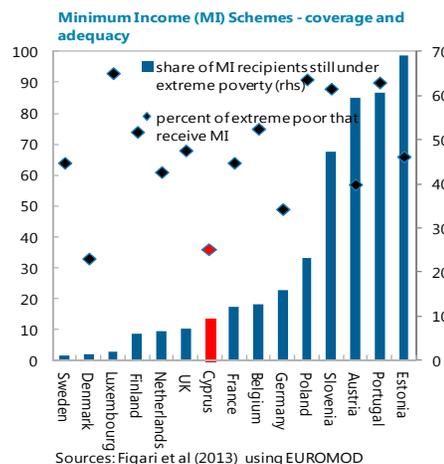
47. Recently-legislated structural reforms should be followed through and fully implemented. Building on the 2012 reforms of the pension system and the wage-indexation (COLA) framework, the authorities initiated additional reforms aimed at: (i) improving the targeting, coverage, and administration of the welfare system; (ii) unifying the revenue administration and enhancing its collection powers; (iii) enhancing public financial management by allowing for medium-term budget formulation, performance-based budgeting, and fiscal risk management; and (iv) facilitating privatization of state-owned assets. To reap their long-term benefits, reforms need to be followed through by implementing remaining secondary legislation, reorganizing resources and building capacity to meet the new needs, monitoring reform outcomes, and adjusting reform parameters as needed. Additional medium-term reforms—such as to healthcare and public

¹² See Selected Issues Paper “Achieving a Durable Fiscal Consolidation.”

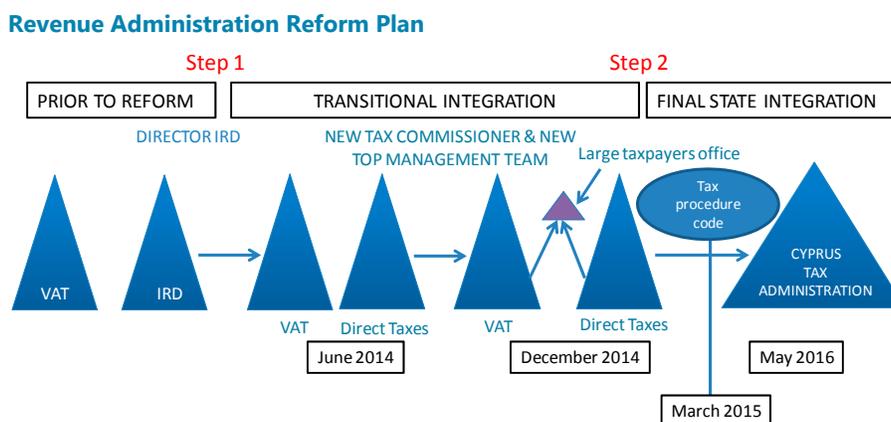
¹³ Box 2 of [IMF Country report No 14/169](#) suggests that small open economies that achieved larger reductions in their wage bill were relatively more successful in improving primary balances and reducing their debt.

administration—need to be appropriately sequenced to avoid capacity overload and to ensure that fiscal risks are minimized.

48. Making the new welfare system operational is critical to ensuring that vulnerable groups are protected during the downturn. The recently-legislated reform, unifying previously fragmented public-assistance benefits under a single guaranteed minimum income (GMI), brings Cyprus’s welfare system in line with best practice in Europe and is expected to improve both the coverage and adequacy of public assistance, reducing relative and extreme poverty by 17 and 70 percent, respectively.¹⁴ Following the adoption of the new law in mid-2014, the authorities need to ensure adequate capacity to cope with the expansion in coverage (by about 20 percent) and to carefully monitor the implementation of the new system. To better identify and prevent abuse, they are building a national benefit registry, cross-checked with other databases, to review beneficiaries’ profiles and eligibility. This could help achieve a more equitable system and generate cost savings.



49. Careful execution of the revenue administration reform is needed to support the fiscal consolidation effort. The reform aims to increase the effectiveness of tax collections by integrating the two tax departments (VAT and direct taxes) under a unified function-based structure. With the new legal structure in place, the authorities should focus on timely implementation of reform steps,—including setting up a large taxpayers’ office and developing a new tax procedure code—with a



¹⁴ See Box 4 of [IMF Country Report No.14/180](#). The relative poverty gap is measured as the relative distance between the income of the poor and the poverty threshold (60 percent of median equivalent income.).

view to achieving full integration of the tax departments over the medium-term. They will need to manage the transition carefully, to ensure that revenue collections are being protected during the transition period, including by making use of new collection-enforcement powers and continuing with joint audits of large and high-risk taxpayers.

50. The authorities should manage fiscal risks prudently and fully implement their new public financial management framework.

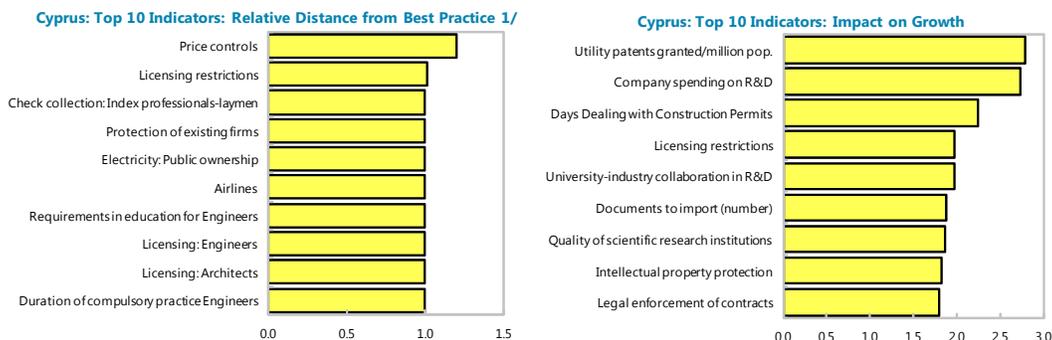
Given fiscal risks related to government guarantees (amounting to 20 percent of GDP), the authorities need to monitor them and put in place a government-guarantee management framework. To address these and other risks related to the debt structure—including sizeable redemptions concentrated immediately after the program period (40 percent of GDP during 2017–20) and a dysfunctional domestic debt market—a medium-term debt-management strategy is needed to provide strategic focus and address operational weaknesses to allow for an eventual exit from official assistance and a full return to markets. Finally, to implement the new fiscal responsibility and budget systems law (FRBSL), the authorities should press ahead with secondary legislation and guidelines and strengthen budget processes.



Source: Ministry of Finance

51. Looking forward, a growth strategy could help boost Cyprus’s competitiveness and economic potential.

Cyprus ranks relatively favorably on structural indicators compared to other countries: it ranked 58th (out of 148) in the World Bank’s 2013–14 global-competitiveness index and 22nd (out of 153) in the 2013 Freedom of the World report. Still, there is room for improvement, and the authorities are developing a strategy to address bottlenecks to growth. The strategy should focus on areas where Cyprus lags relative to best practice and where the impact on growth is the largest, including: (i) opening up of closed professions by streamlining licensing restrictions; (ii) removing barriers to competition, including protection of firms and price controls; (iii) reducing red tape; (v) privatizing state-owned enterprises; (vi) strengthening the legal system; and (vi) fostering innovation. Indeed, structural reforms in these areas are estimated to have a significant



Sources: IMF staff estimates based on data from OECD, World Bank Doing Business, Economic Freedom of the World, and World Economic Freedom databases.

1/ Relative distance is defined as the difference between Cyprus’ index and that of the top 5 in the world, divided by Cyprus’s index.

impact on growth (which could provide an upside to medium-term growth of up to 1.5–3 percentage points).¹⁵

52. The authorities agreed with the identified structural reform needs and priorities. They concurred that careful implementation of the GMI is essential to build credibility for the new reform and were confident that the system will generate cost savings through enhanced scrutiny of eligibility. They acknowledged the heightened risks during the transition to the integrated revenue administration, but also stressed risks related to the immediate and full implementation of the new powers to collect tax debt. They also noted that capacity constraints may pose challenges to their strategy to collect tax debt and monitor government guarantees. They agreed with the need to develop a long-term growth strategy.

STAFF APPRAISAL

53. The Cypriot economy was buffeted by an unprecedented shock in 2013. This exposed large vulnerabilities and imbalances, which culminated in one of the largest banking sector collapses on record. In response, the authorities took exceptional measures, including the resolution of the two largest banks, both of them economically insolvent; recapitalization of the resulting institution through the bail in of creditors, including uninsured depositors; and the imposition of sweeping payment restrictions.

54. The authorities have come a long way in addressing the crisis. In the context of an ambitious adjustment program supported by international financial assistance, they completed the recapitalization of the banking sector consistent with fiscal sustainability, downsized and restructured financial institutions, and liberalized domestic payment flows. These achievements, complemented by ambitious fiscal consolidation and structural reforms, helped Cyprus re-access international markets earlier this year.

55. But overcoming the legacy of the crisis will be challenging. The crisis has imposed a large cost on the economy and on the population. A painful but unavoidable recession is underway, and unemployment remains very high. Both the private and public sectors remain heavily indebted. And the banking sector remains vulnerable, given high and rising NPLs, tight liquidity and capital buffers, and the need to maintain external payment restrictions to protect financial stability.

56. The authorities need to overcome recent delays in the implementation of their adjustment program. Heightened political opposition, entrenched vested interests, and reform fatigue are taking a toll on the program, which has been delayed after eighteen months of strong implementation. The authorities need to redouble their efforts to put the program back on track to achieve a durable economic recovery and an eventual exit from official financing.

¹⁵ See [Cheptea C. and Velculescu D., "A Disaggregated Approach to Prioritizing Structural Reforms for Growth and Employment"](#) in Schindler M. et al., "Jobs and Growth: Supporting the European Recovery," IMF, 2014.

57. Addressing high NPLs is essential for the financial sector's viability and the economy's recovery. To encourage loan restructuring and restore the payment culture, the authorities need to implement without delay legislation to streamline foreclosures. This should be complemented by a comprehensive reform of the legal framework for insolvency. They should also strengthen supervisory incentives for banks to proactively restructure NPLs and attain sustainable solutions.

58. Adequate capital buffers and further bank restructuring are key to reviving lending. The recent recapitalization of Bank of Cyprus is an encouraging sign of the return of confidence in the financial sector. The authorities should stand ready to further strengthen capital buffers consistent with the pan-European comprehensive assessment, and ensure that banks and the coop sector continue with restructuring, including by strengthening processes and governance.

59. External payment restrictions should be managed prudently to safeguard financial stability. Relaxing these restrictions should be predicated on a normalization of bank funding. The approach should be gradual and underpinned by a transparent milestone-based roadmap. Staff supports the request to extend existing exchange restrictions under the IMF's Article VIII. Adequate support by the Euro-system to normalize bank funding and liquidity is essential.

60. Effective prudential and AML/CFT supervision is needed to prevent vulnerabilities from re-emerging. The authorities should maintain tight supervisory oversight of the banking sector as they restructure. At the same time, they need to coordinate closely with the SSM to ensure a smooth transition to the new pan-European supervisory framework. Implementation of the AML/CFT framework should continue to be strengthened.

61. Additional medium-term fiscal consolidation will be needed to ensure debt sustainability. The authorities implemented an ambitious fiscal adjustment which, together with prudent budget execution, helped to reduce the deficit. But with public debt high and rising, an additional medium-term fiscal effort is required to put debt on a sustained downward path. The consolidation should be carefully paced, rely on permanent measures, and be focused on unwinding the spending increases preceding the crisis.

62. With important structural reforms initiated, the focus needs to be on implementation. The authorities recently legislated key reforms to the welfare system, public financial management, and revenue administration. They should ensure that reform implementation continues and manage the transition period prudently. Privatization efforts should be stepped up. Growth-enhancing structural reforms could help increase the economy's long-term potential.

63. The next Article IV Consultation is expected to be held on a 24-month cycle in accordance with the Decision on Article IV Consultation Cycles (Decision No. 14747-(10/96) (9/28/2010)).

Table 1. Cyprus: Selected Economic Indicators, 2008–20

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections												
Real Economy	(Percent change, unless otherwise indicated)												
Real GDP	3.6	-1.9	1.3	0.4	-2.4	-5.4	-3.2	0.4	1.6	2.0	2.2	2.1	1.8
Domestic demand	8.0	-7.0	1.9	-1.5	-3.8	-10.1	-4.3	-0.4	0.9	1.7	1.9	2.0	1.7
Consumption	7.4	-4.6	1.4	1.0	-2.4	-5.6	-2.9	-0.6	0.5	1.3	1.5	1.6	1.2
Private consumption	7.8	-7.5	1.5	1.3	-2.0	-5.7	-2.4	-0.1	1.5	1.7	1.9	1.8	1.4
Public consumption	6.1	6.8	1.0	-0.3	-3.8	-5.0	-4.7	-2.1	-3.2	-0.6	-0.3	0.5	0.6
Fixed investment	6.0	-9.7	-4.9	-8.7	-18.3	-21.6	-13.4	1.3	3.9	4.6	4.9	4.9	4.8
Inventory accumulation 1/	0.9	-1.5	1.8	-0.7	1.3	-2.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.0	1.6	5.0	1.0	0.8	0.7	0.4	0.3	0.2	0.2
Exports of goods and services	-0.5	-10.7	3.8	4.4	-2.5	-4.2	0.4	1.5	2.8	3.1	3.3	3.0	2.9
Imports of goods and services	8.5	-18.6	4.8	-0.2	-5.4	-14.1	-1.8	-0.1	1.5	2.5	2.8	2.8	2.7
Potential GDP growth	2.4	1.7	1.6	1.7	-1.5	-5.4	-3.1	-0.2	0.5	1.0	1.6	1.9	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.3	-3.4	-2.8	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	0.4	0.0	0.7	1.3	1.5	1.7	1.9	1.9
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	-1.3	0.0	0.7	1.3	1.5	1.7	1.9	1.9
Unemployment rate EU stand. (percent)	3.6	5.4	6.3	7.9	11.9	15.9	16.6	16.1	15.0	13.7	12.5	11.3	10.3
Employment growth (percent)	1.7	0.0	1.4	-1.5	-3.3	-5.2	-2.8	0.2	1.4	1.6	1.7	1.6	1.5
Public Finance	(Percent of GDP)												
General government balance	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-4.4	-3.9	-1.3	-0.8	0.6	0.2	-0.1
Revenue	43.1	40.1	40.9	39.9	39.4	41.5	42.3	41.8	42.1	41.5	41.7	41.9	41.9
Expenditure	42.1	46.2	46.2	46.3	45.8	46.4	46.7	45.7	43.3	42.3	41.1	41.7	42.0
Primary Fiscal Balance	3.8	-3.6	-3.0	-4.0	-3.2	-1.9	-1.0	-1.0	1.7	2.5	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.5	86.6	111.5	117.4	126.0	122.5	116.4	111.1	106.5	102.6
Balance of Payments	(Percent of GDP)												
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-1.1	-0.8	-0.3	-0.1	-0.2	-0.2	-0.2
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.9	2.6	3.2	3.8	4.1	4.3	4.2	4.2
Exports of goods and services	45.0	40.2	41.3	42.9	42.9	43.9	45.5	46.3	46.9	47.3	47.6	47.9	48.2
Imports of goods and services	56.4	45.7	47.5	47.2	46.0	42.0	42.8	43.1	43.0	43.2	43.4	43.6	44.0
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.8	-16.7	-16.4	-16.2	-16.2	-16.3	-16.4	-16.5
Services balance	21.0	19.9	20.6	20.1	18.7	19.7	19.3	19.7	20.1	20.3	20.5	20.6	20.7
Income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.7	-2.7	-3.1	-3.2	-3.3	-3.5	-3.5	-3.5
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.4	4.8	-26.3	-11.4	-16.8	-2.2	0.0	0.4	0.7	0.9
Direct investment	-5.2	13.2	0.4	0.7	6.8	1.0	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment	-74.2	-101.1	-11.1	32.2	30.1	71.1	15.6	-5.2	-1.6	-2.2	1.6	10.0	3.0
Other investment	93.8	98.2	19.0	-28.8	-32.4	-98.6	-27.4	-16.0	-5.3	-1.0	-4.3	-13.3	-6.0
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	0.0	0.0	29.3	12.3	17.5	2.3	0.0	-0.3	-0.6	-0.8
European Union	0.0	0.0	0.0	0.0	0.0	27.8	10.2	15.4	1.8	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	1.5	2.1	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	2.0	-2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.6	10.0	13.2	8.3	8.6	8.6	9.1	10.0	10.8	11.3	11.8	12.4
Government	4.9	-0.6	-0.1	-1.8	-2.6	-1.9	-0.7	-0.3	1.9	2.3	3.7	3.3	3.0
Non-government	2.8	9.2	10.0	15.0	10.9	10.5	9.3	9.4	8.2	8.5	7.6	8.5	9.3
Gross capital formation	23.3	19.4	19.8	16.6	15.2	10.5	9.7	9.9	10.4	10.9	11.5	12.0	12.6
Government	5.0	5.1	5.0	5.0	5.3	6.1	5.1	5.1	4.5	4.2	3.9	4.2	4.4
Private	18.3	14.3	14.8	11.6	9.9	4.4	4.6	4.8	5.9	6.7	7.6	7.8	8.3
Foreign saving	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-1.1	-0.8	-0.3	-0.1	-0.2	-0.2	-0.2
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	17.9	17.7	16.5	15.8	15.9	16.4	17.1	17.8	18.5	19.2

Sources: Eurostat, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth.

Table 2. Cyprus: Fiscal Developments and Projections, 2008–20 1/
(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections												
Revenue	43.1	40.1	40.9	39.9	39.4	41.5	42.3	41.8	42.1	41.5	41.7	41.9	41.9
Current revenue	43.0	40.0	40.8	39.9	39.3	41.5	42.3	41.8	42.1	41.5	41.7	41.9	41.9
Tax revenue	30.6	26.4	26.5	26.4	25.9	26.2	26.9	26.8	27.1	27.0	27.2	27.2	27.3
Indirect taxes	17.7	15.2	15.4	14.6	14.9	14.5	15.4	15.5	15.6	15.7	15.8	15.8	15.8
Direct taxes	12.9	11.2	11.1	11.7	11.1	11.6	11.5	11.3	11.4	11.3	11.4	11.4	11.5
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.8	8.7	8.9	8.8	8.5	9.0	9.4	9.4	9.4	9.5	9.5	9.6	9.6
Other current revenue	4.6	4.9	5.4	4.8	4.8	6.3	6.1	5.5	5.6	5.0	5.1	5.1	5.0
Sales	2.9	2.4	2.6	2.4	2.7	2.7	2.6	2.8	2.9	2.9	2.9	2.9	2.9
Other	1.8	2.5	2.8	2.3	2.2	3.6	3.4	2.7	2.7	2.1	2.2	2.2	2.1
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.1	46.2	46.2	46.3	45.8	46.4	46.7	45.7	43.3	42.3	41.1	41.7	42.0
Current expenditure	38.2	40.7	40.9	41.7	42.0	43.4	43.0	42.1	40.2	39.2	38.0	38.6	38.8
Wages and salaries	14.6	16.2	15.8	16.1	15.9	15.6	15.0	14.7	14.2	14.0	13.9	13.6	13.4
Goods and services	5.0	5.4	5.6	5.3	4.9	4.7	4.7	4.7	4.5	4.2	4.0	4.0	4.0
Social Transfers	12.2	13.5	14.4	14.7	14.7	15.7	17.0	16.8	15.9	15.3	14.7	14.7	14.8
Subsidies	0.4	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Interest payments 2/	2.8	2.6	2.2	2.4	3.2	3.0	3.4	2.9	3.0	3.3	3.4	3.8	4.1
Other current expenditure	3.1	2.9	2.5	2.8	2.7	3.8	2.3	2.3	2.1	1.8	1.6	1.9	2.1
Capital expenditure 3/	4.0	5.5	5.2	4.5	3.8	2.9	3.7	3.6	3.1	3.1	3.1	3.1	3.1
Overall balance 4/	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-4.4	-3.9	-1.3	-0.8	0.6	0.2	-0.1
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-4.4	-3.9	-1.3	-0.8	0.6	0.2	-0.1
Net financial transactions	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-4.4	-3.9	-1.3	-0.8	0.6	0.2	-0.1
Net acquisition of financial assets	-4.4	2.7	-0.6	5.3	8.7	13.6	-3.9	5.8	-1.2	-2.3	0.0	0.0	0.0
Currency and deposits	-4.5	1.9	-1.3	4.7	-3.6	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares 5/	0.0	0.0	0.0	0.0	0.0	9.1	-9.5	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.2	0.6	0.7	1.1	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	-0.3	0.0	0.0	0.0	10.5	0.4	11.9	5.8	-1.2	-2.3	0.0	0.0	0.0
Other assets	0.2	0.3	0.0	-0.4	0.0	0.1	-6.3	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-5.3	8.8	4.7	11.7	15.1	18.5	0.4	9.7	0.0	-1.6	-0.6	-0.2	0.1
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.3	9.2	4.8	7.6	1.8	-10.3	-5.7	-6.7	1.6	1.4	0.3	1.0	1.5
Loans	3.0	-0.3	0.0	4.0	12.7	28.8	6.1	16.5	-1.6	-3.0	-0.9	-1.2	-1.4
Other liabilities	0.1	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance 6/	3.8	-3.6	-3.0	-4.0	-3.2	-1.9	-1.0	-1.0	1.7	2.5	4.0	4.0	4.0
Public debt	48.9	58.5	61.3	71.5	86.6	111.5	117.4	126.0	122.5	116.4	111.1	106.5	102.6

Sources: Eurostat; and IMF staff estimates.

1/ Historical fiscal statistics until 2012 are based on Eurostat and are thus reported on an accrual basis. For 2013 and projections, and to be consistent with the cash basis of the program, the fiscal statistics are reported on a cash basis.

2/ In 2014 and from 2017 onwards, part of the interest bill previously capitalized is projected to be paid annually.

3/ Capital expenditure in 2014, 2015, and 2016 include payments for already called guarantees and those that are expected to be called in the corresponding years which are recorded as capital transfers under ESA.

4/ Projections for 2015-18 include unspecified additional fiscal measures as agreed under the program. In 2015, unspecified measures are all included in social transfers. For 2016-2018, 70 percent are assumed on the spending side and the rest on the revenue side.

5/ The composition of net acquisition of financial assets was corrected in 2013 by increasing securities other than shares and reducing shares and other equity to reflect the holdings of ESM bonds rather than the purchase of equity in the coops which occurred in 2014. The operation is correspondingly reversed in 2014 reflecting the purchase of equity in the coops with the ESM bonds.

6/ Primary fiscal balances in 2015 and 2016 include expected dividends of €0.2 billion, to be distributed by the CBC in line with CBC's duties under the Treaties and the Statute.

Table 3. Cyprus: Balance of Payments, 2008–20 1/

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
							Projections						
	(Millions of Euros)												
Current account balance	-2,679	-1,808	-1,711	-602	-1,217	-310	-169	-134	-54	-20	-35	-45	-48
Trade balance (Goods and Services)	-1,954	-929	-1,084	-763	-546	313	418	512	632	701	757	784	815
Goods balance	-5,556	-4,291	-4,665	-4,349	-3,856	-2,941	-2,628	-2,620	-2,666	-2,768	-2,893	-3,032	-3,173
Exports	1,190	1,002	1,137	1,411	1,440	1,501	1,582	1,660	1,746	1,829	1,920	2,009	2,101
Imports	-6,746	-5,293	-5,802	-5,760	-5,296	-4,442	-4,211	-4,280	-4,412	-4,597	-4,813	-5,041	-5,274
Services Balance	3,602	3,362	3,581	3,585	3,310	3,253	3,046	3,132	3,298	3,469	3,650	3,816	3,988
Exports	6,538	5,779	6,049	6,262	6,167	5,750	5,586	5,714	5,959	6,243	6,553	6,856	7,169
Imports	-2,936	-2,417	-2,468	-2,676	-2,857	-2,497	-2,540	-2,582	-2,661	-2,773	-2,903	-3,041	-3,181
Current income, net	-662	-685	-379	357	-456	-452	-432	-493	-525	-559	-614	-645	-664
Current transfers, net	-63	-193	-116	-196	-215	-171	-155	-152	-161	-163	-178	-184	-199
Private	23	-107	-56	-101	-155	-127	-180	-176	-179	-181	-188	-196	-203
Public	-86	-86	-60	-94	-60	-44	26	24	18	18	10	12	5
Capital account, net	6	50	36	46	23	244	27	27	27	27	27	27	27
Financial account, net	2,765	1,835	1,647	781	847	-4,333	-1,791	-2,676	-356	-1	64	130	181
Direct investment	-890	2,224	65	132	1,197	169	79	699	779	537	534	741	769
Portfolio investment	-12,722	-17,039	-1,934	5,753	5,340	11,734	2,453	-831	-270	-371	291	1,845	574
Other investment	16,085	16,558	3,313	-5,146	-5,748	-16,266	-4,323	-2,545	-865	-166	-761	-2,455	-1,162
Reserves (- inflow; + outflow)	291	93	200	43	57	30	0	0	0	0	0	0	0
Program financing	...	...	...	...	0	4,838	1,933	2,783	383	-7	-56	-112	-161
European Union	...	...	...	...	0	4,585	1,600	2,450	300	0	0	0	0
IMF	...	...	...	...	0	253	333	333	83	-7	-56	-112	-161
Errors and omissions	-92	-78	31	-225	346	-439	0	0	0	0	0	0	0
	(Percent of GDP)												
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-1.1	-0.8	-0.3	-0.1	-0.2	-0.2	-0.2
Trade balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.9	2.6	3.2	3.8	4.1	4.3	4.2	4.2
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.8	-16.7	-16.4	-16.2	-16.2	-16.3	-16.4	-16.5
Exports	6.9	5.9	6.5	7.9	8.1	9.1	10.0	10.4	10.6	10.7	10.8	10.8	10.9
Imports	-39.3	-31.4	-33.3	-32.2	-29.9	-26.9	-26.7	-26.9	-26.8	-26.9	-27.1	-27.2	-27.4
Services balance	21.0	19.9	20.6	20.1	18.7	19.7	19.3	19.7	20.1	20.3	20.5	20.6	20.7
Exports	38.1	34.3	34.8	35.0	34.8	34.8	35.5	35.9	36.3	36.6	36.8	37.0	37.3
Imports	-17.1	-14.3	-14.2	-15.0	-16.1	-15.1	-16.1	-16.2	-16.2	-16.2	-16.3	-16.4	-16.5
Current income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.7	-2.7	-3.1	-3.2	-3.3	-3.5	-3.5	-3.5
Current transfers, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Private	0.1	-0.6	-0.3	-0.6	-0.9	-0.8	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Public	-0.5	-0.5	-0.3	-0.5	-0.3	-0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.4	4.8	-26.3	-11.4	-16.8	-2.2	0.0	0.4	0.7	0.9
Direct investment	-5.2	13.2	0.4	0.7	6.8	1.0	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment 2/	-74.2	-101.1	-11.1	32.2	30.1	71.1	15.6	-5.2	-1.6	-2.2	1.6	10.0	3.0
Other investment 2/	93.8	98.2	19.0	-28.8	-32.4	-98.6	-27.4	-16.0	-5.3	-1.0	-4.3	-13.3	-6.0
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	...	...	...	...	0.0	29.3	12.3	17.5	2.3	0.0	-0.3	-0.6	-0.8
European Union	...	...	...	...	0.0	27.8	10.2	15.4	1.8	0.0	0.0	0.0	0.0
IMF	...	0.0	0.0	0.0	0.0	1.5	2.1	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	2.0	-2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Balance of Payments historical data and projections exclude data related to the operations by entities without a physical presence in Cyprus as data coverage on these entities is still incomplete and subject to substantial revisions. This is also consistent with the treatment of these entities in the National Accounts.

2/ 2008-09 data reflect transactions between Greek banks and their subsidiaries in Cyprus.

Table 4. Cyprus: Monetary Survey, 2008–20
(Billions of euros, unless otherwise indicated, end of period)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections												
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)													
Assets	118.1	139.4	135.0	131.4	128.1	90.3	91.0	89.6	88.9	87.9	88.6	89.7	91.0
Claims on Central Bank of Cyprus	1.3	3.1	2.3	2.9	3.9	2.7	2.6	2.6	2.6	2.6	2.7	2.7	2.8
Claims on Cypriot resident other MFIs	3.3	5.4	5.6	5.0	4.6	3.3	4.4	4.5	4.6	4.8	5.0	5.2	5.4
Claims on Cypriot resident non MFIs	47.2	50.3	54.0	58.2	60.6	55.0	52.9	52.3	51.3	49.6	49.3	49.4	49.7
General government	3.7	4.6	4.5	5.3	6.5	5.4	4.9	5.4	5.4	4.1	4.1	4.1	4.1
Private sector excluding brass plates 1/	39.4	42.7	46.5	48.6	49.3	46.5	45.1	43.9	43.0	42.5	42.2	42.3	42.6
Households	19.1	20.6	22.5	23.5	23.9	22.3	21.8	21.4	21.0	20.6	20.4	20.4	20.5
Non-financial corporations	19.7	21.5	23.3	24.1	24.4	23.4	22.6	21.8	21.3	21.1	21.0	21.1	21.3
Non-bank financial intermediaries	0.6	0.6	0.7	1.0	1.0	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Brass plates 2/	4.1	3.0	3.0	4.4	4.8	3.1	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Claims on non-residents	63.4	76.9	69.3	61.3	55.9	25.3	26.1	25.9	26.2	26.8	27.5	28.2	28.9
Other assets	2.9	3.8	3.8	3.9	3.2	3.9	5.0	4.4	4.2	4.2	4.2	4.2	4.2
Liabilities	118.1	139.4	135.0	131.6	128.1	90.3	91.0	89.6	88.9	87.9	88.6	89.7	91.0
Liabilities to the Central Bank of Cyprus and Eurosystem	4.7	7.6	5.5	5.5	9.8	11.2	8.2	7.8	7.0	5.0	4.5	4.2	4.0
Liabilities to Cypriot resident other MFI	3.3	5.3	5.5	4.9	4.5	3.1	3.5	3.5	3.7	3.8	4.0	4.1	4.3
Deposits of Cypriot resident non MFIs	39.5	41.0	45.4	43.7	43.3	33.0	31.5	31.1	31.1	31.6	32.3	33.2	34.1
General government	0.3	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Private sector excluding brass plates	33.4	34.5	36.8	37.4	37.5	29.9	28.6	28.2	28.2	28.7	29.4	30.3	31.2
Households	23.4	24.6	25.4	26.0	26.4	23.3	22.3	22.0	22.0	22.4	22.9	23.6	24.3
Non-financial corporations	6.3	6.1	6.7	6.7	5.7	3.9	3.7	3.7	3.7	3.8	3.9	4.0	4.1
Non-bank financial intermediaries	3.6	3.9	4.7	4.6	5.4	2.7	2.6	2.6	2.6	2.6	2.7	2.8	2.9
Brass plates	5.7	6.1	8.1	5.8	5.3	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Deposits of non-residents	51.7	66.6	60.6	56.5	51.3	24.5	22.6	22.0	22.0	22.3	22.7	23.0	23.3
Debt securities	5.6	4.8	2.4	2.6	1.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital and reserves	10.0	10.8	12.8	11.3	15.1	16.4	23.0	23.0	23.0	23.0	23.0	23.0	23.0
Other liabilities	3.4	3.3	2.8	7.1	2.4	1.6	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Money and Credit													
General government sector credit, net	4.5	5.3	5.2	5.3	7.2	5.5	4.4	5.0	5.0	3.7	3.7	3.7	3.7
Private sector credit excluding brass plates	39.5	42.7	46.5	48.6	49.3	46.5	45.1	43.9	43.0	42.5	42.2	42.3	42.6
Brass plates credit	4.1	3.0	3.0	4.4	4.8	3.1	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Cypriot resident broad money (M2)	40.6	42.2	46.6	45.0	44.6	34.5	32.9	32.6	32.7	33.2	34.0	34.9	35.9
Cypriot resident narrow money (M1)	9.1	10.4	10.6	11.1	11.5	10.4	10.2	10.2	10.5	10.9	11.3	11.7	12.1
(Percent of GDP)													
General government sector credit, net	26.4	31.6	30.1	29.4	40.4	33.5	28.2	31.2	30.3	21.8	20.7	19.9	19.1
Private sector credit excluding brass plates	230.0	253.6	267.2	272.1	278.1	281.9	286.4	275.8	261.5	248.7	237.1	228.2	221.3
Brass plates credit	23.9	17.5	17.4	24.3	27.0	18.6	18.6	18.5	18.0	17.4	16.8	16.3	15.8
Cypriot resident broad money (M2)	236.7	250.2	267.4	251.7	251.9	208.9	208.8	204.7	198.8	194.6	191.0	188.7	186.5
Cypriot resident narrow money (M1)	53.0	61.8	61.2	62.2	64.8	63.0	64.9	63.9	63.6	63.7	63.3	63.1	62.8
(Annual percentage change)													
General government sector credit, net	...	17.4	-1.6	0.4	36.2	-22.9	-19.5	11.8	0.3	-25.5	-0.8	-0.3	0.1
Private sector credit excluding brass plates	...	8.3	8.8	4.6	1.3	-5.6	-3.0	-2.6	-2.2	-1.2	-0.7	0.2	0.7
Brass plates credit	...	-28.1	2.3	44.0	9.9	-35.7	-4.5	0.2	0.5	0.6	0.7	0.7	0.6
Cypriot resident broad money (M2)	...	3.9	10.4	-3.4	-0.8	-22.8	-4.6	-0.8	0.1	1.7	2.3	2.9	2.7
Cypriot resident narrow money (M1)	...	14.5	2.3	4.4	3.2	-9.4	-1.7	-0.3	2.6	4.1	3.5	3.7	3.5
Memorandum items:													
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	...	3.4	6.5	1.7	0.3	-20.2	-4.5	-1.3	-0.1	1.7	2.4	3.1	2.9
Brass plates deposits (y-o-y percent change)	...	6.2	33.8	-28.3	-9.4	-50.4	-4.5	0.1	0.3	0.3	0.3	0.3	0.3

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

1/ Includes public entities classified outside the general government. The data excludes brass plates, which are companies with a physical presence in Cyprus and, therefore, treated as residents but with limited interaction with the domestic economy.

2/ Data on brass plates only became available from July 2008 onwards.

Table 5. Cyprus: Financial Soundness Indicators, 2010–14 1/
(Percent, unless otherwise specified)

	2010	2011	2012	2013	2014
Capital Adequacy					
Total risk asset ratio	11.9	7.2	6.1	11.7	11.8
Tier I risk asset ratio	10.5	6.0	5.3	11.3	11.5
Core Tier I risk asset ratio	8.1	3.2	3.4	10.6	11.1
Risk weighted assets (billions of euro)	69.2	67.8	62.4	36.9	37.8
Asset Quality					
Non-performing loans to total gross loans 2/	12.4	16.2	25.5	46.2	51.1
Provisions to nonperforming loans	61.2	49.4	47.9	31.0	34.4
Earnings and Profitability					
Return on assets	0.4	-4.4	-4.8	-1.7	0.2
Return on equity	7.5	-75.0	-113.1	-24.9	2.9
Cost to income ratio	53.7	48.9	58.8	...	34.4
Net interest margin	1.9	2.4	2.4	2.9	3.5
Liquidity					
Liquid assets to total assets	10.0	9.4	8.6	6.8	7.6
Customer deposits to total (non-interbank) loans	113.8	101.1	96.8	73.9	74.4
Market Indicators (end period)					
Cyprus Stock Exchange (CSE) General Index (Mar 2004=1000)	1055.2	295.9	114.9	103.3	118.4
Market capitalization (CSE) (percent of GDP)	29.2	24.4	9.9	8.7	10.8

Sources: CBC; and IMF staff calculations.

1/ These FSIs cover consolidated accounts of domestic and foreign banks operating in Cyprus. For 2014 data are as of March.

2/ NPLs are defined as loans in arrears for more than 90 days and restructured loans which at the time of restructuring presented arrears for a period of more than 60 days, regardless of tangible or other collateral.

Annex 1. Cyprus: Risk Assessment Matrix¹

Risk	Relative Likelihood and Transmission Channels	Expected Impact of Risk	Policy Response
1. Protracted period of slower growth in advanced economies	High	High	
	Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation.	Significant trade linkages with the EU would weaken growth in Cyprus through lower exports and tourism and adverse confidence effects. Stagnation and low inflation could complicate public debt sustainability and private sector deleveraging and negatively impact banks' balance sheets	Additional fiscal adjustment needed to attain medium-term primary fiscal surplus targets and ensure debt sustainability needs to be carefully balance to avoid a large and negative impulse in the short run.
2. Regional geopolitical risks from increasing tensions surrounding Russia/Ukraine and the Middle East	Medium	High	
	A sharp increase in geopolitical tensions surrounding Russia/Ukraine that creates significant disruptions in global financial, trade and commodity markets. A sharp rise in oil prices, with negative spillovers to the global economy due to tensions in the Middle East.	An escalation of sanctions could reduce growth in Cyprus given strong real and financial links with Russia. High oil prices would spillover into reduced growth in Cyprus and increased external financing needs for energy-related imports.	Fiscal automatic stabilizers should be allowed to operate in the short run. Efforts to advance structural reforms to promote growth should be intensified.
3. Sovereign stress re-emerges due to prolonged delay in program implementation and unanticipated outcomes from the comprehensive bank assessment	High	High	
	Bank-sovereign-real economy links could re-intensify because of stalled or incomplete delivery of policy commitments at the national or euro-area level.	Financial sector stability, growth prospects, and debt sustainability would be severely affected. Pressure on banks in the euro area could extend to Cypriot banks and reignite deposit outflows. Cyprus's recently restored access to the capital markets could be lost again.	Efforts need to be intensified to put the program back on track. Banks should build capital buffers. The banking union should be strengthened and completed.
4. Financial sector stress could reemerge due to insufficient progress in addressing NPLs or to a too rapid relaxation of external payment restrictions	High	High	
	A sovereign-bank negative feedback loop could be reignited due to concerns about bank viability given high NPLs. A rapid relaxation of external payment restrictions could exhaust liquidity buffers.	Deposit outflows could re-intensify. Financial sector stability could be affected, with strong repercussions on economic activity and debt sustainability.	The strategy supported by the EFF would need to be adjusted. Additional financing measures may be required.
5. Weak recovery of domestic demand and inability to reduce public and private sector debt	Medium	High	
	Debt overhang could imply low private consumption and investment for an extended period.	Lower growth and increased opposition to further austerity would prolong Cyprus's high debt problem and would hurt balance sheets.	Intensify efforts to reduce NPLs and promote private sector debt-restructuring. Implement medium-term fiscal consolidation

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

Annex 2. Public Sector Debt Sustainability Analysis

This annex presents an analysis of Cyprus's public debt sustainability. The overall assessment is that full implementation of the program can maintain Cyprus's debt on a sustainable trajectory. However, high debt levels, downside risks to growth, and large contingent and implicit liabilities make the debt trajectory vulnerable to shocks. In particular, a growth shock, combined with higher interest rates and a worse primary balance, or a deeper recession combined with a materialization of contingent liabilities could push debt to very high levels. Under such scenarios, additional financing measures and commitments from European partners would be needed to protect debt sustainability.

Cyprus's public debt is projected to peak at 126 percent of GDP in 2015 before gradually declining toward 100 percent of GDP by 2020. The rise in debt in 2014–15 (from 111 percent of GDP in 2013) reflects the prevalence of primary fiscal deficits combined with a continued recession in 2014 and only a slight recovery in 2015. In 2014, these effects are offset by the expected conclusion of a €1 billion (6 percent of GDP) swap of debt held by the CBC for government-owned land. The medium term decline is predicated on the assumption of continued fiscal consolidation as envisaged under the program and a gradual pick-up of economic activity. With respect to the fourth review projections, the baseline debt projections were revised up for 2014 and down for 2015 to reflect a re-phasing of ESM disbursements. The path from 2016 onwards has been slightly revised up, as the downward revision of nominal GDP more than offsets the interest savings resulting from the partial repayment of the Laiki recapitalization bond with the proceeds from the new bond issuance.

Debt projections are highly vulnerable to shocks (Figure A1.1). The baseline debt level is high and exceeds the benchmark above which the risk of debt distress is assessed to increase (85 percent of GDP). Under most adverse and combined shocks—including to growth, inflation, and the primary balance—debt could reach between 130 and 160 percent of GDP by 2020.¹ Moreover, several indicators such as spreads and external financing needs continue to point to a high-risk classification for Cyprus. The recent debt management operation has helped smooth the debt maturity profile immediately following the program period and lowered risks associated with shocks to the primary balance, real interest rate, and real exchange rate. Gross financing needs risk indicators remain vulnerable to growth and contingent liability shocks.

While forecasting performance has been mixed—given the materialization of unforeseen tail risks—the current macroeconomic baseline remains conservative relative to macroeconomic outturns to date (Figure A1.2). Growth, deflator, and primary balance projection errors appear optimistic relative to other program countries, especially as 2012 and 2013 growth deviations were significantly outside the inter-quartile range. However, these reflected the effects of the power plant accident in 2011 and the materialization of tail risk of an unprecedented banking sector crisis in 2013—exacerbated by the Greek PSI—which could not have been foreseen in the years preceding

¹ The parameters of the asymmetric distribution were calibrated to capture the predominance of downside risks in the medium term on growth and the primary balance due to a prolonged deleveraging and fiscal adjustment fatigue. Consistent with this, upside growth shocks were limited to 1 percentage point and upside primary balance shocks to 2 percentage points.

the events. Since the onset of the program, growth and fiscal projections have been consistently more conservative than the outturns. For example, growth in 2013 was 3.3 percentage points better than projected at the time of the program request (-5.4 compared to -8.7 percent), and the 2013 primary balance was 0.5 percentage points better than projected (-1.9 compared to -2.4 percent of GDP). Medium-term projections—which were revised down during the fourth review—remain conservative relative to other countries that suffered from banking crises and subsequent credit-less recoveries.² Nevertheless, as noted in the text, downside medium-term risks remain.

Standard indicators suggest that the projected fiscal adjustment is ambitious, although Cyprus’s strong fiscal track record thus far provides some comfort (Figure A1.2 continued). The level of cyclically-adjusted primary balance is considered borderline realistic, and the three-year adjustment is seen as ambitious. However, such large primary balance adjustments are not without precedent. Moreover, the authorities’ disciplined implementation of adjustment measures in 2013–14 and additional discretionary tightening led to consistent over-performance of program targets. Finally, these indicators should be interpreted with caution, given the unusually high uncertainty surrounding the estimation of the output gap and cyclically-adjusted fiscal balances in the current recession.

Debt structure indicators point to vulnerabilities, but there are mitigating factors. The large external gross financing needs reflect mainly the need to repay maturing short-term debt and the large amount of uninsured foreign deposits. External payment restrictions mitigate the risks of abrupt outflows. The relatively low and fixed interest rate of official liabilities combined with their long term maturity mitigates interest rate and financing risks. Finally, while bond yields and spreads remain higher than in other countries, they have significantly declined since last year. Specifically, five-year bond yields are at around 5 percent in the secondary markets, compared to yields above 10 percent in 2013.

Public sector debt remains vulnerable to adverse macro-fiscal shocks (Figure A1.5, top, and Figure A1.5 continued). The main risks analyzed include:

- **Growth risk.** Assuming a decline in growth by two historical standard deviations (i.e. about 7 percentage points) for 2015 and 2016, a corresponding deterioration in non-interest revenue of 0.4 percent per percentage point of growth reduction, recovering to baseline levels in two years thereafter, and a decline of 0.25 percentage points per point of growth of the deflator, the debt ratio would increase to 167 percent of GDP by 2016 and 152 percent by 2020.
- **Primary balance risk.** A shock reducing the planned fiscal adjustment in 2015–18 by 50 percent, capturing the risk of reform fatigue, would increase the debt ratio to 126 percent of GDP in 2016 and to 111 percent of GDP by 2020.
- **Interest rate risk.** While the growing share of official financing in the coming years considerably reduces interest rate risks, ESM financing and new market financing after the program are still a

² See Box 1 of Country Report No 13/374.

function of market conditions. A shock increasing the real interest rate by 3 percentage points each year during 2015–20 would lead debt to reach 124 percent of GDP in 2016 and 110 percent of GDP in 2020.

- **Combination of macro-fiscal risks.** A combination of the growth, interest rate, and primary balance shocks above would lead to a debt ratio of 167 percent of GDP in 2016 and 157 percent of GDP in 2020.
- **Deflation** (Figure A1.5, continued): Deflator growth could be lower than envisaged in the baseline if downward wage pressures pass through to prices faster than anticipated. In this case, debt would increase to 127 percent of GDP in 2016 and 113 percent of GDP in 2020.
- **More protracted recession** (Figure A1.5, continued). A slower and prolonged deleveraging could lead to a more protracted recession. In combination with a lower deflator (0.25 pt per point of growth), this would lead debt to rise to 134 percent of GDP in 2016 and to 125 percent of GDP by 2020.
- **Risks related to the asset swap and privatization proceeds** (not shown). If the debt swap (envisaged in 2014) were not carried out, debt in 2020 would increase by about 6 percentage points of GDP. If the envisaged privatization starting in 2015 were not implemented, this would increase debt by about 8 percentage points of GDP in 2020.

Contingent liabilities also pose risks to debt sustainability (Figure A1.5, bottom). Additional bank needs, to the extent that they remain within the program buffer (€2 billion, or 13 percent of GDP), would not have an impact on debt sustainability. However, should bank needs exceed the buffer, by say, 10 percent of GDP, and be combined with a deeper recession (by 5 percentage points), this would increase debt to 147 percent of GDP in 2016 and to 137 percent of GDP by 2020. A full materialization of government guarantees (i.e. all €3 billion government guarantees are called) would bring debt to 129 percent of GDP in 2016 and to 112 percent in 2020.

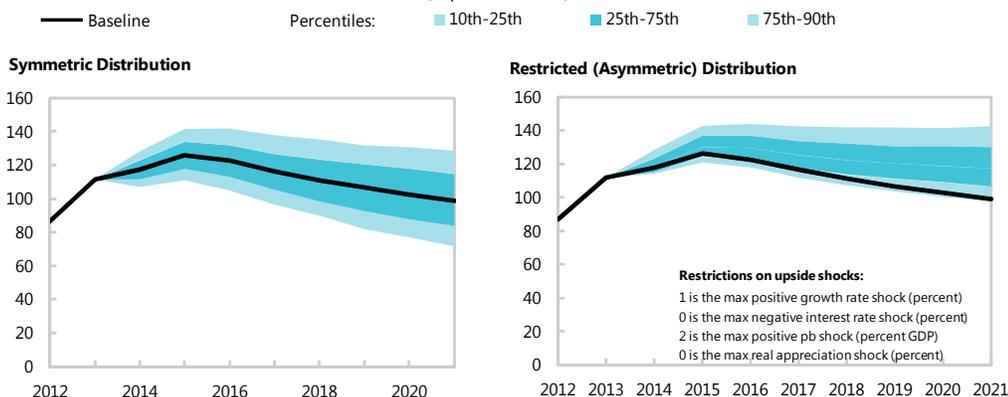
Figure A2.1 Cyprus: Public Debt Sustainability Analysis - Risk Assessment

Heat Map

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

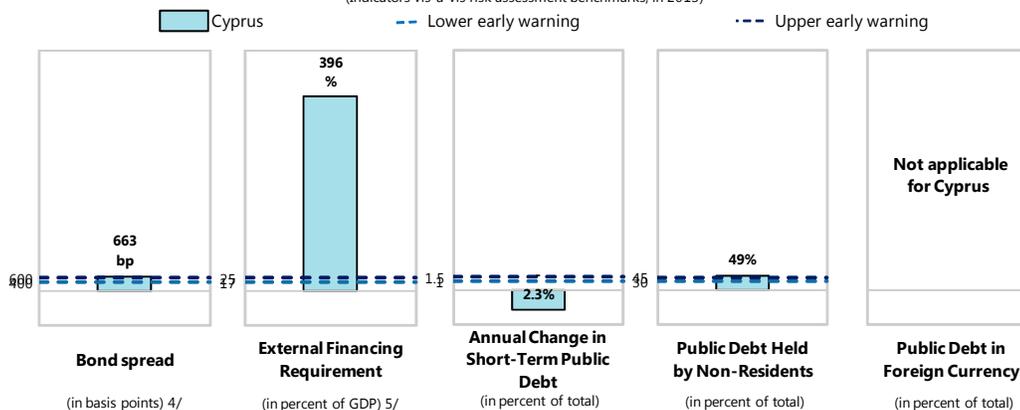
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. The baseline debt path and the analysis based on it assume the full utilization of program buffers.

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

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

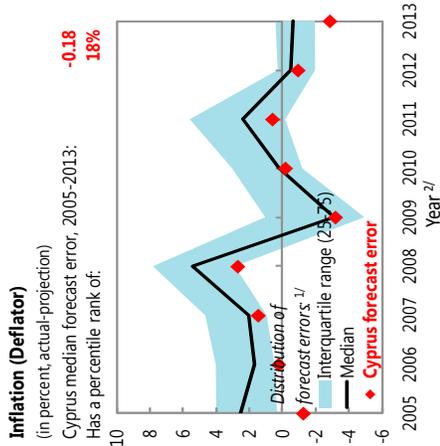
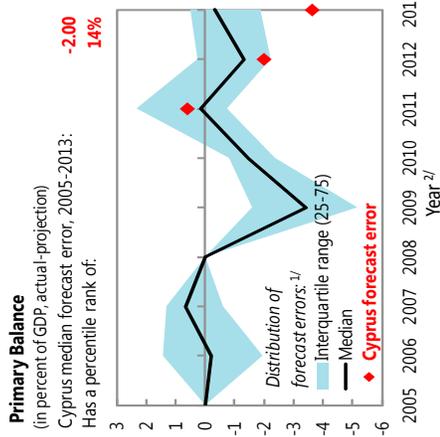
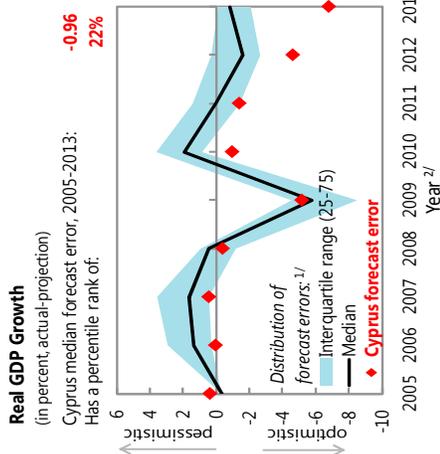
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 13-Jun-14 through 11-Sep-14.

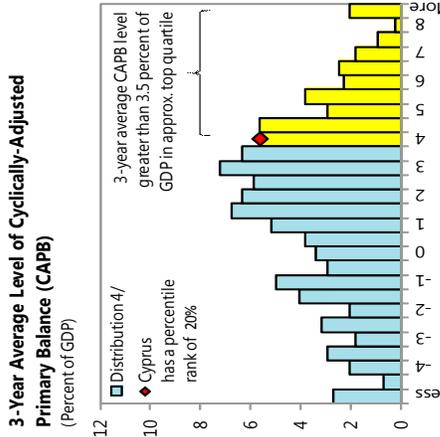
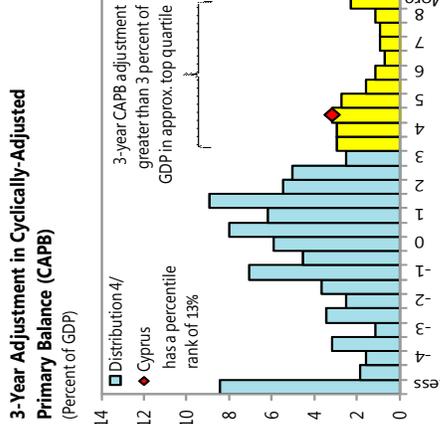
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A2.2. Cyprus: Public Debt Sustainability Analysis - Realism of Baseline Assumptions

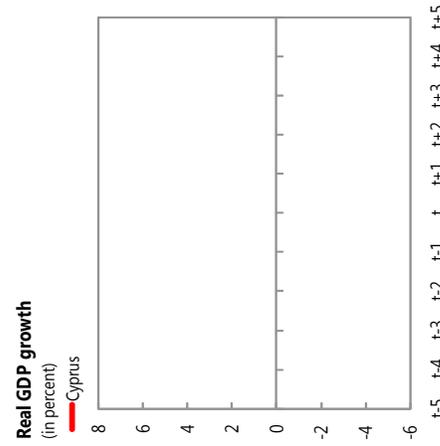
Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment



Boom-Bust Analysis^{3/}



Source : IMF Staff.

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

2/ Projections made in the spring WEO vintage of the preceding year. The 2012 spring WEO forecast did not factor in extreme tail risks which materialized in March 2013.

3/ Not applicable for Cyprus.

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

Figure A2.3 Cyprus: Public Debt Sustainability Analysis - Baseline Scenario

(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators^{1/}

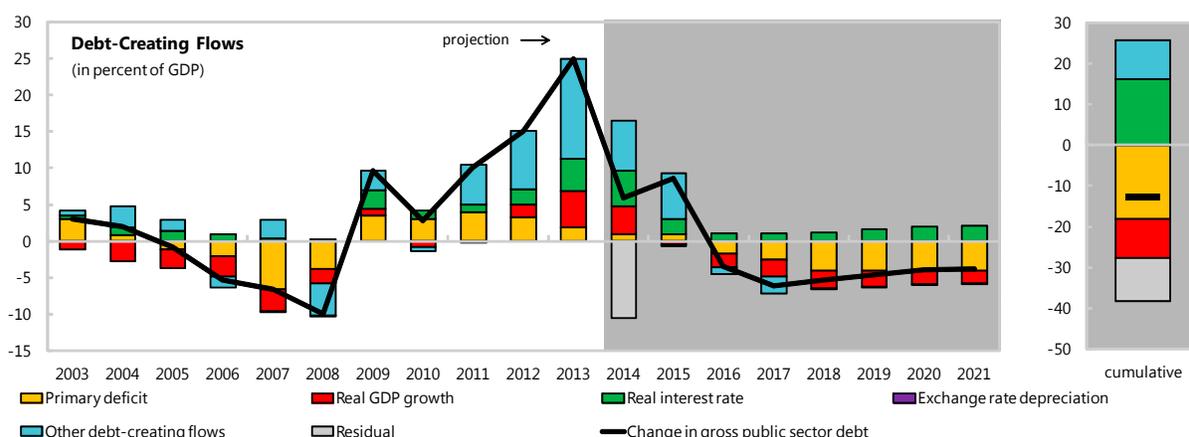
	Actual			Projections							
	2003-2011 ^{2/}	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	64.0	86.6	111.5	117.4	126.0	122.5	116.4	111.1	106.5	102.6	98.9
Public gross financing needs	14.0	18.9	19.2	16.4	16.2	9.8	14.4	8.0	16.2	14.5	8.9
Real GDP growth (in percent)	2.5	-2.4	-5.4	-3.2	0.4	1.6	2.0	2.2	2.1	1.8	1.8
Inflation (GDP deflator, in percent)	3.1	1.6	-1.5	-1.3	0.7	1.5	1.8	1.9	2.0	2.0	1.9
Nominal GDP growth (in percent)	5.7	-0.9	-6.9	-4.5	1.1	3.1	3.9	4.2	4.1	3.9	3.8
Effective interest rate (in percent) ^{4/}	5.0	4.4	3.3	2.9	2.5	2.4	2.8	3.1	3.6	4.0	4.0

As of September 11, 2014

Sovereign Spreads		
EMBIG (bp) 3/		378
5Y CDS (bp)		367
Ratings		
	Foreign	Local
Moody's	Caa3	Caa3
S&P's	B	B
Fitch	B-	B-

Contribution to Changes in Public Debt

	Actual			Projections								cumulative	debt-stabilizing primary balance ^{9/}
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021		
Change in gross public sector debt	0.5	15.1	24.9	5.9	8.6	-3.5	-6.1	-5.3	-4.6	-3.9	-3.8	-5.0	
Identified debt-creating flows	0.5	15.1	24.9	16.4	8.8	-3.5	-6.1	-5.3	-4.6	-3.9	-3.8	5.8	
Primary deficit	0.1	3.2	1.9	1.0	1.0	-1.7	-2.5	-4.0	-4.0	-4.0	-4.0	-10.3	0.2
Primary (noninterest) revenue and grants	41.0	39.4	41.5	42.3	41.8	42.1	41.5	41.7	41.9	41.9	41.9	251.3	
Primary (noninterest) expenditure	41.1	42.6	43.4	43.3	42.8	40.4	39.0	37.7	37.9	37.9	37.9	241.0	
Automatic debt dynamics ^{5/}	-0.5	3.8	9.4	8.7	1.6	-0.8	-1.3	-1.2	-0.6	0.1	0.3	6.4	
Interest rate/growth differential ^{6/}	-0.5	3.8	9.4	8.7	1.6	-0.8	-1.3	-1.2	-0.6	0.1	0.3	6.4	
Of which: real interest rate	1.0	2.1	4.4	4.9	2.1	1.1	1.1	1.2	1.7	2.0	2.1	12.1	
Of which: real GDP growth	-1.6	1.7	5.0	3.8	-0.5	-1.9	-2.4	-2.4	-2.3	-1.9	-1.8	-5.7	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...	...	...
Other identified debt-creating flows	1.0	8.1	13.6	6.8	6.2	-0.9	-2.3	0.0	0.0	0.0	-0.1	9.7	
Net privatization/asset sales proceeds	0.0	0.0	0.0	-0.6	-3.1	-3.0	-2.3	0.0	0.0	0.0	0.0	-9.2	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro)	1.0	8.1	13.6	7.4	9.3	2.1	0.0	0.0	0.0	0.0	-0.1	18.8	
Residual, including asset changes ^{8/}	0.0	0.0	0.0	-10.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	-10.8	



Source: IMF staff estimates.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)]$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

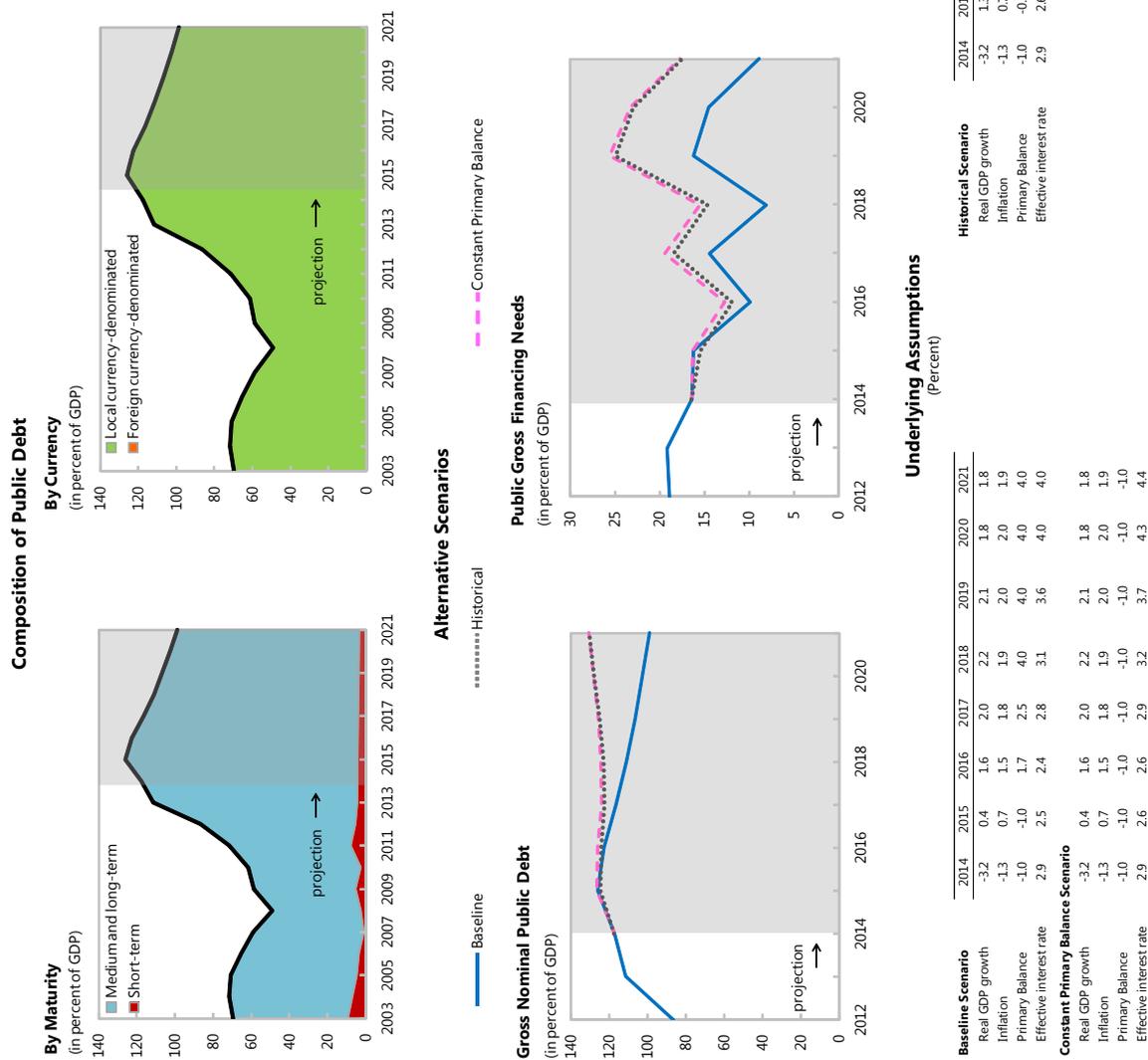
6/ The real interest rate contribution is derived from the denominator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ For projections, includes exchange rate changes during the projection period. In 2014, the residual reflects the Euro 1 billion asset swap and the pre-payment of a bond maturing in 2017.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A2.4 Cyprus: Public Debt Sustainability Analysis - Composition of Public Debt and Alternative Scenarios 1/



Source: IMF staff estimates.
1/ Inflation in the tables refer to GDP deflator growth.

Figure A2.5 Cyprus: Public Debt Sustainability Analysis - Stress Tests 1/

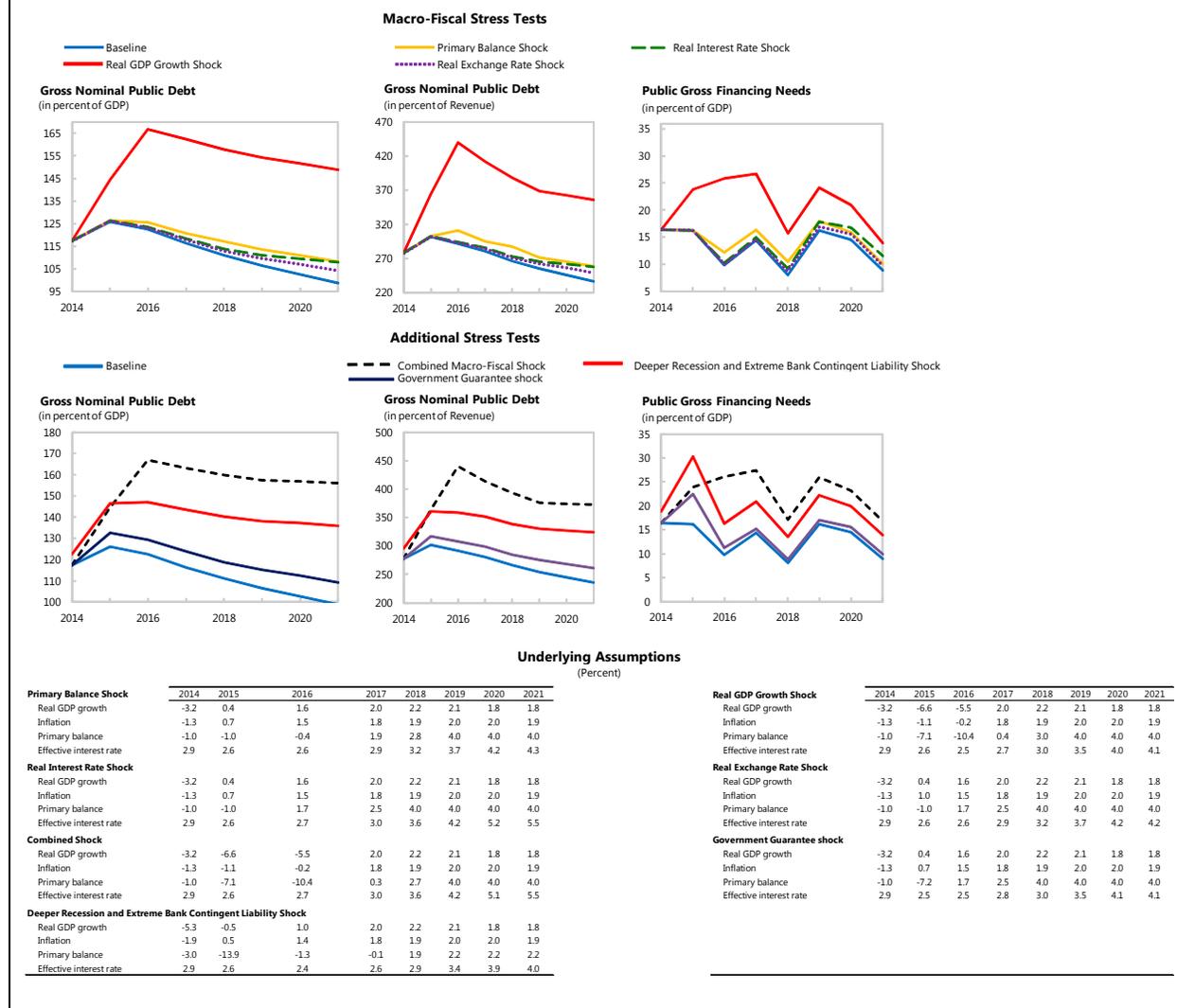
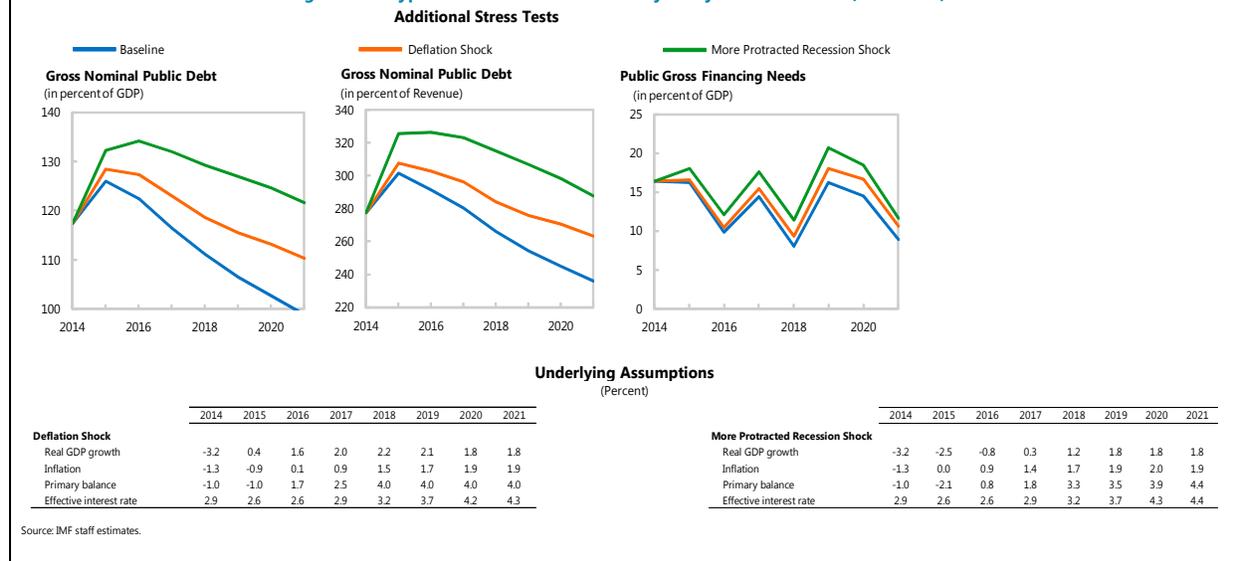


Figure A2.5 Cyprus: Public Debt Sustainability Analysis - Stress Tests (concluded)



Annex 3. External Debt Sustainability and Real Exchange Rate Assessment

External sector debt fell substantially in 2013 (Table A3.1). Total external debt fell from 448 percent of GDP in 2012 to 348 percent of GDP in 2013 mainly due to a halving of banking sector liabilities (mostly deposits). At end-2013, the financial sector represented close to 45 percent of external debt, while the share of general government debt doubled from 9 to 18 percent due to official financing from the ESM and IMF.

A gradual decline in external debt is expected over the medium term. Projected current account surpluses over the medium term coupled with a pick-up in GDP growth is expected to result in a decline in external debt to 287 percent of GDP in 2021. Stabilization in the banking sector and a gradual fiscal adjustment are also expected to contribute to a substantial decline in gross financing needs relative to the pre-crisis period. Compared with the previous medium-term projection, external debt is expected to be lower by close to 10 percent of GDP reflecting a lower initial level of debt in 2014.

The baseline scenario is vulnerable to shocks. The external debt trajectory is most vulnerable under the historical scenario which assumes that key macroeconomic variables, including GDP growth, interest rates and the current account, revert to levels over the previous five years. Since this includes the severe shock from 2013, this scenario is unlikely. Alternative scenarios of shocks to growth and interest rates would substantially slow the pace of debt reduction in the medium term.

Restoring external stability requires placing the financial sector on a firmer footing and lowering public debt. Despite the sale of banks' Greek operations in 2013—which reduced both liabilities and assets abroad—the IIP remained large and negative, at -86 percent of GDP at end-2013. Reducing it to its 2010 level (-35 percent of GDP) requires running current account surpluses on the order of 5 percent for a prolonged period (10 years). An adjustment of this scale is not expected to be achieved solely through the real exchange rate. However, further depreciation of the exchange rate beyond what standard models imply (see below) will likely be needed to help improve the IIP. More importantly, given the large share of banking and public sector liabilities in the IIP, measures are needed to rebuild confidence in the financial sector, gradually remove external payment restrictions and reduce reliance on foreign deposits, and achieve and sustain primary fiscal surpluses to put public sector debt on a sustained downward path.

Although the current account has adjusted, further moderate depreciation in the real effective exchange rate (REER) is projected over the medium term. The collapse in domestic demand following the crisis led the trade balance to a surplus in 2013 for the first time since 2001, mainly due to a sharp compression of imports. Due to wage adjustment, economy-wide unit labor costs have fallen by 12 percent in the first quarter of 2014 relative to their peak in 2011. And falling prices relative to trading partners resulted in a depreciation of the REER by about 10 percent since its peak in 2009 (CPI-based). Still, at end-2013, it remained 3 percentage points higher than its long-run historical average (1980–2008), suggesting that a further moderate adjustment can be expected over the medium term. Such adjustment—namely a cumulative inflation differential of about 4

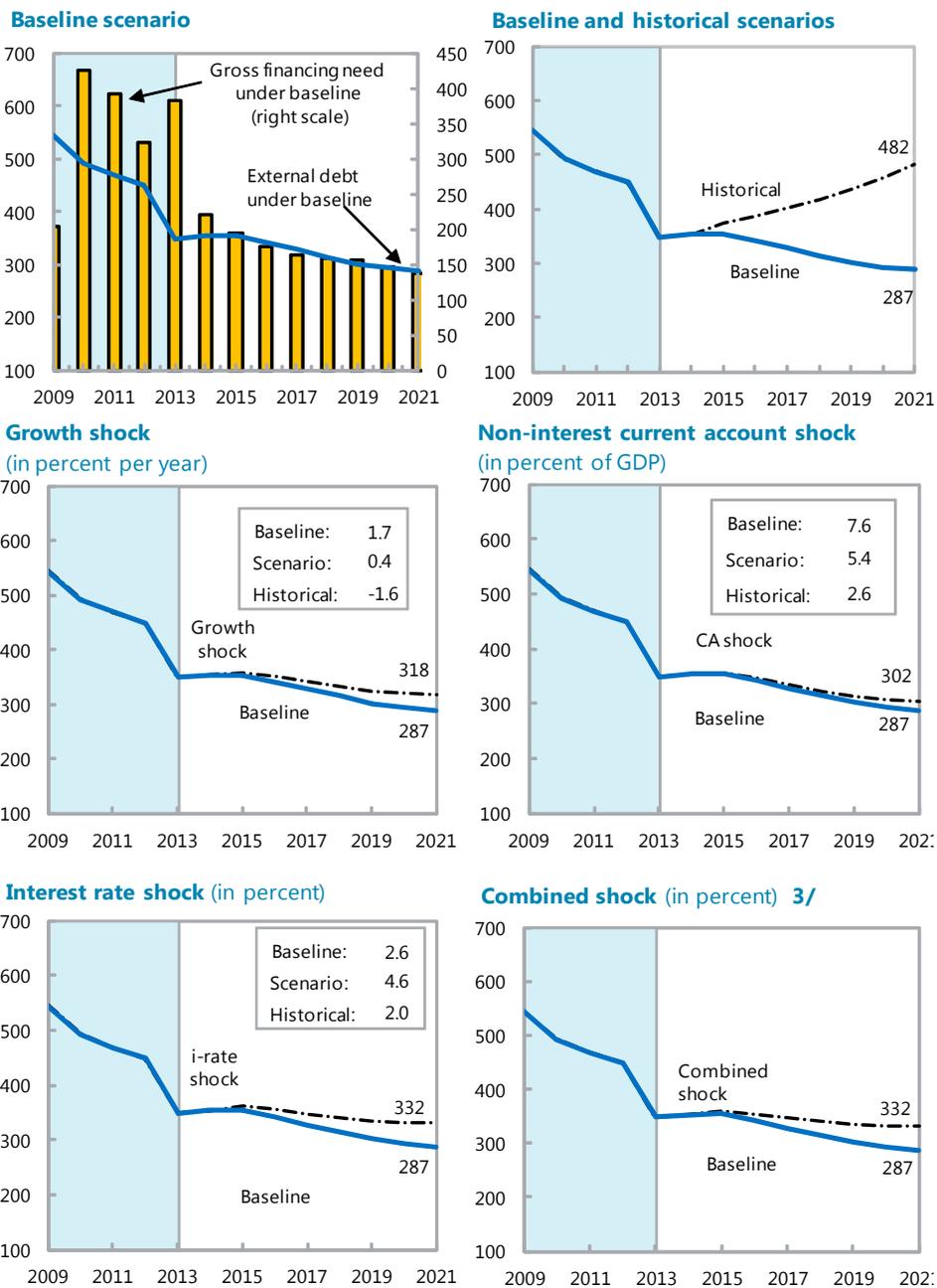
percentage points relative to trading partners during 2014–20—is incorporated into the baseline projections.

Standard CGER-type methodologies for assessing the equilibrium exchange rate suggest that REER would be broadly in line with fundamentals in the medium-to long-term. Taking into account the adjustment incorporated in the baseline projections, the REER method points to an overvaluation of up to 7.9 percent over the medium term. The macro-balance approach, on the other hand, suggests a small undervaluation of 0.7 percent. This is underpinned by an estimated current account norm of -3.8 percent of GDP, reflecting the large net foreign asset position and negative oil trade balance, compared with the projected underlying value of -0.2 percent of GDP over the medium run. Similarly, the external sustainability approach suggests a small undervaluation of 0.5 percent, given that the current account deficit required to maintain the IIP at the 2010 level (2.7 percent of GDP) is higher than the long-term projected deficit under the macroeconomic baseline.

	Current account (Percent of GDP)	Estimated over/ undervaluation
Macro-balance approach	-3.80%	-0.70%
REER approach	--	7.90%
External sustainability approach (Stabilizing IIP at -35% of GDP, 2010 level)	-2.70%	-0.50%

Source: IMF CGER Toolkit.

Figure A3.1 Cyprus: External Debt Sustainability- Bound Tests 1/ 2/
(Percent of GDP)



Sources: Ministry of Finance; CBC; and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Table A3.1. Cyprus: External Debt Sustainability Framework, 2009-2021
(Percent of GDP, unless otherwise indicated)

	Actual							Projections							Debt-stabilizing non-interest current account 6/
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021		
Baseline: External debt	544.1	491.9	468.2	448.5	348.0	353.2	353.6	340.9	327.8	314.2	301.0	293.1	287.5	-7.1	
Change in external debt	223.9	-52.2	-23.6	-19.8	-100.5	5.2	0.4	-12.7	-13.2	-13.6	-13.2	-8.0	-5.6		
Identified external debt-creating flows (4+8+9)	2.1	24.3	7.0	-23.7	59.1	8.8	-4.0	-9.4	-9.1	-10.0	-12.1	-9.7	-9.3		
Current account deficit, excluding interest payments	2.5	1.4	-5.8	-3.4	-7.8	-7.0	-7.2	-7.8	-7.9	-7.8	-7.6	-7.6	-7.6		
Deficit in balance of goods and services	5.5	6.2	4.3	3.1	-1.9	-2.6	-3.2	-3.8	-4.1	-4.3	-4.2	-4.2	-4.2		
Exports	40.2	41.3	42.9	42.9	43.9	45.5	46.3	46.9	47.3	47.6	47.9	48.2	48.6		
Imports	45.7	47.5	47.2	46.0	42.0	42.8	43.1	43.0	43.2	43.4	43.6	44.0	44.3		
Net non-debt creating capital inflows (negative)	7.0	1.8	-7.2	-12.8	-15.2	-3.6	-3.3	-4.4	-2.7	-3.3	-6.0	-4.6	-4.4		
Automatic debt dynamics 1/	-7.4	21.1	20.0	-7.5	82.1	19.4	6.6	2.8	1.6	1.2	1.5	2.5	2.7		
Contribution from nominal interest rate	8.2	8.5	9.2	10.3	9.7	8.0	8.0	8.1	8.1	8.0	7.8	7.8	7.9		
Contribution from real GDP growth	5.7	-7.3	-2.2	10.9	28.2	11.4	-1.5	-5.3	-6.5	-6.8	-6.3	-5.3	-5.2		
Contribution from price and exchange rate changes 2/	-21.3	19.9	13.0	-28.6	44.3	...	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	221.7	-76.5	-30.6	3.9	-159.5	-3.6	4.3	-3.3	-4.1	-3.6	-1.1	1.7	3.7		
External debt-to-exports ratio (in percent)	1352.4	1191.4	1091.1	1044.8	792.1	776.5	764.2	727.2	693.2	659.5	628.8	608.2	592.0		
Gross external financing need (in billions of US dollars) 4/	50.9	103.0	93.2	79.9	81.1	46.3	41.6	39.6	38.5	39.4	40.5	40.1	38.8		
in percent of GDP	205.0	424.8	392.8	324.1	382.3	5-Year	5-Year	5-Year	5-Year	5-Year	5-Year	5-Year	5-Year		
Scenario with key variables at their historical averages 5/						353.2	372.9	387.4	401.7	417.2	436.9	457.5	482.0	13.9	
Key Macroeconomic Assumptions Underlying Baseline															
Real GDP growth (in percent)	-1.9	1.3	0.4	-2.4	-5.4	-1.6	2.6	1.6	2.0	2.2	2.1	1.8	1.8		
GDP deflator in US dollars (change in percent)	7.1	-3.5	-2.6	6.5	-9.0	-0.3	6.9	1.7	2.5	2.9	3.0	2.0	1.9		
Nominal external interest rate (in percent)	2.7	1.5	1.8	2.3	1.9	2.0	0.5	2.3	2.3	2.4	2.5	2.6	2.7		
Growth of exports (US dollar terms, in percent)	-6.1	0.3	1.7	4.0	-11.9	-2.4	6.5	1.9	4.7	5.9	6.0	5.7	4.6		
Growth of imports (US dollar terms, in percent)	-14.8	1.5	-2.8	1.3	-21.3	-7.2	10.3	0.3	3.4	4.5	5.4	5.8	4.6		
Current account balance, excluding interest payments	-2.5	-1.4	5.8	3.4	7.8	2.6	4.5	7.0	7.2	7.8	7.9	7.6	7.6		
Net non-debt creating capital inflows	-7.0	-1.8	7.2	12.8	15.2	5.3	9.5	3.6	3.3	4.4	2.7	3.3	4.4		

Source: IMF staff estimates.

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

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

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

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

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

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



CYPRUS

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 3, 2014

Prepared by

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	5

FUND RELATIONS

(As of August 31, 2014)

Membership Status: Joined December 21, 1961; Article VIII

General Resources Account:	SDR Million	Percent of Quota
Quota	158.20	100.00
Fund holdings of currency	480.92	304.00
Reserve position in Fund	48.54	30.68

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	132.80	100.00
Holdings	110.67	83.34

Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Extended Arrangement	371.25	234.67

Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
EFF	5/15/13	5/14/16	891.00	371.25

Projected Payments to the Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
Principal				6.19	43.31
Charges/Interest	1.01	3.99	3.99	3.99	3.82
Total	1.01	3.99	3.99	10.17	47.13

Exchange Rate Arrangement and Exchange Restrictions:

Cyprus's currency is the euro, which floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4. Cyprus maintains three exchange restrictions under Section 2(a) arising from: (i) limits on payments for certain transactions involving normal business activity, including the import of goods and services; (ii) limitations on certain invisible payments by individuals, including firm limits on remittances for living expenses for certain family members; and (iii) limits on access to certain funds deposited with financial institutions in

Cyprus that prevent non-residents from accessing, converting and transferring out of Cyprus recently acquired net income from current international transactions or investment income.

Safeguards Assessment:

The CBC has made progress in implementing recommendations since the 2013 safeguards assessment in the areas of governance, financial reporting transparency, and internal audit. However, some measures to further enhance financial reporting and strengthen the legal framework still remain outstanding. The CBC continues to publish its audited financial statements in a timely manner.

Last article IV consultations and program relations:

The last Article IV consultation was concluded on November 18, 2011 (IMF Country Report No. 11/31). Article IV consultations with Cyprus are on the 24-month cycle during the Extended Arrangement.

Cyprus's three-year, SDR 891 million (563 percent of quota) Extended Arrangement under the EFF was approved by the IMF Executive Board on May 15 2013, and the first four reviews under the program were completed on schedule.

Technical Assistance:

Department	Purpose	Date
MAE	Government debt management	February-March 1989
FAD	VAT training program	June-October 1992
MAE	Financial sector liberalization	Nov.-Dec. 1993
MAE	Reform of government securities	April-May 1994
STA	Special data dissemination standard	August 1997
STA	Balance of payments	March 1999
STA	Balance of payments	May-July 2001
STA	Balance of payments	Nov. 2001-March 2002
STA	Balance of payments	April-June 2002
FAD	Public investment and PPPs	March-April 2006
FAD	Medium-term budget framework	May 2006
FAD	Medium-term budget framework	October 2007
STA	Special data dissemination standard	May 2007
STA	Special data dissemination standard	March 2009
STA	Balance of payments	July 2011
FAD	Public financial management	February 2013
FAD	Revenue administration diagnostic	February 2013
FAD	Expenditure rationalization	February 2013
FAD	Public financial management follow-up	April 2013
MCM	Natural resources management	June 2013

FAD	Social welfare reform	June 2013
FAD	Public financial management follow-up	June 2013
FAD	Organic budget law	August 2013
FAD	Revenue administration reform	September 2013
FAD	Property tax	October 2013
MCM/LEG	Sovereign wealth management	November 2013
FAD	Revenue administration reform	November 2013
LEG	Debt restructuring legal framework	November 2013
FAD	Monitoring guarantees and SOEs	December 2013
LEG	Capacity development in AML/CFT	January 2013
FAD	Public financial management follow-up	March 2014
LEG	Tax administration legal framework	May 2014
FAD	Revenue administration follow-up	July 2014
FAD	Public financial management follow-up	September 2014
MCM	Debt management	September 2014

An FAD long term PFM resident advisor assumed her position in February 2014.

Resident Representative:

Mr. Vincenzo Guzzo assumed his position in September 2013.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance.

National accounts and real sector data: In September 2014, the new European System of National and Regional Accounts (ESA 2010) will replace the current ESA 1995 implying methodological changes and historical revisions to national accounts series.

Financial sector data: The CBC has adjusted reporting guidelines to comply with European standards. While past data has been restated, the structural break may result in errors in the time series for the data preceding mid-2013. The migration to Basel 3, which will begin in 2014, implies a change in the definitions of capital and risk coverage and will generate a structural break in the time series.

External data: The CBC compiles and disseminates balance of payments statistics in national publications on a quarterly basis and annual basis. This data treats Special Purpose Vehicles (SPVs) as non-residents. The authorities will begin the publication of balance of payments data on the basis of BPM6 in November 2014. In the past, current account statistics have been subject to very large revisions due to misclassification of items in the income account.

II. Data Standards and Quality

Cyprus subscribes to the Fund's Special Data Dissemination Standard (SDDS). Cyprus's economic database is comprehensive and of generally good quality. Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a wide range of economic and financial data, as well as a calendar of dates for the main statistical releases. Cyprus is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the *European System of Accounts 1995* (ESA95). No data ROSC is available.

Cyprus: Table of Common Indicators Required for Surveillance
(as of August 31, 2014)

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	July 2014	Aug. 2014	M	M	M
Reserve/Base Money	July 2014	Aug. 2014	M	M	M
Broad Money	July 2014	Aug. 2014	M	M	M
Central Bank Balance Sheet	July 2014	Aug. 2014	M	M	M
Consolidated Balance Sheet of the Banking System	July 2014	Aug. 2014	M	M	M
Interest Rates ²	Current	Current	D	D	D
Consumer Price Index	July 2014	Aug. 2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	July 2014	Aug. 2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	July 2014	Aug. 2014	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	July 2014	Aug. 2014	M	M	M
External Current Account Balance	2014:Q1	Aug. 2014	Q	Q	Q
Exports and Imports of Goods and Services	2014:Q1	Aug. 2014	Q	Q	Q
GDP/GNP	2014:Q1	Aug. 2014	Q	Q	Q
Gross External Debt	2014:Q1	Aug. 2014	Q	Q	Q
International investment position ⁶	2014:Q1	Aug. 2014	Q	Q	Q

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government, social security funds and local governments.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).



CYPRUS

STAFF REPORT FOR 2014 ARTICLE IV CONSULTATION— SUPPLEMENTARY INFORMATION

October 17, 2014

Prepared By

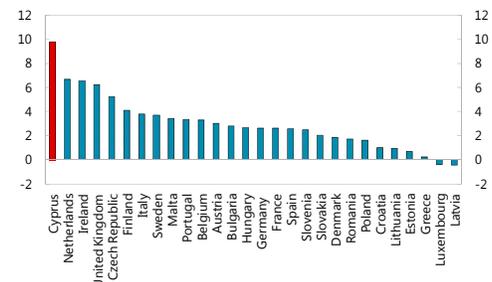
European Department

1. This supplement provides information that has become available since the issuance of the staff report on October 3, 2014. This information does not alter the thrust of the staff appraisal.

2. Cyprus’s nominal GDP level for 2013

was revised up by about 10 percent. This revision follows the adoption of ESA2010 methodology, the incorporation of new data (such as the results of the 2011 population census), and other improvements in data compilation. Despite the shift in the level of GDP, its growth rate since 2008 was largely unchanged. All demand components were revised, in particular capital formation, exports and imports. The revision was the largest among euro-area countries, and significantly larger than the euro-area average of 3 percent.

Size of Nominal GDP Revision under ESA2010, 2013
(In percent of GDP under ESA95)



Sources: Eurostat; and IMF staff estimates.

Sources of Revision, 2013

	Revision (%)
Adoption of ESA 2010	1.0
Incorporation of new data	6.4
Improved methods of compilation	2.4
In total	9.8

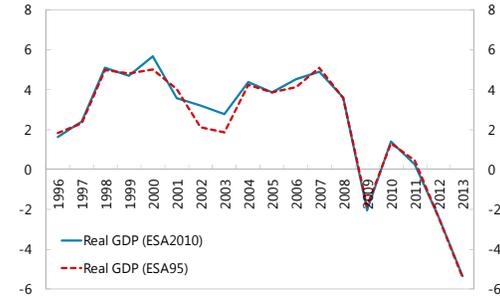
Source: Cystat.

Sizes of Revision, 2013

	Revision (%)	Revision (mln)
Gross Domestic Product (GDP)	9.8	1,615
Private consumption	7.6	865
Fixed capital formation	26.9	516
Exports of goods & services	23.9	1,779
Imports of goods & services	22.0	1,578

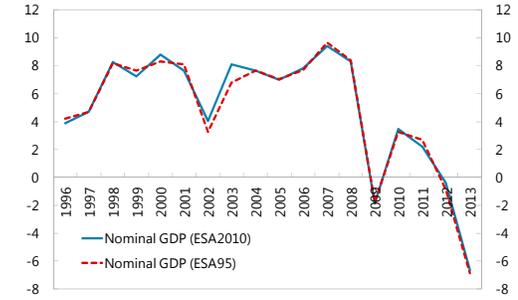
Sources: Cystat; and IMF staff estimates.

Cyprus: Real GDP
(Percent change, year-on-year)



Sources: Cystat; and IMF staff estimates.

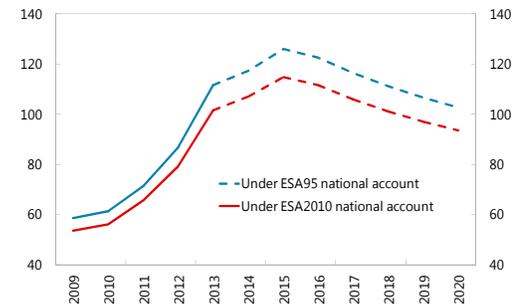
Cyprus: Nominal GDP
(Percent change, year-on-year)



Sources: Cystat; and IMF staff estimates.

3. The sizeable GDP revision implies a reduction in key macroeconomic ratios. For example, as a result of the higher denominator, the 2013 debt-to-GDP ratio would become 102 percent of GDP (rather than 112 percent), and the fiscal deficit-to-GDP ratio would be 4.4 percent of GDP (compared to 4.9 percent). The public debt projections would correspondingly shift downward. Private sector indebtedness would be 370 percent of GDP (rather than 410 percent). On the external side, the end-2013 current account deficit-to-GDP ratio would amount to 1.7 percent of GDP (rather than 1.9 percent), while the external-debt-to-GDP ratio would be 317 percent of GDP (rather than 348 percent).

Cyprus: Gross Nominal Public Debt
(In percent of GDP)



Sources: Cystat; Eurostat; and IMF staff estimates.

4. Other data revisions are expected later this year, that could further affect key macroeconomic ratios. The adoption of the ESA2010 methodology for the fiscal accounts is expected in the last quarter of the year. On the BoP side, the authorities are expected to switch to BPM6 in November. These methodological changes are expected to lead to further changes to the fiscal and external accounts, which may partly offset the effect of the GDP level increase.



INTERNATIONAL MONETARY FUND



Press Release No. 14/477
FOR IMMEDIATE RELEASE
October 22, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with Cyprus

On October 20, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Cyprus.

Large imbalances accumulated prior to the global financial crisis culminated in the collapse of Cyprus's banking system in early 2013. In response, the authorities took unprecedented measures upfront to resolve and recapitalize weak systemic banks at no fiscal cost and adopted a three-year economic-adjustment program aiming to secure financial stability and fiscal sustainability.

The program is supported by international financial assistance of about €10 billion, of which about €1 billion is provided by the IMF under the Extended Fund Facility arrangement, and €9 billion by the European Stability Mechanism. About €5.75 billion has already been disbursed under the program by the IMF and the ESM.

Cyprus has made considerable progress in addressing the crisis. In the context of their adjustment program, the authorities have restructured and recapitalized the financial sector while preserving fiscal sustainability, removed domestic payment restrictions imposed at the height of the crisis, consolidated the public finances, and initiated structural reforms. These achievements helped Cyprus re-access international capital markets earlier this year.

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.

However, overcoming the legacies of the crisis is still challenging, and the outlook remains difficult. The economy contracted sharply in 2013, and unemployment is very high. Output is expected to decline this year by a further 3.2 percent before recovering modestly next year. The private and public sectors are heavily indebted. The banking sector remains vulnerable given high and rising non-performing loans and tight funding conditions, with external payment restrictions still needed to protect financial stability. Achieving a durable economic recovery will critically depend on maintaining the reform momentum, which requires overcoming recent delays in program implementation.

Executive Board Assessment²

Executive Directors commended the authorities' strong efforts to address the recent economic and financial crisis, including measures to recapitalize and restructure the banking sector, liberalize domestic-payment flows, consolidate the public finances, and initiate structural reforms. Nevertheless, Directors agreed that Cyprus' macroeconomic situation continues to be difficult and full and timely implementation of the adjustment program supported by the IMF's Extended Fund Facility remains critical for a durable recovery.

Directors stressed that addressing the high level of non-performing loans to help revive credit and support growth should be a priority. Acknowledging progress in establishing bank internal debt-restructuring units, they highlighted the need for an effective and fair foreclosure regime, complemented by reforms of the legal-insolvency framework that facilitate debt restructuring and preserve the payment culture.

Directors welcomed the recapitalization of the financial sector in a manner consistent with maintaining fiscal sustainability, including the recent market recapitalization of the largest bank. Looking ahead, they called for capital buffers in line with the outcome of the European Central Bank's comprehensive assessment and for further efforts to restructure banks and the cooperative sector. Directors also supported plans to strengthen bank supervision and regulation in the transition to the pan-European Single Supervisory Mechanism and steps to enhance the implementation of the anti money-laundering framework.

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

Directors called for prudent management of external-payment restrictions to safeguard financial stability and agreed that their relaxation should be gradual and transparent. In this context, they underscored the importance of normalizing bank funding and liquidity and noted that Eurosystem support remains essential.

Directors welcomed the authorities' ambitious fiscal consolidation so far. However, with public debt still high, they noted that additional efforts will be required to achieve medium-term fiscal targets. Directors emphasized the need for a judiciously paced adjustment based on permanent measures aimed at reversing the pre-crisis increase in spending.

Directors commended the authorities for putting in place comprehensive structural reforms. They underscored that continued implementation of reforms of revenue administration, public financial management, and the welfare system are key to safeguarding the sustainability of the fiscal position while protecting vulnerable groups. Directors also encouraged the authorities to privatize state-owned enterprises and develop a strategy to boost competitiveness and potential growth.

Cyprus: Selected Economic Indicators, 2008–20

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections												
Real Economy	(Percent change, unless otherwise indicated)												
Real GDP	3.6	-1.9	1.3	0.4	-2.4	-5.4	-3.2	0.4	1.6	2.0	2.2	2.1	1.8
Domestic demand	8.0	-7.0	1.9	-1.5	-3.8	-10.1	-4.3	-0.4	0.9	1.7	1.9	2.0	1.7
Consumption	7.4	-4.6	1.4	1.0	-2.4	-5.6	-2.9	-0.6	0.5	1.3	1.5	1.6	1.2
Private consumption	7.8	-7.5	1.5	1.3	-2.0	-5.7	-2.4	-0.1	1.5	1.7	1.9	1.8	1.4
Public consumption	6.1	6.8	1.0	-0.3	-3.8	-5.0	-4.7	-2.1	-3.2	-0.6	-0.3	0.5	0.6
Fixed investment	6.0	-9.7	-4.9	-8.7	-18.3	-21.6	-13.4	1.3	3.9	4.6	4.9	4.9	4.8
Inventory accumulation 1/	0.9	-1.5	1.8	-0.7	1.3	-2.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-5.1	6.0	-0.7	2.0	1.6	5.0	1.0	0.8	0.7	0.4	0.3	0.2	0.2
Exports of goods and services	-0.5	-10.7	3.8	4.4	-2.5	-4.2	0.4	1.5	2.8	3.1	3.3	3.0	2.9
Imports of goods and services	8.5	-18.6	4.8	-0.2	-5.4	-14.1	-1.8	-0.1	1.5	2.5	2.8	2.8	2.7
Potential GDP growth	2.4	1.7	1.6	1.7	-1.5	-5.4	-3.1	-0.2	0.5	1.0	1.6	1.9	1.8
Output gap (percent of potential GDP)	2.8	-0.8	-1.2	-2.4	-3.3	-3.3	-3.4	-2.8	-1.8	-0.9	-0.3	-0.1	0.0
HICP (period average)	4.4	0.2	2.6	3.5	3.1	0.4	0.0	0.7	1.3	1.5	1.7	1.9	1.9
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	-1.3	0.0	0.7	1.3	1.5	1.7	1.9	1.9
Unemployment rate EU stand. (percent)	3.6	5.4	6.3	7.9	11.9	15.9	16.6	16.1	15.0	13.7	12.5	11.3	10.3
Employment growth (percent)	1.7	0.0	1.4	-1.5	-3.3	-5.2	-2.8	0.2	1.4	1.6	1.7	1.6	1.5
Public Finance	(Percent of GDP)												
General government balance	0.9	-6.1	-5.3	-6.3	-6.4	-4.9	-4.4	-3.9	-1.3	-0.8	0.6	0.2	-0.1
Revenue	43.1	40.1	40.9	39.9	39.4	41.5	42.3	41.8	42.1	41.5	41.7	41.9	41.9
Expenditure	42.1	46.2	46.2	46.3	45.8	46.4	46.7	45.7	43.3	42.3	41.1	41.7	42.0
Primary Fiscal Balance	3.8	-3.6	-3.0	-4.0	-3.2	-1.9	-1.0	-1.0	1.7	2.5	4.0	4.0	4.0
General government debt	48.9	58.5	61.3	71.5	86.6	111.5	117.4	126.0	122.5	116.4	111.1	106.5	102.6
Balance of Payments	(Percent of GDP)												
Current account balance	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-1.1	-0.8	-0.3	-0.1	-0.2	-0.2	-0.2
Trade Balance (goods and services)	-11.4	-5.5	-6.2	-4.3	-3.1	1.9	2.6	3.2	3.8	4.1	4.3	4.2	4.2
Exports of goods and services	45.0	40.2	41.3	42.9	42.9	43.9	45.5	46.3	46.9	47.3	47.6	47.9	48.2
Imports of goods and services	56.4	45.7	47.5	47.2	46.0	42.0	42.8	43.1	43.0	43.2	43.4	43.6	44.0
Goods balance	-32.4	-25.5	-26.8	-24.3	-21.8	-17.8	-16.7	-16.4	-16.2	-16.2	-16.3	-16.4	-16.5
Services balance	21.0	19.9	20.6	20.1	18.7	19.7	19.3	19.7	20.1	20.3	20.5	20.6	20.7
Income, net	-3.9	-4.1	-2.2	2.0	-2.6	-2.7	-2.7	-3.1	-3.2	-3.3	-3.5	-3.5	-3.5
Transfer, net	-0.4	-1.1	-0.7	-1.1	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account, net	0.0	0.3	0.2	0.3	0.1	1.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Financial account, net	16.1	10.9	9.5	4.4	4.8	-26.3	-11.4	-16.8	-2.2	0.0	0.4	0.7	0.9
Direct investment	-5.2	13.2	0.4	0.7	6.8	1.0	0.5	4.4	4.7	3.1	3.0	4.0	4.0
Portfolio investment	-74.2	-101.1	-11.1	32.2	30.1	71.1	15.6	-5.2	-1.6	-2.2	1.6	10.0	3.0
Other investment	93.8	98.2	19.0	-28.8	-32.4	-98.6	-27.4	-16.0	-5.3	-1.0	-4.3	-13.3	-6.0
Reserves (- inflow; + outflow)	1.7	0.6	1.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	0.0	0.0	0.0	0.0	0.0	29.3	12.3	17.5	2.3	0.0	-0.3	-0.6	-0.8
European Union	0.0	0.0	0.0	0.0	0.0	27.8	10.2	15.4	1.8	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	1.5	2.1	2.1	0.5	0.0	-0.3	-0.6	-0.8
Errors and omissions	-0.5	-0.5	0.2	-1.3	2.0	-2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance													
National saving	7.7	8.6	10.0	13.2	8.3	8.6	8.6	9.1	10.0	10.8	11.3	11.8	12.4
Government	4.9	-0.6	-0.1	-1.8	-2.6	-1.9	-0.7	-0.3	1.9	2.3	3.7	3.3	3.0
Non-government	2.8	9.2	10.0	15.0	10.9	10.5	9.3	9.4	8.2	8.5	7.6	8.5	9.3
Gross capital formation	23.3	19.4	19.8	16.6	15.2	10.5	9.7	9.9	10.4	10.9	11.5	12.0	12.6
Government	5.0	5.1	5.0	5.0	5.3	6.1	5.1	5.1	4.5	4.2	3.9	4.2	4.4
Private	18.3	14.3	14.8	11.6	9.9	4.4	4.6	4.8	5.9	6.7	7.6	7.8	8.3
Foreign saving	-15.6	-10.7	-9.8	-3.4	-6.9	-1.9	-1.1	-0.8	-0.3	-0.1	-0.2	-0.2	-0.2
Memorandum Item:													
Nominal GDP (billions of euros)	17.2	16.9	17.4	17.9	17.7	16.5	15.8	15.9	16.4	17.1	17.8	18.5	19.2

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

1/ Contribution to growth.

**Statement by Mr. Menno Snel, Executive Director for Cyprus, and Mr. Ektoras
Kanaris, Advisor to the Executive Director
October 20, 2014**

We thank staff for a well laid out Article IV report and the detailed supplementary papers. The Article IV report appropriately captures the grim story of the island's recent economic history. Looking back, it will hopefully serve as yet another useful reminder of how a twist of unforeseen events, mixed with lingering vulnerabilities, policy indecisiveness but also broader politics, can fester into a treacherous combination that can bring a country to its knees in an instant.

In the years leading to the start of the global financial crisis in 2008, Cyprus had been posting strong growth rates of around 4 percent, the unemployment rate was hovering close to 4 percent, inflation was at low levels, the public finances were in surplus and the debt-to-GDP ratio was below 50 percent. However, with a booming economy came complacency, and serious fragilities were quietly being amplified in the background while policy responses were either timid or absent. Rapidly rising property prices contributed to an overdependence of public finances on the property sector, leading to a wealth effect that gradually started to hamper competitiveness. When the property bubble burst, the first cracks in the banking system started to emerge while persistent reluctance to correct long standing imbalances and continued lax fiscal and macro prudential policies had started taking their toll on the country's ability to refinance its debt at rates compatible with long term fiscal sustainability. These imbalances became increasingly more evident in 2011 when the large exposure of the country's banks to a then fragile Greece led to a series of rating agency downgrades. By mid-2011, Cyprus had lost access to long-term sovereign debt markets.

Even by then, these imbalances were arguably still manageable, if prompt action had been taken: the economy was still growing q-o-q and the banks were still solvent and capitalized. However, the unforeseen events that followed accelerated and exacerbated the island's problems. In July 2011, a catastrophic explosion of a huge cache of confiscated munitions stored at a naval base destroyed Cyprus's nearby power plant which supplied power to half of the island, and led to a then estimated burden of over €2 billion on the government's ailing budget. The fallout included systematic electricity blackouts, with adverse effects on output and government revenues while deepening the sense of economic uncertainty. By that point in time, the economy was thrown into recession. Three months later, in October, 2011, the decisions taken on the Greek PSI wiped out overnight more than €4.5 billion in bank assets (over 25% of GDP) with an ensuing substantial loss in bank capital. Within just a few months, these two events sunk the economy deep into uncharted territory. Failing to request immediate assistance at that point, Cyprus's fate became gloomier by the day. In the meantime, the banking sector, now undercapitalized, was increasingly cut off from international market funding.

It was not until June 2012 that Cyprus requested official support in the form of a combined European and IMF package. However, upcoming elections caused delays in concluding an assistance package, and negotiations were caught up in a broader unfavorable political nebula. By early 2013, statements and rumors in the press regarding deposit haircuts and the consequent fall in confidence led to accelerated and substantial deposit outflows. Against the background of these severe economic and financial disturbances, on March 16 and 25, 2013, an agreement was forged with the newly elected government on an EU-IMF supported program.

In an unprecedented manner, beyond the core elements of an officially supported program, depositors of the island's two largest banks were bailed-in. Uninsured depositors of Laiki bank and Bank of Cyprus were bailed in using 100 percent and 47.5 percent of their deposits over €100 000 respectively. With the conclusion of the exercise, a total of €9.4 billion was affected, including €1.5 billion of debt. Amidst financial turmoil and public outcry, a two week bank holiday was imposed, followed by the introduction of capital controls and restrictions on cash withdrawals in a bid to prevent a bank run. Cyprus was in a state of paralysis and some market commentators, in their own right, believed the island's euro exit was inevitable and imminent.

Developments since the onset of the program and review status

A year and a half later, following a vast array of bold fiscal, structural and financial sector policies, the economy is mending at a rapid pace and well beyond what was expected at the program inception. Landmark reforms included a fiscal consolidation of over 10 percent of GDP between 2013 and 2014, reform of the General Social Insurance and the Government Pension Scheme, reform of the wage indexation system, adoption of the Fiscal Responsibility and Budget Systems Law, the introduction of the Medium Term Budget Framework, the modernization and refinement of the social welfare system, the unification and empowerment of tax departments and the introduction of the privatization framework. In the financial sector, following the bail-in of uninsured depositors and the imposition of restrictive measures, key policies included the merger of 93 coops into 18 entities, the unified supervision of banks and coops under the Central Bank, the recapitalisation of the cooperative sector, the strengthening of the AML/CFT framework and policies targeting the areas of governance, loan origination and arrears management. Progress is being made, inter alia, with a wide range of the goods and services market such as regulated professions, public administration review, public financial management, housing market, health, tourism and energy. With over 200 completed actions in four reviews, Cyprus has begun to reap the benefits of steadfast program implementation.

The positive side-effects of this effort were broad based. By now, the financial system finds itself closer to a stable state, underscored by the normalization of deposit flows, even as all domestic restrictions have been absent since May 2014. At the same time, rating agencies

have been reversing a long trend of successive downgrades and sovereign bond yields have been on a steady downward trend. In June 2014, Cyprus tapped the international bond markets after three years of absence— and a year ahead of schedule- through a heavily oversubscribed five year paper issuance. The banking system has also received the attention of foreign funds. In November 2013, Hellenic Bank was recapitalized by new private investors who have also indicated their intention to cover any potential capital needs following the conclusion of the ECB’s comprehensive assessment. More recently, in September 2014, Bank of Cyprus has successfully undergone a 1 billion share capital increase through foreign participation. The latter boosted its CET1 capital ratio to 15 percent. The bank has also been able to reduce its ELA dependence by another €800 million.

While Cyprus has adhered to and consistently overperformed the program’s quantitative conditionality, the completion of the 5th review, originally scheduled to take place in September 2014, has been delayed due to one incomplete prior action. The government, which lost the House majority in February 2014, has been working hard to fulfill the prior action on the foreclosure law and build on its excellent track record. However, the smooth transition into the new foreclosure framework proved somewhat too ambitious. While the actual foreclosure law was passed – and is actually currently active - the House majority voted some side-legislation rendering the effectiveness of the foreclosure law’s objectives weaker. Since then, most of the associated bills have been referred to the Supreme Court to review their constitutionality with a final decision to be expected in early November. Importantly, however, the government’s efforts throughout this process underscore once again its commitment to abide to program conditionality. In the same context, the authorities’ prudent fiscal management has given Cyprus the benefit of time since the accumulated fiscal buffers have eliminated any imminent financing threats. Nonetheless, the authorities are in complete agreement with staff views regarding the necessity of a well-functioning foreclosure framework complemented by a modernized insolvency regime as the best way to promote debt restructurings and address the high NPLs. Their efforts, irrespective of the ensuing delays, should be acknowledged.

Macroeconomic developments

The real economy also delivered positive surprises. To put this into perspective, at program inception, growth estimates for 2013 ranged from -8.7 percent (program estimates) up to -20 percent (market analysts), with the year ending with drop in output of -5.4 percent. For 2014, program estimates stood at -4.8 percent (3rd review) with the latest revised forecast envisaging a 3.2 percent drop in output. The authorities do not expect the economy to contract more than 3.0 percent. Indications to date point indeed towards such an outcome as the annualized growth for the first half of the year was -2.5 percent. Moreover, the second quarter’s -0.3 percent q-o-q growth rate was the lowest quarterly contraction since the aforementioned naval base blast in July 2011. Regarding the outlook, the staff report

accurately captures the authorities' views which point to somewhat more positive medium term outcomes.

There are several reasons contributing to these better-than-expected outcomes, not least the price and wage flexibility exhibited by the economy. Wages in both the public and private sectors have been subject to a large downward adjustment. While the cost of adjustment is painful, it is contributing towards improved competitiveness. Cyprus saw a decline in its labour costs of 6.5 percent in Q4 2013. The adjustment continued well into 2014 with Eurostat's latest publication indicating another 3.9 decrease by Q2 2014 compared with the same quarter of the previous year. At the same time, the public sector workforce was significantly reduced over the last years and by Q2 2014, the number of broad public sector employees stood at levels last seen in 2007, representing a decrease of around 10 percent from their peak in 2011. Inevitably, unemployment was a victim of the adjustment effort, peaking at 16 percent in 2013. However, with the recession moderating, the growth in unemployment is now reversing, falling to 15.4 percent in August, and constituting the fourth consecutive monthly drop. In terms of price developments, inflation averaged -0.3 percent in the first eight months of 2014. While having a positive impact on competitiveness, these levels warrant caution as they also impede the authorities' efforts to resume growth and reduce the debt overhang.

Public Finances

Cyprus continues to achieve -and surpass- all its fiscal targets, as it has done since the beginning of the program. This has been despite the deep recession, evidencing the authorities' intent and determination to meet their fiscal balance objectives for the coming years. It is also useful to recall that the 2014 budget, on the authorities' own initiative, included additional fiscal consolidation that went beyond program requirements. As a result of prudent management, public finances are running almost two years ahead of the original program profile. As staff correctly identifies, preliminary August figures point to continued overperformance. To specify, there is a primary surplus of +2.9 percent of GDP for the first eight months of 2014. In fact, where the target for 2014 is for a primary deficit of -1.6 percent of GDP (4th review), the authorities expect to end the year with a primary surplus.

The authorities clearly share staff's view about the need for a credible but balanced fiscal adjustment over time, as evidenced by their track record. They also concur with the need to ensure the fiscal neutrality of the new welfare reform. The Guaranteed Minimum Income, which is now operational, has been designed in a way that improves targeting and reduces benefit abuse. These goals appear to have been met as the new refined selection process appears to have contained benefit abuse bringing in associated savings relative to what was expected. Regarding the calls for additional adjustment measures over the medium term, the authorities' share the objectives behind staff's proposals presented in the Selected Issues. Indeed, they wish to reaffirm their intention to do what is necessary to achieve the 4 percent

primary surplus by 2018. It should be pointed out that the authorities project a more modest fiscal effort than that envisaged by staff. Further measures will of course need to be balanced against the still recessionary and fragile environment, future macroeconomic outcomes, the broader external environment and the added value/loss of pushing the economy more than may really be necessary. In each review so far, the authorities' internal projections presented in mission discussions have consistently outperformed those of staff.

The authorities take note of the accompanying Public Sector Debt Sustainability Analysis. While staff expects Cyprus public debt to GDP to peak in 2015 at 126.2 per cent, the authorities wish to reveal the possibility that debt to GDP may peak this year and at much lower levels. While staff's DSA assumes full disbursement of the buffer at over €2 billion (13 percent of GDP), the authorities consider that this prospect does not constitute a realistic baseline scenario by now. The authorities would also expect the baseline scenario to be updated with any new information following the completion of the ECB's comprehensive assessment on October 26. Moreover, the output level revision scheduled later this year to conform to ESA2010 standards is expected to further decrease the debt-to-GDP ratio by a sizeable amount.

As a general remark, while conservative assumptions have their benefit, they could also mislead broader market participants with a direct (miscalculated) impact on future policy.

Financial sector

The authorities are acutely aware of the remaining challenges outlined by staff. The report correctly highlights the criticality of addressing the high level of NPLs which may pose a threat to the banking system's long-term viability. The authorities share staff views that NPLs exceed what could be explained by unemployment. As such, the rise in NPLs can be largely explained by a large number of strategic defaulters. The latter is being fuelled by the uncertainty created regarding the treatment of NPLs, and the lack of tools to lay the foundations and incentives for healthy debt restructurings. In response, as outlined earlier, significant efforts have been put into building the necessary framework to effectively address arrears and accelerate sustainable restructuring. This was an exercise that involved reform at many levels including banks, supervision, legislation and civil institutions. So far, banks have established specialized units to deal with troubled borrowers and have been gradually building capacity with the help of external consultants. The process was complemented by the Central Bank's Arrears Management Framework (AMF), the Code of Conduct (CoC) for borrowers and creditors, and the loan origination directive. The authorities agree that where implementation reveals weaknesses, these tools should be refined accordingly. As such, the Central Bank intends to further improve the AMF and CoC accordingly upon the conclusion of the SSM transition and the comprehensive assessment, both of which have been straining the Central Bank's operational capacity. Finally, the authorities agree that in the absence of

an efficient foreclosure and insolvency framework, the exercise remains incomplete. They will continue to push this forward with the same determination shown thus far.

Conclusion

The Cyprus case has raised important policy issues, not least in the areas of modern bank resolution, program design and timing, the size of financial systems/institutions, corporate governance as well as the inability of regulators or other international economic surveyors – including the Fund – to ring louder bells in the years leading to this. Even as some of these issues feature prominently in international fora, including last week's Annual Meetings, some of the answers remain elusive. The island's story also serves as another stark example of how inaction can lead to severe economic dislocations. In a still fragile environment such as the current one, it is a timely reminder that timid policies will only postpone underlying problems which will come to haunt the country later on. As the story unfolds itself, it may also prove that firm upfront action can lead to a faster adjustment than otherwise.

Faced with an unprecedented economic shock in the island's modern history, the authorities have come a long way in addressing the crisis. As staff concludes, a number of challenges remain. Nevertheless, following eighteen months of strong implementation Cyprus finds itself in a good place to continue along the agreed path. The authorities are cognizant that the achievements to date will be jeopardized if there is a hint of complacency and are therefore determined to push through their commitments even as headwinds have emerged. With continued guidance from staff and careful policy design for the remainder of the program, the authorities are confident that Cyprus will soon return to growth and broad-based economic prosperity.