

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

Recent Economic Developments and Outlook

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

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

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

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

Policy Mix over the Near Term

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

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

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

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

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

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

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

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

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

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

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

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

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

Medium Term Challenges: Capital Account Liberalization

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

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

raise them to 10 percent in January 2000 in anticipation of a possible increase in the riskiness of lending following liberalization.

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

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

Structural Reforms

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

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

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

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

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

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

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

Conclusion

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