INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/148

CYPRUS

June 2017

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

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

- A **Press Release** summarizing the views of the of the Executive Board as expressed during its June 7, 2017 consideration of the staff report that concluded the First Post-Program Monitoring discussions with Cyprus.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 7, 2017, following discussions that ended on April 3, 2017, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 22, 2017.
- A **Statement by the Executive Director** for Cyprus.

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

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June 8, 2017

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

IMF Executive Board Concludes First Post-Program Monitoring Discussion with Cyprus

On June 7, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the first Post-Program Monitoring Discussion[1] with Cyprus.

Cyprus's economic recovery has continued to strengthen in the 15 months since it exited from the Fund-supported program. Economic growth has been broad-based and reached a robust 2.8 percent in 2016, supporting a sharp drop in the unemployment rate. Excluding large one-off imports, the current account deficit continued to narrow and earlier gains in price competitiveness have been preserved. The fiscal primary surplus reached a sizable 2.3 percent of GDP (on a cash basis) in 2016, supported by reforms undertaken in previous years and improving cyclical conditions, and the cost of market-based borrowing by the sovereign has fallen considerably. The restructuring of nonperforming loans has also gained momentum. Still, the clean-up of private and public sector balance sheets is progressing slowly, and indebtedness remains very large.

Over the medium term, the pace of growth is expected to gradually ease to just over 2 percent, due mainly to two factors: an expected pickup in private sector debt servicing and rebuilding of savings buffers, which will trim consumption growth; and gradual dissipation of the current ongoing surge in investment. Coupled with write-down of debt, the stepped-up debt servicing will gradually restore private indebtedness to a more sustainable level and improve the banking sector's financial health. The fiscal primary surplus is expected to reach 3 percent of GDP in 2017 and moderate to 2½ percent of GDP during 2018–22, helping to lower public debt net of cash holdings to just over 80 percent of GDP by 2022.

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

Executive Board Assessment[2]

Executive Directors welcomed Cyprus's notable economic achievements since exiting the Fund-supported program in early 2016, including strengthening output and employment growth, sizable primary fiscal surpluses, and an ongoing gradual healing of the banking system. Nonetheless, these achievements have not yet resulted in significant reductions in the high levels of private-sector debt, nonperforming loans, and general government liabilities. Directors, therefore, urged the authorities to build on their efforts.

Directors noted that Cyprus's capacity to repay the Fund is satisfactory but subject to risks. Sustained moderate GDP growth and primary fiscal surpluses are expected to underpin repayment capacity, supported by a backloaded maturity profile of official debt and continued access to capital markets on favorable terms. Directors welcomed the authorities' intention to repay early part of Fund credit, which would further reduce debt servicing cost. Nonetheless, to safeguard repayment ability in the event of volatile economic growth and financial shocks, Directors urged more ambitious policies to increase policy buffers and reduce private and public sector debt.

Directors recommended measures to accelerate the downward paths of nonperforming loans and private sector leverage to strengthen the efficiency of credit allocation, eliminate debt overhangs, protect the adequacy of banks' capital, and improve the payment culture. Directors advised formulating tools that incentivize banks to offer sustainable loan workout packages to viable debtors and increase reliance on third-party debt servicers, while also streamlining court procedures for claims settlement and ensuring that regulations encourage timely recognition of losses.

Directors called for further efforts to curb public debt to create fiscal headroom and insulate the downward path of public debt from potential shocks. This could be achieved by saving overperformance and windfall revenues and restarting stalled privatizations. A few Directors cautioned, however, that additional fiscal effort could hinder the economic recovery. Directors noted that allocating additional resources to growth-enhancing public investment and implementing structural fiscal reforms to avoid expenditure slippages and unfunded tax cuts are also essential to bring down public debt. Directors welcomed the authorities' commitment to ensure that healthcare, public sector wage bill, and public sector pension reforms do not pose risks to fiscal sustainability.

Directors encouraged the authorities to restart macro-critical structural reforms to enhance competition and encourage broad-based investment and economic growth. Directors recommend establishing a dedicated commercial court, strengthening enforcement of commercial claims, and reviving the privatization program.

[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.

Cyprus: Selected Economic Indicators, 2014–2018

	2014	2015	2016	Projections 2017	Projections 2018
	(Percent change, unless otherwise indicated)				
Output/Demand					
Real GDP	-1.5	1.7	2.8	2.7	2.5
Domestic demand	-1.5	3.0	3.9	1.4	3.9
Consumption	-1.2	1.4	2.0	2.0	1.8
Private consumption	0.7	1.9	2.9	2.3	1.7
Public consumption	-7.9	-0.6	-1.4	1.0	2.0
Fixed investment	-17.5	12.0	26.0	-4.5	15.0
Inventory accumulation 1/	2.2	0.3	-1.5	0.4	0.0
Foreign balance 1/	-0.1	-1.3	-1.0	1.4	-1.4
Exports of goods and services	4.2	0.0	3.6	2.2	5.0
Imports of goods and services	4.6	2.1	5.3	0.0	7.4
Potential GDP growth	0.2	0.4	0.7	1.0	1.3
Output gap (percent of potential GDP)	-6.6	-5.4	-3.4	-1.8	-0.7
Prices					
HICP (period average, percent)	-0.3	-1.5	-1.2	1.5	1.4
HICP (end of period, percent)	-0.9	-0.6	0.0	1.5	1.4
Employment					
Unemployment rate (EU standard, percent)	16.2	14.9	13.3	11.8	10.7
Employment growth (percent)	-0.6	-1.3	1.9	1.9	1.8
Public Finance	(Percent of GDP)				
General government balance	-0.2	-1.4	-0.3	0.6	-0.2
Revenue	39.3	38.9	38.8	39.2	38.2
Expenditure	39.5	40.3	39.1	38.5	38.4
Primary Fiscal Balance	2.8	1.4	2.3	3.0	2.3
General government debt	107.1	107.5	107.8	106.8	105.1
Balance of Payments					
Current account balance	-4.3	-2.9	-5.3	-3.2	-3.5
Trade Balance (goods and services)	2.1	0.3	0.0	1.2	1.0
Nominal GDP (billions of euros)	17.6	17.6	17.9	18.4	19.1

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

1/ Contribution to growth (percentage points).

INTERNATIONAL MONETARY FUND

CYPRUS

FIRST POST-PROGRAM MONITORING DISCUSSIONS

May 22, 2017

EXECUTIVE SUMMARY

The economic recovery has strengthened since Cyprus exited the Fund-supported program 15 months ago. Broad-based growth and improved external competitiveness have reduced unemployment. The fiscal position is in small surplus. External adjustment has continued, and borrowing costs for the public and private sectors have moderated. While the stock of credit continues to decline, returning confidence in the banks has encouraged deposit inflows.

However, stock imbalances remain stubbornly high. The economy's recent strong flow performance has not significantly dented Cyprus's elevated private sector debt, nonperforming loans or general government liabilities. While the economy is expected to sustain a solid pace of growth and servicing of existing debt is forecast to pick up, indebtedness is likely to moderate only slowly.

Capacity to repay the Fund is expected to be satisfactory under the baseline, but is vulnerable to idiosyncratic events. Sustained primary fiscal surpluses, solid GDP growth, contained public borrowing needs and sound debt management practices are expected to preserve market access on favorable terms. However, repayment capacity could weaken in the event of a new boom-bust cycle, if fiscal discipline were eroded or risks in banks' balance sheets were to materialize.

To reinforce capacity to repay against adverse shocks, ambitious policies should be pursued to frontload private and public debt reduction and support long-term growth. This requires:

- **Creating precautionary fiscal headroom** by reversing ½ percentage point of the recent structural loosening, saving windfall revenue and selling public assets;
- **Accelerating NPL workouts and reducing excessive debt burdens** through durable restructuring of viable debts, including write-downs, and greater recourse to third-party debt servicers; and
- **Advancing macro-critical structural reforms** in the areas of commercial claims' enforcement, judiciary, revenue administration, privatization of state-owned assets and business procedures.

Approved By
Philip Gerson and Daria Zakharova
Prepared By
European Department

Discussions took place in Nicosia during March 27–April 3, 2017. The staff team comprised R. van Elkan (head), S. Choi, H. Takizawa (all EUR), V. Crispolti (FAD), H. Oura (SPR), N. Rendak (LEG), M. Souto and O. Wuensch (both MCM) and V. Guzzo and M. Heracleous (IMF resident representative office in Nicosia). A. de Lannoy (Executive Director) joined several meetings. T. Chen and D. Noren (both EUR) supported the mission from headquarters.

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ANNEXES

BACKGROUND

1. **The Fund initiated post-program monitoring (PPM) on March 18, 2016, after the authorities cancelled Cyprus's Extended Arrangement under the Extended Fund Facility (EFF).** The first PPM mission was conducted jointly with the European Commission (EC), European Central Bank (ECB) and European Stability Mechanism (ESM).[1]

2. **By the time PPM was initiated, Cyprus had made considerable progress in stabilizing and beginning to turn around the economy, although significant challenges remained.** Growth turned positive in 2015. The banking sector was adequately capitalized and provisioned, a comprehensive package of legal tools to tackle indebtedness had been adopted, and workouts of nonperforming loans (NPLs) were accelerating. The fiscal balance had shifted into surplus and public debt had stabilized, albeit at the high level of 107 percent of GDP, and Cyprus had tapped international capital markets on several occasions. However, at 48 percent of lending (just under 140 percent of GDP) in early 2016, the NPL ratio remained extremely high. In addition, reform momentum had visibly slowed and several structural measures designed to lock in past gains were not completed. Moreover, without an ESM arrangement or an investment grade rating, Cypriot sovereign bonds lost eligibility for ECB refinancing and asset purchase programs.

RECENT DEVELOPMENTS AND GROWTH PROSPECTS

3. **The incipient economic recovery has strengthened further since Cyprus exited the EFF arrangement, despite contracting bank credit.** Growth was 2.8 percent in 2016, well above the 1.7 percent recorded the previous year. On the production side, tourism benefited from measures to extend the season as well as demand diversion from elsewhere in the region owing to security concerns. Professional services also grew robustly, reflecting Cyprus's importance as a regional financial and business center. In addition, the construction and real estate sectors began to emerge from the deep slump they entered early in the crisis, aided by several temporary and new permanent incentives and external financing. On the expenditure side, private consumption grew briskly, supported by higher employment and real wages, as well as drawing down of savings and non-servicing of debt by a sizable share of borrowers. Exports of services—mostly tourism and business services—were also brisk. At end-2016, real output was 6 percent below its pre-crisis peak and 3½ percent below potential, despite some downgrading of potential growth due to the crisis and slow reform momentum.

4. **External adjustment has continued, supported by earlier gains in price competitiveness, while private financial inflows have surged.** Falling prices and wages since the crisis have led to real effective exchange rate (REER) depreciation of 10 percent and 20 percent, respectively, in terms of consumer prices and unit labor costs. The overall current account deficit widened to 5.3 percent of GDP including a large, one-off ship import, but excluding this one-off, the

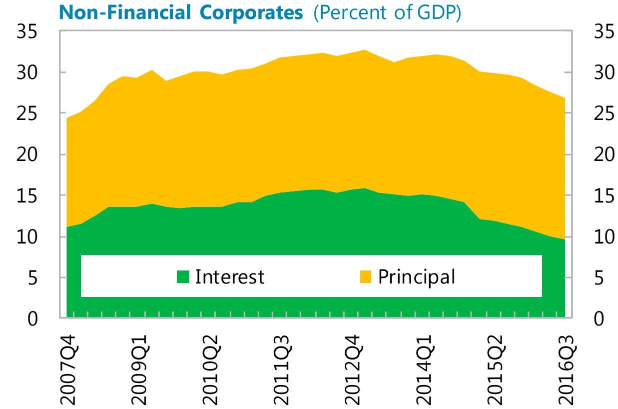
[1] See Annex I. The three-year ESM program, initiated on March 7, 2013, expired at the time the Fund's EFF arrangement was cancelled.

deficit narrowed to 2.3 percent of GDP in 2016, about ½ percentage point less than in the previous year, supported by a rising general government primary surplus. As in 2015, private net financial inflows reached 30 percent of GDP (including activities of special purpose entities (SPEs) with little economic presence in Cyprus), likely attracted by relatively high interest rates and the citizenship-by-investment scheme.

5. The labor market is recovering, and Cyprus recently exited its extended bout of deflation. The seasonally-adjusted unemployment rate dropped sharply to 12.8 percent in the 2017:Q1 against 14.9 percent in 2015, although it remains well above pre-crisis levels. Stronger demand for labor and expiration of the temporary solidarity levy on wages lifted nominal disposable incomes, with real wages receiving a further boost from the declining price level, given Cyprus's heavy dependence on imported fuel. Inflation turned positive at end 2016, and reached 2 percent in April.

6. Interest rates continue to moderate, reflecting Cyprus's improved economic performance and accommodative monetary conditions in the euro area. Yields have decreased and spreads have narrowed alongside several rating upgrades by the major rating agencies.[2] However, with the sovereign at least one notch below investment grade and Cyprus outside an ESM program, government bonds are ineligible for ECB operations.[3] Interest obligations on private sector debt are estimated to have moderated to 10 percent of GDP, although part of this goes unpaid.

Cyprus: Debt Service Obligations of Households and Non-Financial Corporates (Percent of GDP)



Sources: Central Bank of Cyprus; IMF staff calculations.

7. Despite the economic recovery, repair of private balance sheets is progressing very slowly. Domestic indebtedness remains high at about 350 percent of GDP. While in the aggregate, households have large positive financial net worth, their debt ratio is the highest in the euro area at 123 percent of GDP at end-2016. In addition, households have been running negative saving rates, drawing down their financial assets. Debts of domestic nonfinancial corporates, at 225 percent of GDP (of which one-third is owed by SPEs classified as residents but with little physical presence in Cyprus), are extremely high, but have moderated marginally. Liabilities are mostly in the form of bank loans.

8. The banking sector has adequate liquidity and capital, but asset quality remains very poor and domestic credit to households and nonfinancial corporates is declining:

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[2] S&P upgraded Cyprus to one notch below investment grade in March 2017, with a stable outlook.

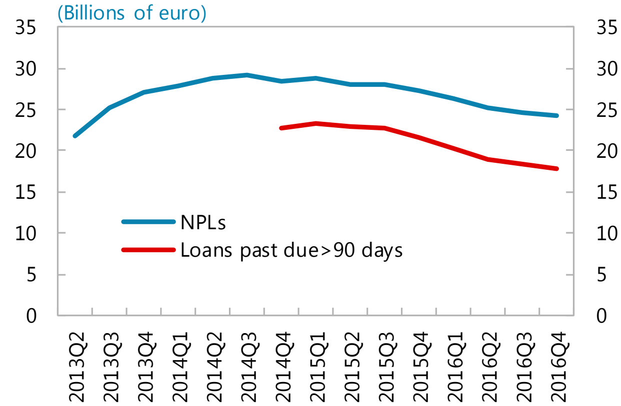
[3] ECB policies may indirectly benefit Cypriot yields through investors' portfolio rebalancing.

- Deposits increased in 2016, for the first time since the 2013 bail-in, on firming confidence and still relatively-high (though moderating) interest rates. With total credit continuing to contract, banks have ample liquidity, and loan-to-deposit ratios are between 50 and 100 percent at the three large domestic banks. In January 2017, Bank of Cyprus (BoC) repaid the remaining balance on its emergency liquidity assistance.

- The Single Supervisory Mechanism's (SSM's) 2016 review assessed the capital positions of the three large banks as adequate. Banks' relatively low provisioning ratio of just under 40 percent of NPLs is mitigated by real estate collateral with an expected average cash recovery rate of 62 percent of NPLs. Banks are profitable, although returns are low on narrow interest margins and low cash earnings due to the large NPL stock, even though provisioning has moderated. Following the late-2015 capital injection, restructuring of the public Co-op bank, with the goal of phased privatization, is proceeding on schedule.

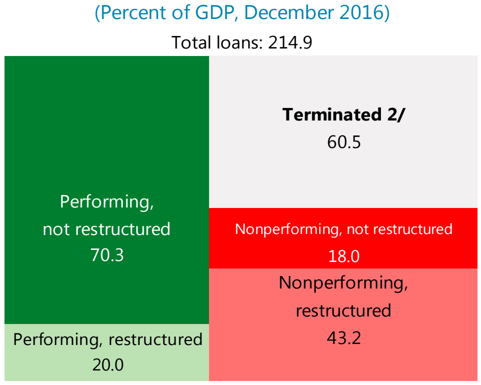
- NPLs have fallen by €5.0 billion since their peak to €24.2 billion (135 percent of GDP—by far the highest in Europe—and 46 percent of total loans) as of end-2016, through a mix of restructuring tools: repayments, write-downs and loan-to-real estate swaps. The NPL ratio for the three large domestic banks is higher, at almost 60 percent. About one third of NPLs have been restructured at least once.

Cyprus: Non-Performing Loans
(Billions of euro)



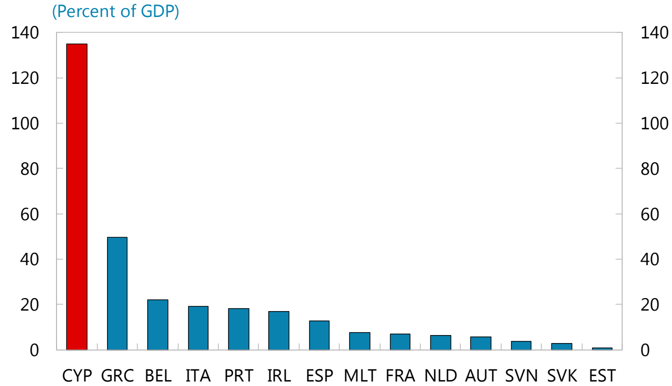
Sources: Central Bank of Cyprus; and IMF staff estimates.

Cyprus: Loans by Classification 1/
(Percent of GDP, December 2016)



Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Local operations only. Excluding RCB bank.
2/ An account is considered terminated if the outstanding balance has been called in.

NPL-to-GDP Ratio in Euro-Area Countries /1
(Percent of GDP)



Sources: FSI, WEO, and IMF staff calculations.
1/ As of 2016Q4, or the latest data available.

9. Following a nearly 30 percent decline, real estate prices have recently stabilized, supported by foreign buyers. Standard metrics indicate that prices are not overvalued. The market appears bifurcated, with renewed interest in luxury properties, partly owing to the citizenship-by-investment scheme and bank sales of higher-end properties acquired through debt-asset swaps. With most loans backed by real estate, credit quality and provisioning needs are sensitive to property prices.

10. The upcoming presidential election campaign is likely to focus on the economy and reunification issues. Presidential elections are slated for February 2018. Discussions between the leaders of the Greek-Cypriot and Turkish-Cypriot communities are ongoing to resolve the long-standing division of the island and create a federal united Cyprus.

Forecast

Staff's views

11. Over the medium term, growth is forecast to ease from its post-crisis rebound as stepped-up debt servicing curbs private spending. Growth is projected to moderate slightly to 2.7 percent in 2017, and to stabilize around 2.1 percent over the medium term. This reflects a slower pace of private consumption growth as improved payment discipline brought by enhancement of banks' loan restructuring procedures (see below) causes faster pay-down of debt and rebuilding of depleted savings. Investment is expected to continue to recover, supported by sustained capital inflows and new bank lending to dynamic firms. With wages growing in line with productivity, price competitiveness would be preserved, keeping external demand brisk. The envisaged output path is expected to eliminate the negative output gap and lower unemployment in the medium term. Moreover, faster repayment (and write-down) of debt during the next few years would help to gradually restore debt to a level consistent with the private sector's long-term carrying capacity, better positioning borrowers to utilize future new loans to support sustainable growth.

Authorities' views

12. Robust, broad-based growth is set to continue, supporting further declines in unemployment and NPLs. Growth is expected to overperform staff's forecasts, approaching 3 percent during 2017–18 and remain at about 2¾ percent thereafter, mainly reflecting faster investment growth. While the traditional sectors of tourism, business services and shipping are expected to remain the main drivers, robust growth is expected to be underpinned by a pipeline of large private and public investments in tourism, gaming and higher education. In addition, the citizenship-by-investment scheme was amended to attract investors seeking to relocate their business headquarters.

CAPACITY TO REPAY

Capacity to repay refers to the ability to make timely repayments of outstanding Fund credit under baseline and plausible risk scenarios, without the need for a successor arrangement, future support from official creditors, other contingent backstops or policy actions that would create undue economic hardship. With IMF financing provided to support the budget, the health of public finances is a key determinant of Cyprus's repayment capacity, requiring an assessment of the sustainability of public debt that, in turn, depends on solvency and access to liquidity. As Cyprus is a small economy in a large reserve currency-issuing monetary union, reserve adequacy is not germane.

13. Repayments to the Fund are scheduled to begin in 2017 and run through 2026. Obligations to the Fund—the sum of repurchases and charges—are expected to peak at €184 million (0.9 percent of GDP and 2.2 percent of general government revenue) in 2021. Scheduled repayments to the Fund do not exceed 9 percent of total public sector debt service costs in any year, and early repayments are permissible.

A. Repayment Capacity Under the Baseline Scenario

Staff's views

14. Capacity to repay the Fund is expected to be satisfactory under the baseline, despite high public debt and increasing reliance on market-based funding. Continued market access is expected to be underpinned by a sustained primary fiscal surplus, solid GDP growth and limited gross public borrowing needs.

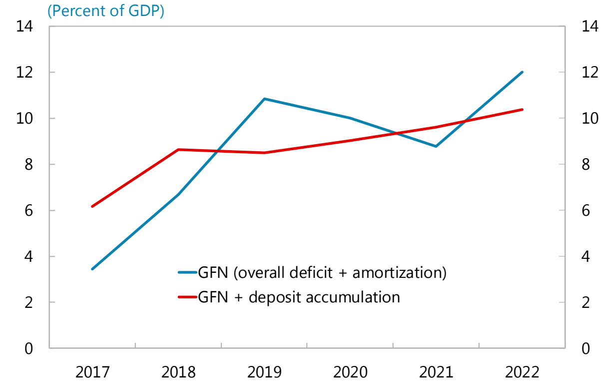
Solvency considerations

- At 107.8 percent of GDP in 2016, gross public debt is currently well above the 85 percent of GDP public debt threshold for advanced countries, although including cash on hand, net debt was somewhat lower than gross, at 102.2 percent of GDP. Brisk GDP growth and the sizable fiscal primary surplus envisaged in the baseline would lower gross public debt to 87 percent of GDP (and net debt to 82 percent) by 2022. Moreover, the debt ratio would continue to decline thereafter. Nonetheless, gross debt would remain elevated and exceed the 72 percent of GDP targeted for 2022 in the 9th program review, owing to smaller primary surpluses and less recourse to privatization and debt-asset swaps (Annex II).

Liquidity and debt management

- Annual gross public financing needs (GPFN) are expected to remain well below the 20 percent benchmark for advanced economies, peaking at 10.9 percent of GDP in the baseline, based on the existing profile of debt maturities (Annex II). The containment of GPFN despite elevated public debt reflects primary surpluses of around 2½ percent of GDP, together with the large share of official debt with long maturities and a back-loaded repayment profile.

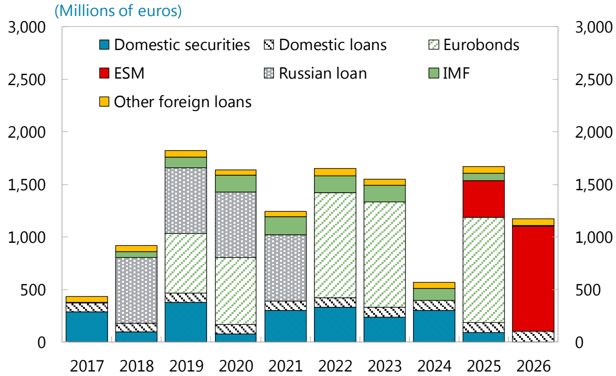
Cyprus: Gross Public Financing Needs
(Percent of GDP)



Source: IMF staff projections.

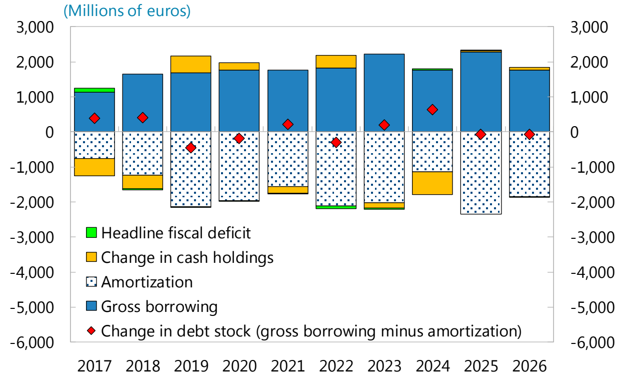
- There is scope for debt management operations to flatten out GPFN peaks, while keeping market borrowing relatively constant each year. The profile of redemptions can be smoothed by further lengthening maturities on new issues of marketable securities beyond the current average of five years, and through debt buy-backs. Building an adequate cash buffer in advance of peak amortizations would help to pre-fund large amortizations and smooth the profile of gross market borrowing. Accordingly, gross medium- and long-term borrowing in the securities market can be kept generally within a moderate €1–1.5 billion per year. Cash buildup during 2022–24 would also help pre-finance initial repayments to the ESM during 2025–31. However, net new borrowing to finance accumulation of cash slows the decline in gross debt, while cash buffers and debt buy-backs are costly.

Cyprus: Amortization of Existing MLT Debt
(Millions of euros)



Source: Public Debt Management Office.

Cyprus: Sources and Uses of Funds
(Millions of euros)



Source: IMF staff projections.

Cost of—and access to—market financing

- Market access on continued favorable terms is expected to be supported by a steady reduction in public debt reflecting a sustained primary surplus and sound debt management practices, including pre-financing of amortizations and lengthening of debt maturities. The most recent Eurobond issue (in July 2016) was well received in terms of demand and spread, even without an ECB backstop, and secondary market yields since then are consistent with continued access on similar terms.

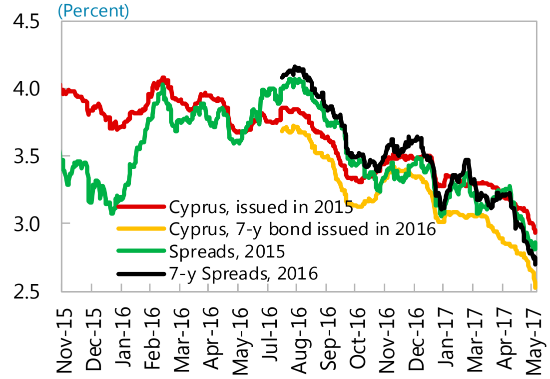
Cyprus: Sovereign Eurobond Issuance Since 2014

Issue date	Duration (year)	Amount issued (€mn)	Stock (€mn)	Coupon rate (percent)	Spreads at issuance (bpts) 1/
June 25, 2014 2/	5	750	566	4.75	446
May 6, 2015 2/	7	1,000	1,000	3.875	343
November 4, 2015 2/	10	1,000	1,000	4.25	338
July 26, 2016	7	1,000	1,000	3.75	410

Souces: Debt Management Office.
1/ For 10-year bonds, vis-à-vis 10-year German bunds issued around the same time; for bonds with other maturities, vis-à-vis bunds with similar residual maturity.
2/ These bonds were eligible for the ECB's public sector purchase program (PSPP). In total, the ECB purchased €285mn Cypriot bonds.

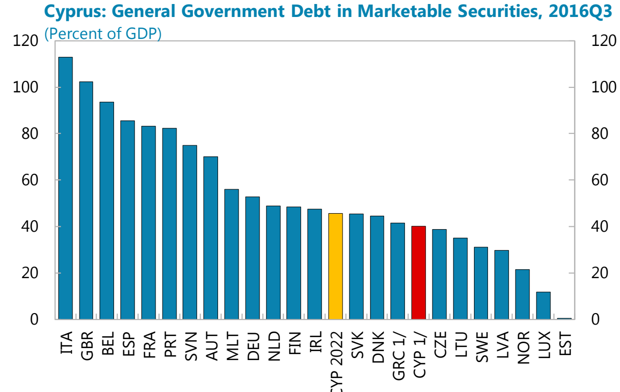
- Total interest costs will continue to benefit from the sizable share of official debt in total debt. Loans from the ESM and Russia, which account for the bulk of Cyprus's official debt, carry lower interest rates than Eurobonds. The cost of that part of Fund credit subject to the level-based surcharge is currently marginally above the cost of market-based funding.[4] While new market-based financing will carry higher interest rates than most maturing official debt (because of predicted future tightening of global monetary conditions and some re-widening of spreads), the interest bill is expected to remain contained. Achieving investment grade, which would make Cyprus eligible for ECB facilities, could further lower interest costs.

Cyprus: 10-Year Government Bond Yields and Spreads
(Percent)



- Nonetheless, reliance on market-based funding—at 35 percent of GDP in 2016 and rising to an estimated 45 percent of GDP by 2022—is relatively high in the absence of an investment grade rating or eligibility for ECB facilities, which could make the risk premium more volatile. However, the envisaged sizable cash buffers would protect against a temporary market shutdown.

Cyprus: General Government Debt in Marketable Securities, 2016Q3
(Percent of GDP)



Sources: BIS, WEO and IMF staff calculations.
1/ Currently without investment grade.

[4] EFF arrangements are subject to a level-based surcharge of 200 bps when credit outstanding exceeds 187.5 percent of quota and an additional time-based surcharge of 100 bps when credit outstanding is above this threshold for more than 51 months (effective from September 2019). Both surcharges are levied on the balance that exceeds 187.5 percent, and are in addition to the Fund's basic rate of charge.

Authorities' views

15. Cyprus's capacity to repay is strong, underpinned by prudent fiscal policies and debt management strategies. Cash on hand currently exceeds total debt amortization for 2017, and options for early repayment of part of Fund credit are being explored. With the fiscal balance remaining in surplus over the medium term, debt will be on a declining path, and adequate cash buffers will be accumulated in advance of large scheduled amortizations. Net debt, which is a more relevant concept, will therefore decrease earlier than gross debt. There is also some scope for debt buybacks, focusing on reducing repayment peaks, mainly by targeting market-based debt. However, consideration could also be given to early repayment of part of official debt, particularly if investment grade is achieved, which would further reduce the cost of market borrowing.

B. Risks to Repayment Capacity

Staff's views

16. Analysis of debt sustainability and financing needs indicates that repayment capacity is generally resilient to standardized shocks (Annex II), but could be weakened by plausible country-specific events through their effects on growth, the fiscal balance and borrowing costs (Annex III):[5]

- ***Risks from growth.*** Faster economic growth, if sustained, would strengthen repayment capacity, although risks to long-term growth are tilted to the downside. Recent robust growth could persist if substantial private debt continues to go unserviced. Private financial inflows could remain elevated, limiting the dampening effect on growth from a weak banking sector. Erosion of fiscal and wage discipline could also provide a temporary boost to growth. However, materialization of these short-term growth impulses alongside continued postponement of structural reforms could reverse previous fiscal, financial and price competitiveness gains. This could lay the basis for a new boom-bust cycle that would impair repayment capacity, especially if capital inflows reverse following expiration of minimum investment periods under the citizenship-by-investment scheme. Longer-term growth could also be affected by (i) retreat from cross-border integration, including due to Brexit; (ii) tighter global financial conditions leading to a slowdown or reversal of capital inflows or to renewed European bank distress; (iii) renewed international initiatives on corporate taxation and sharing of tax information; and (iv) reduced correspondent banking relationships.

- ***Risks from banks' distressed assets.*** Without faster reduction in NPLs, banks could remain a contingent public liability for an extended period. Banks' loan workout strategies are showing promise but CBC restructuring targets are only partially achieved. If the current pace were to continue, NPL cleanup would be a lengthy process, continuing to weigh on banks' profits and

[5] Reunification of Cyprus could influence capacity to repay through its potential to generate new economic opportunities, but would not be without risks to growth and fiscal sustainability. Legacy issues, including the treatment of existing public debt, would also need to be clarified. Reunification is not expected to impact the legal status of outstanding Fund credit: in line with the IMF's legal framework, the Republic of Cyprus's (RoC's) outstanding credit to the IMF would remain an international obligation of the (post-reunification) federal government of the RoC.

capital. In addition, progress could slow as banks complete the restructuring of larger, better-collateralized loans and move to smaller claims on households and SMEs. Moreover, if legal or other impediments to reducing NPLs are more severe than expected, investor and creditor confidence could be eroded, leading to renewed spillovers from banks to the sovereign. Realization of a contingent liability shock of 10 percent of banking sector assets (about 40 percent of GDP) would sharply raise GPFN and public debt and could cause borrowing costs to jump and even interrupt market access (Annex II).[6]

- ***Risks from the public sector.*** Fiscal slippages in response to renewed spending pressure could reduce the primary surplus, although any windfall hydrocarbon revenue could reduce debt. Introduction of a national health scheme without adequate spending safeguards, the absence of a legislative mechanism to contain the public sector wage bill, or risks of litigation or compensation arising from the 2013 depositor bail-in could erode the primary surplus, raise borrowing costs and further slow the decrease in public debt. Standard DSA stress tests indicate that the effect of a standardized primary balance shock on the debt ratio and GPFN is contained (Annex II). However, the effect would be larger if costs of market borrowing were to rise following a weakening in market sentiment or a sudden stop in market access. A combination of standardized macro-fiscal shocks could cause peak GPFN to rise sharply to 17.4 percent of GDP, although it would remain below the threshold. Current plans envisage allocating a large share of possible future hydrocarbon revenues to redeem public debt, but rising political pressure could weaken this proposal and elicit additional spending.

Authorities' views

17. Official growth and fiscal forecasts are attainable, although guarding against complacency is essential. Growth is likely to be more durable than before the crisis because it does not rely on deficit-financed fiscal spending or credit-financed construction activity. Nonetheless, the remnants of the crisis have not been fully eliminated and it is essential to continue responsible economic policies. Legacy NPLs are the main concern, although risks are mitigated by high provisioning and collateral coverage that renders unlikely realization of any future contingent liability. Moreover, the EU's Banking Recovery and Resolution Directive (BRRD) limits future banking-sovereign links. However, while healthy growth rates are expected, high NPLs could generate an adverse cycle of too few credit-worthy borrowers that holds down GDP growth. The recent slower pace of structural reform could also retard potential growth. Adequate safeguards are needed to ensure health care reform does not weaken competitiveness or the fiscal position. Conversely, large offshore energy reserves present a significant upside to potential growth that could rival existing key sectors, while also providing considerable fiscal resources to pay-down public debt and build-up a sovereign wealth fund.

[6] Public support to clean up the Cypriot banks (including bail-in and capital injections from the budget) amounted to around 70 percent of GDP. A further 40 percent of GDP contingent liability shock could be considered a tail risk event.

POLICY DISCUSSIONS

Cyprus's positive economic "flow" performance has not yet led to a discernable decrease in its extremely large stock imbalances, which continue to pose a risk to capacity to repay. More vigorous policy action is needed to deliver a decisive upfront decrease in private and public debt to reduce the likelihood and cost of adverse balance sheet shocks and to create fiscal space to better absorb costs were such shocks to materialize.

A. Financial Sector

18. Restructuring of NPLs has gained momentum, but there are challenges to timely resolution. Banks are making headway with restructuring, with 40 percent of all NPLs having received some form of loan modification. However, progress is uneven across banks reflecting differences in the type of borrowers, willingness to use available legal tools, and capacities to manage workouts. More than 20 percent of restructured loans have been re-restructured and some new NPLs continue to emerge. Also, as of end-2016, banks in the aggregate missed three of the four loan restructuring targets set by the CBC. While all the big three local banks have set up dedicated internal loan workout units, one recently joined with a foreign company to create a separate NPL servicing entity to accelerate debt workout. Legal tools for dealing with distressed debt—including more effective foreclosure, sale of loans, insolvency procedures—have seen limited use. Debt-for-property swaps are used mainly for large clients, which has increased banks' real estate portfolios, and banks are seeking to have the law requiring divestment within three years relaxed. Issuance and transfer of title deeds remains very slow.

Staff's views

19. Banks should not defer NPL restructurings in the expectation that future gains in output and property prices would autonomously improve recovery rates. With the economy into its third year of recovery, banks should know the size of haircuts needed to restore individual clients to a sustainable position. Moreover, further delay encourages and rewards strategic default and increases banks' credit exposure to unviable borrowers through evergreening of accrued-but-unpaid interest. In addition, sustained high NPLs expose banks to competition from new entrants unencumbered by distressed assets, enabling them to offer more competitive interest rates and lure away better clients. Instead, banks should undertake durable and sustainable loan workouts where borrowers are viable, or speedy liquidation if they are not. New lending should be underpinned by robust lending standards, strong business plans from borrowers and close monitoring of credit risk.

20. A combination of approaches is likely needed to accelerate progress with NPLs:

- ***Small borrowers.*** Four-fifths of NPLs are owed by households and SMEs. Consistent application of standardized procedures would expedite progress on the large volume of these loans and limit incentives for borrowers to hold out for increasingly more generous offers. Banks should consider outsourcing restructuring to a third-party provider, thereby avoiding the need to significantly increase in-house specialty skills while ensuring an arm's length creditor-debtor relationship.

- ***Real estate portfolios.*** Debt-asset swaps are warranted when prospects of future price gains are good and in the context of a larger restructuring deal. However, banks should avoid warehousing real estate on their balance sheets, which would concentrate property risk and tie up expensive capital. Properties should be taken on banks' books at forced-sale prices, and to minimize fire sales, the current fixed time limit for divesting real estate should be replaced with a capital surcharge that varies with the share of real estate in a bank's portfolio and with the length of time it is held.

- ***Provisioning.*** The level of provisions should be adjusted if liquidation of collateral is slower—and hence expected market value is lower—than previously anticipated. However, pressing banks to hold ever-larger provisions may encourage greater risk-taking.

- ***Divesting parcels of distressed assets.*** Prospects for a stand-alone asset management company appear limited owing to difficulties of price discovery, especially given the systemic nature of Cyprus's NPLs. Moreover, large pools of public or private resources are not available to fill the likely gap between market price and book value of assets, including because of restrictions on state aid. However, banks could consider selling small bundles of NPLs—including through securitization—to attract specialized foreign buyers to Cyprus who would help to gradually develop a market for distressed assets.

- ***Enhancing operational and legal tools.*** Operational barriers to NPL resolution, such as regulatory incentives encouraging banks to delay recognition of losses or to dispose of collateral should be removed.[7] Given the large role of the courts in debt resolution, improving the efficiency of the judiciary is essential (see below). Problems related to issuing and transferring legacy title deeds should be addressed, and the process for new title deeds should function efficiently to avoid a recurrence of past problems. More active use of the new insolvency and foreclosure frameworks would also help speed NPL resolution.

21. Policies should be readied to guard against an unsustainable credit-fueled upswing in property prices. Recent incentives provided timely countercyclical support to real estate and construction. While some have been rolled back, others remain in place and risk becoming procyclical. If credit to finance construction were to increase strongly, consideration should be given to raising banks' countercyclical capital buffer (currently set at zero) on construction and real estate exposures. Reinstating the immovable property tax (IPT, see below), applying it to updated property values, while clarifying that payment is the obligation of the current title holder, would restore a

[7] For example, International Financial Reporting Standard (IFRS) 9, to be introduced at the beginning of 2018, requires classifying and provisioning based on expected credit losses, even if the loan is currently performing.

potentially useful countercyclical tool and encourage title transfer to buyers.[8] Further reducing the links of the citizenship-by-investment scheme to real estate while ensuring full compliance with AML/CFT standards would help avoid over-supply of luxury properties and risks of a future price correction, protect the integrity of the scheme and mitigate risks to correspondent banking relationships.[9]

Authorities' views

22. The banking sector continues to improve, although faster progress with NPL reduction is needed. Confidence in the banks has risen, leading to the return of some deposits that had previously fled the system. NPL reduction has accelerated, but the effectiveness of some forbearance practices may be questionable, and improvements in banks' procedures are required to avoid possible additional impairment needs. Some banks' NPL strategies may need to be revised to reduce the rate of re-restructured loans, and the CBC is currently considering refinements to existing NPL policies. Banks also need to be prepared for additional regulatory requirements (e.g., IFRS9 and minimum own-funds and eligible liabilities (MREL) requirements, which will impact their balance sheets, potentially in a material way), while guarding against more risky lending strategies. Removing the maximum holding period for real estate would facilitate voluntary debt-asset swaps, which are more efficient than foreclosure and seizure of collateral. More generally, incentives provided to the property sector have benefited the real economy, the fiscal accounts and the quality of banks' assets. With construction activity still well below its previous peak, no imminent risk of a property boom is evident, although developments should be monitored.

B. Fiscal Policy

23. The recent 2017–20 Stability Program for Cyprus confirms the authorities' intention to place public debt on a downward path and to maintain sizable fiscal primary surpluses. Mainly on the assumption of a faster growth path than projected by staff, the authorities are targeting an accrual-based primary surplus of 2.6 percent of GDP for 2017 (against a 3 percent outturn in 2016), and gradually raising the target to 3 percent by 2019. The authorities project that these fiscal targets, together with sustained robust GDP growth, would decrease gross public debt by close to 20 percentage points to 88.8 percent of GDP by 2020 (against staff's projection of 94 percent of GDP).

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[8] The tax was rescinded to support recovery of the housing market and because of unclear assignment of payment responsibility given widespread failure to issue and transfer property titles.

[9] The current scheme requires a minimum own-equity investment of €2 million, held for at least three years, and purchase of a residence with a minimum price of €500,000, to be held indefinitely. While the range of eligible investments was broadened beyond real estate, much of the investment remains focused in that sector.

Staff's views

24. Expiring temporary measures and new initiatives loosened the fiscal stance during 2015–17, but are offset by cyclical and one-off revenue. These measures have a cumulative effect of 1.4 percent of GDP, and are backloaded to 2017.[10] Nonetheless, the cash-based primary surplus is expected to increase by about 0.7 percentage points this year to 3 percent of GDP on account of large one-off revenue and further cyclical gains brought by the narrowing output gap.[11,12] From 2018, with the expiration of the one-off revenue, the primary surplus is expected to fall back to around 2.5 percent of GDP, despite an already-legislated increase in pension contributions from 2019 that will raise 0.3 percentage points per year.

25. Restarting privatization, saving windfall revenue and reversing some of the recent structural loosening would safeguard the downward debt path and create precautionary headroom. Aiming to achieve net public debt—defined as gross public debt minus cash holdings—of around 75 percent of GDP by 2022 (against staff's baseline forecast of 82 percent) is appropriately prudent given current ineligibility for ECB refinancing facilities and the risk of a contingent liability shock. Restoring the frozen privatization program could reduce debt by more than 5 percent of GDP. Additional fiscal effort of about ½ percentage point—thereby reversing one-third of the recent structural easing—is warranted to accelerate debt reduction. Under staff's macroeconomic forecasts, this would bring the primary surplus to around 3.5 percent of GDP in 2017 and 3 percent of GDP during 2018–22. Any overperformance and windfall revenue should also be saved. With GDP growth largely driven by external factors, the recommended modest fiscal tightening is unlikely to materially dampen activity, and would also be appropriate from a cyclical perspective given the projected opening of a positive output gap. Room should also be made for growth-enhancing public investment, which was squeezed during the crisis. Reinstating the IPT and relying on updated property values as well as raising citizenship and residency application fees would support these goals. Guarding against fiscal slippage is also essential, including minimizing the fiscal impact of the proposed national health service, avoiding further unfunded tax cuts, and adopting the long-delayed civil service reform bill, which would provide greater assurance relative to the current collective agreement that public-sector wage growth will be permanently contained.

Authorities' views

26. The authorities remain committed to a prudent fiscal stance to reduce the elevated level of public debt. During 2017–20, a primary surplus of around 3 percent of GDP will be

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

[11] One-off revenue in 2017 derives from the sale of gas exploration rights (0.6 percent of GDP) and a boost to value-added tax from temporarily exempting property purchases from future capital gains tax.

[12] The key differences between staff's (cash-based) and the authorities' (accrual-based) forecasts for 2017 are: (i) inclusion in staff's forecast of revenue from oil exploration rights, which is assumed to be fully saved; (ii) differences in the timing of recording of one-off tax revenue and outlays for military equipment; and (iii) the authorities' more optimistic macroeconomic forecasts (which persist throughout the projection period).

targeted and windfall revenue will be used to reduce debt. The sustained revenue overperformance of recent years is expected to offset the cost of terminating the temporary wage levy and abolishing the IPT. However, adopting fiscal tightening measures would be detrimental to GDP growth and hence counterproductive for raising the primary surplus and reducing debt. Provided it is not deficit financed, sustained rapid growth is the most effective way to lower public debt. Reinstating the IPT or reducing the investment focus of citizenship and residency programs are therefore not warranted as they would weigh on growth. An economic impact review of the planned National Health Service (NHS) is underway, which will help guide policy design to ensure the NHS does not pose a risk to fiscal sustainability or competitiveness. Risks are limited from the public-sector wage bill owing to the agreement with the public-sector unions to cap the increase below nominal GDP growth (which replicates the provision in the civil service reform law currently awaiting parliamentary approval) and a proposed indefinite freeze on hiring, or from public sector pension costs in view of rising savings from previously-adopted reforms.

C. Structural Reforms

27. Progress with macro-critical structural reforms has largely stalled. Privatization of the operations of Limassol port was completed and the new operator has been in place since January 2017. Removal by parliament of funding for the privatization agency has halted most asset sales. Reorganization and consolidation of local governments is on hold, although current proposals envisage few resource savings. There is broad agreement among the main stakeholders that the court system and legal enforcement are in urgent need of improvement.

Staff's views

28. Judicial reform and opening protected sectors to greater competition are crucial to support growth and reduce NPLs. Weak legal enforcement results in slow, costly and unpredictable enforcement of commercial claims, which discourages investment and hinders productivity. A new dedicated commercial court, greater specialization of judges, moving from paper to electronic record keeping and introducing streamlined enforcement of small claims would help preserve the value of claims, enhance legal certainty and reduce costs of contract enforcement. Restarting privatization would increase competition, help modernize key sectors and reduce public debt.

Authorities' views

29. Modernization and reorganization of the courts is moving forward, but prospects for other reforms appear more limited ahead of the elections. Plans to establish a separate, dedicated commercial court are proceeding, with a bill to be submitted to parliament in 2017:Q3, which would allow the new court to be fully operational by the beginning of 2018. Preparatory work on a bill to convert the Cyprus Telecommunications Authority (CYTA) into a joint-stock company that could eventually attract a minority strategic investor, while protecting the employment status of existing workers, is underway. Unbundling of the generation and transmission capacities of the Electricity Authority of Cyprus (EAC) will enhance competition in the economy. Proposals to privatize several small assets are also being developed. However, significant progress in most areas is unlikely in the coming months.

STAFF APPRAISAL

30. Cyprus's economic recovery has gathered momentum since the exit from the Fund-supported program 15 months ago, but stock imbalances remain stubbornly high. Broad-based GDP growth strengthened in 2016, helping to raise employment, while previous improvements in price competitiveness have been maintained. In the public sector, a sizable primary fiscal surplus was achieved, supported by earlier reforms and improving cyclical conditions. In the banking sector, emergency liquidity support has been repaid, deposits are returning, and restructuring of nonperforming loans has gained momentum. Nonetheless, these achievements have not yet resulted in significant reductions in very high private sector debt, nonperforming loans and general government liabilities.

31. The recovery is forecast to continue, alongside repair of private sector balance sheets. Over the medium term, activity is expected to remain broad-based, supported by robust foreign demand and external financing. However, the pace of growth is projected to slow as servicing of existing private debt picks up and depleted savings are restored, thus diverting some resources from spending, but which would help sustain longer-term growth.

32. Capacity to repay the Fund is expected to be satisfactory under the baseline scenario, but downside risks remain. Medium-term projections of moderate GDP growth and sizable fiscal primary surpluses, together with the back-loaded repayment profile of official public debt, the sovereign's ready access to market funding on good terms and scope to further smooth public debt redemptions underpin the assessment of a satisfactory repayment capacity. Hydrocarbon reserves represent an important upside potential for repayment capacity through faster growth and windfall fiscal revenue. Conversely, ability to repay would be weakened in the event of a new boom-bust growth cycle, erosion of fiscal discipline or materialization of risks in banks' balance sheets.

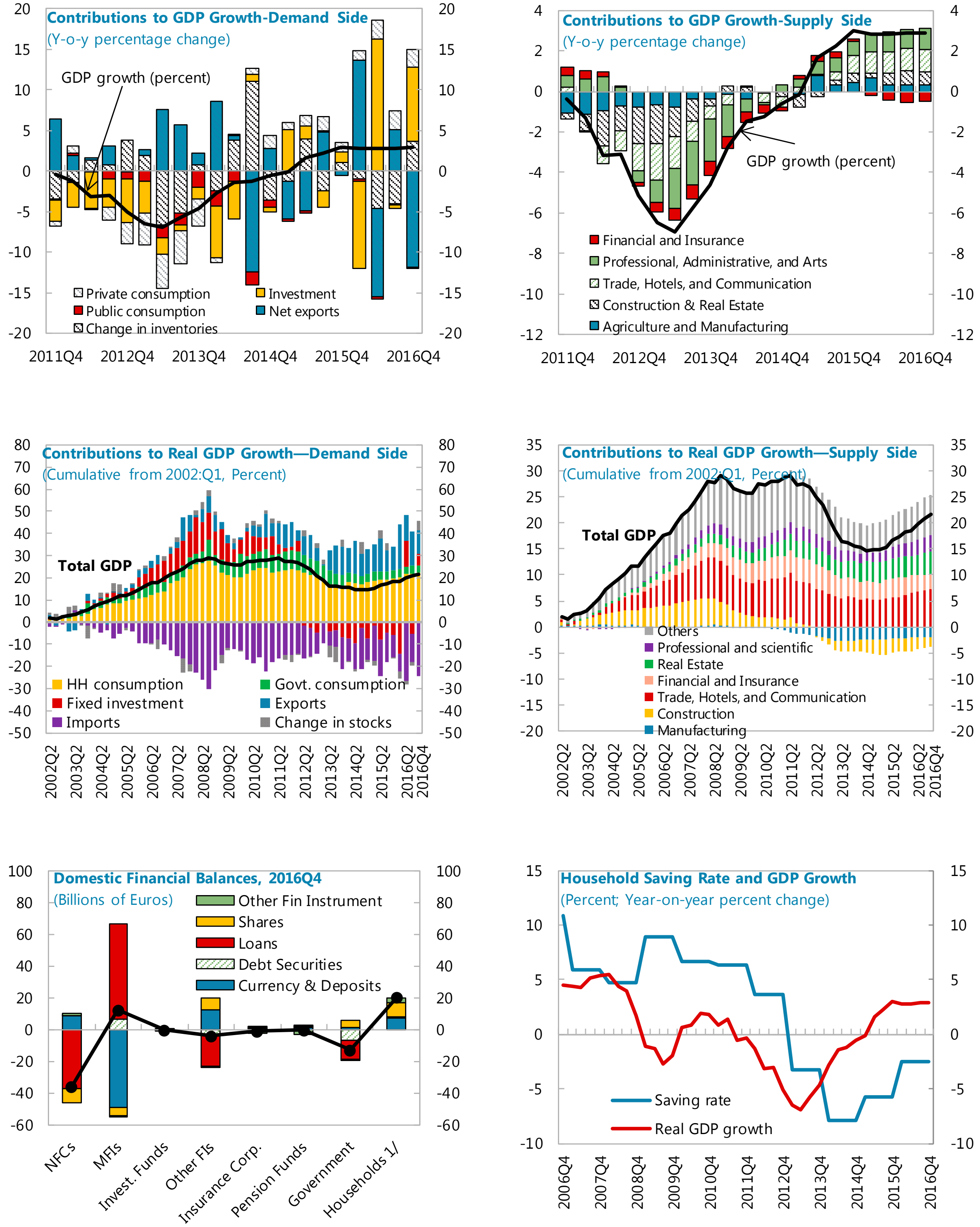
33. To reinforce capacity to repay against downside shocks, ambitious policies are warranted to front load reductions of private and public debt. This would help rebuild policy buffers, cement confidence in macroeconomic fundamentals and policy commitments, and reduce the potential for a renewed banking-sovereign nexus. While engineering faster near-term growth could deliver a quicker upfront decrease in debt, the benefits may not be lasting if growth were to subsequently reverse.

34. Accelerating public debt reduction would create precautionary headroom and insulate the downward path of debt from potential shocks. Rolling back part of the recent sizable structural loosening, saving overperformance and windfall revenue, and restarting stalled privatizations would reduce net public debt to an appropriately-prudent 75 percent of GDP by 2022. Raising spending on growth-enhancing public investment, preventing expenditure slippages and avoiding further unfunded tax cuts will also be essential to bring down debt.

35. More decisive reductions in nonperforming loans and private sector leverage are needed. This would improve the efficiency of credit allocation, reduce debt to sustainable levels, limit competition from other financial intermediaries unencumbered by weak assets and protect the adequacy of banks' capital positions. Moreover, waiting for the economy to grow out of excessive debt is unlikely to be successful as it entrenches a culture of strategic default. Instead, banks should rely on durable loan workouts for viable debtors, including write-downs, and greater recourse to third-party debt servicers. Operational and legal tools should also be refined to facilitate loan restructuring, including by streamlining court procedures and ensuring that regulations encourage timely recognition of losses.

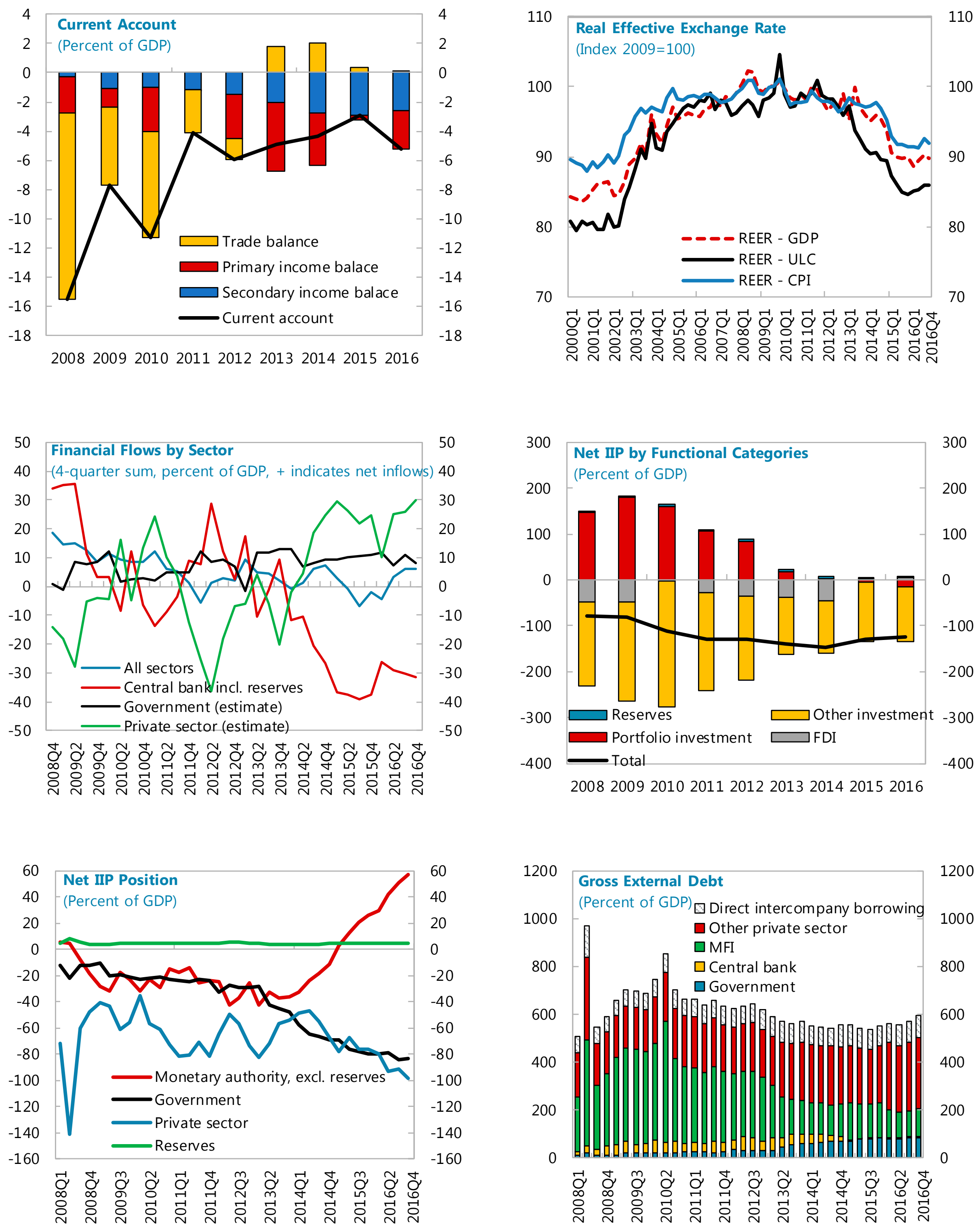
36. Macro-critical structural reforms should be restarted. The focus should be on strengthening legal enforcement of commercial claims and speeding up court procedures, reviving the privatization program and streamlining business procedures.

Figure 1. Cyprus: Macroeconomic Performance



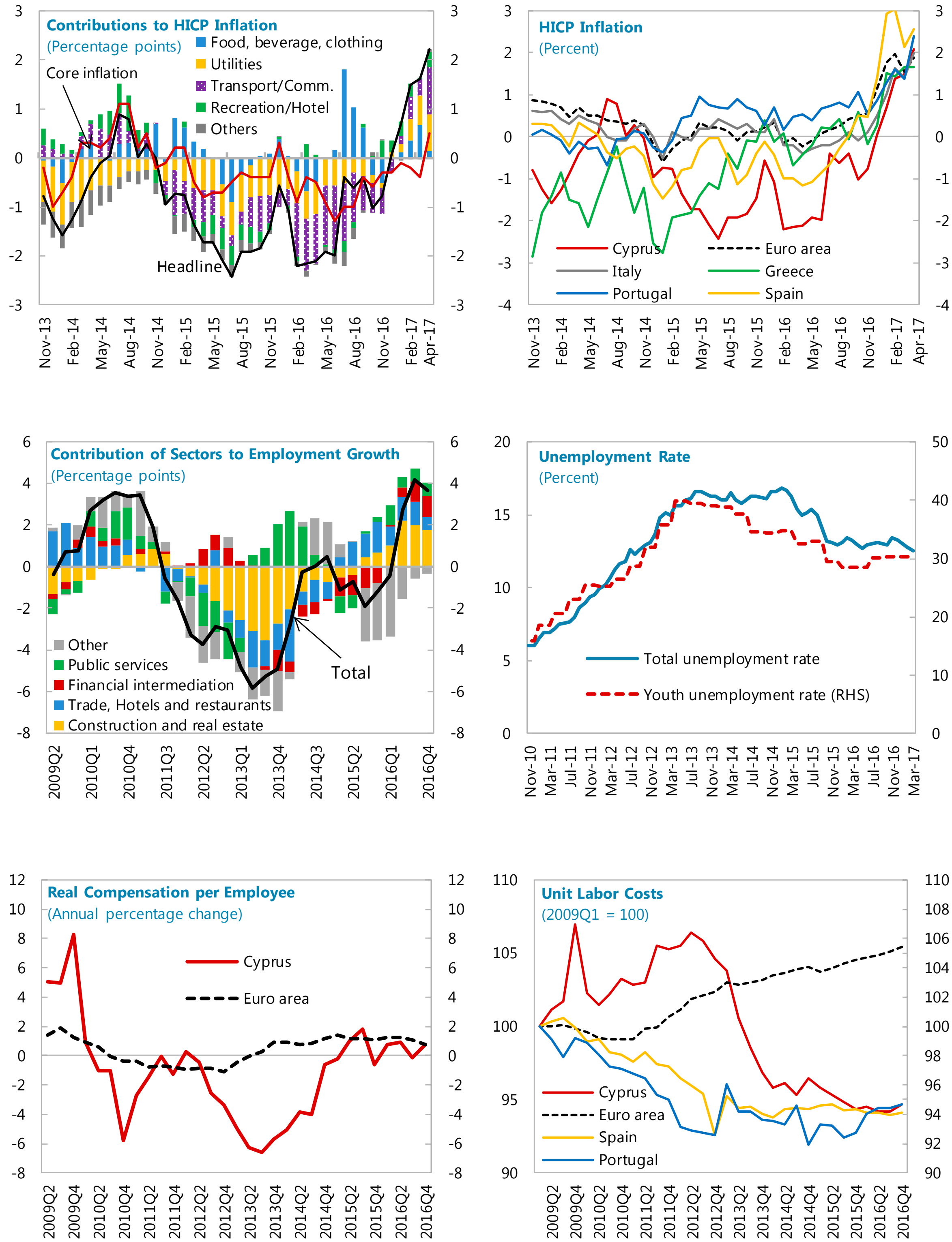
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Loans are included in currency & deposits.

Figure 2. Cyprus: External Indicators



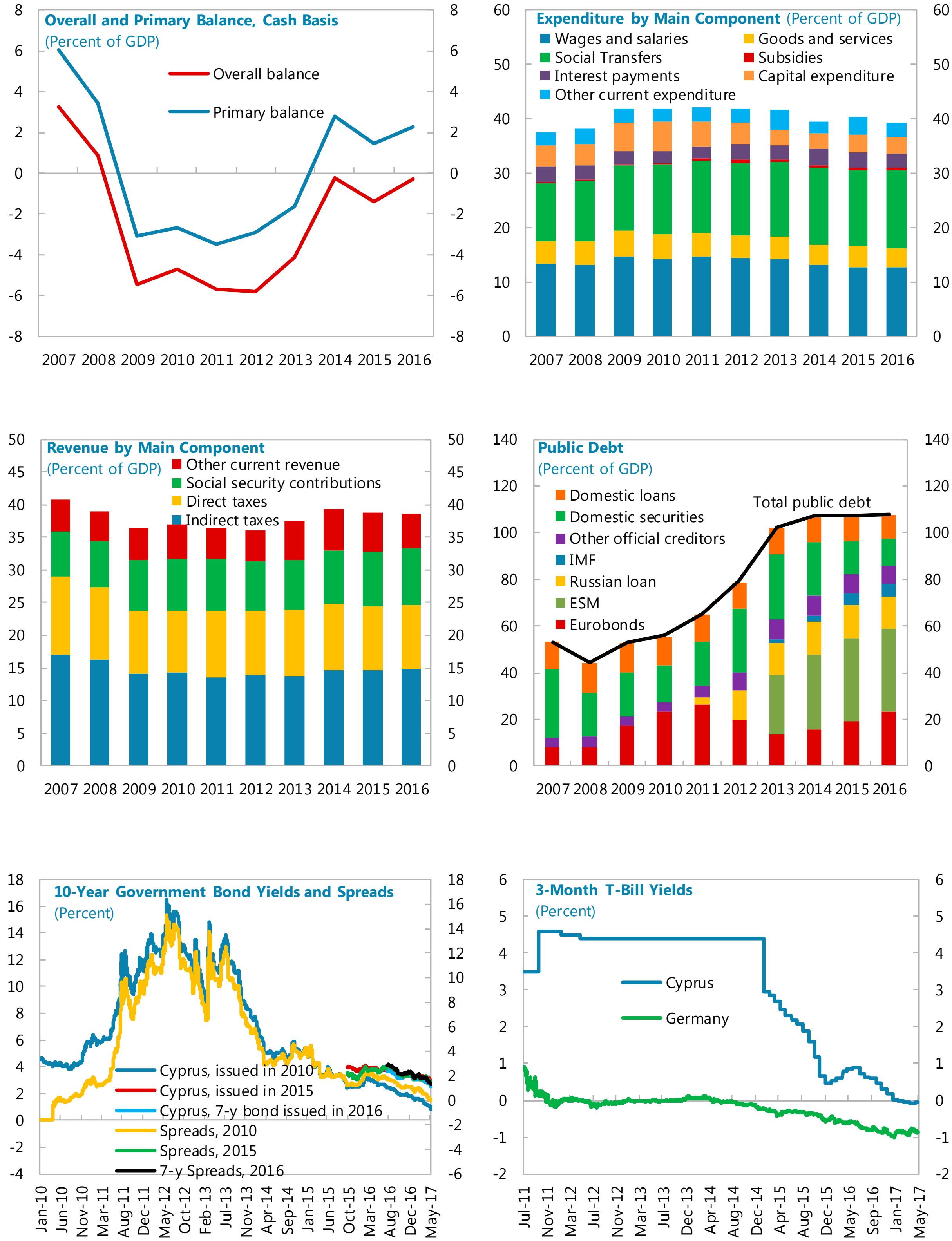
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 3. Cyprus: Inflation and Labor Market



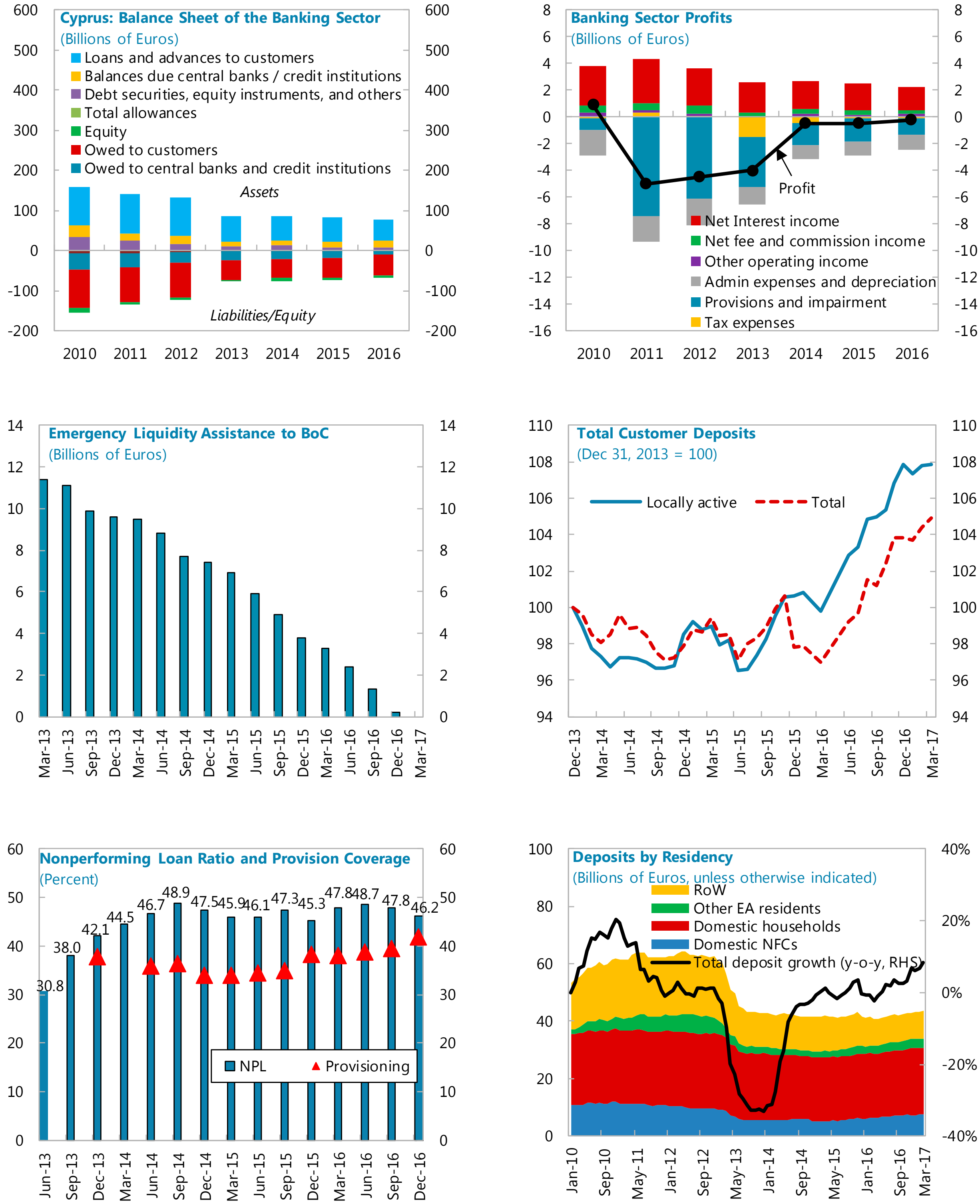
Sources: Cystat; ECB; Eurostat; and IMF staff estimates.

Figure 4. Cyprus: Fiscal Developments



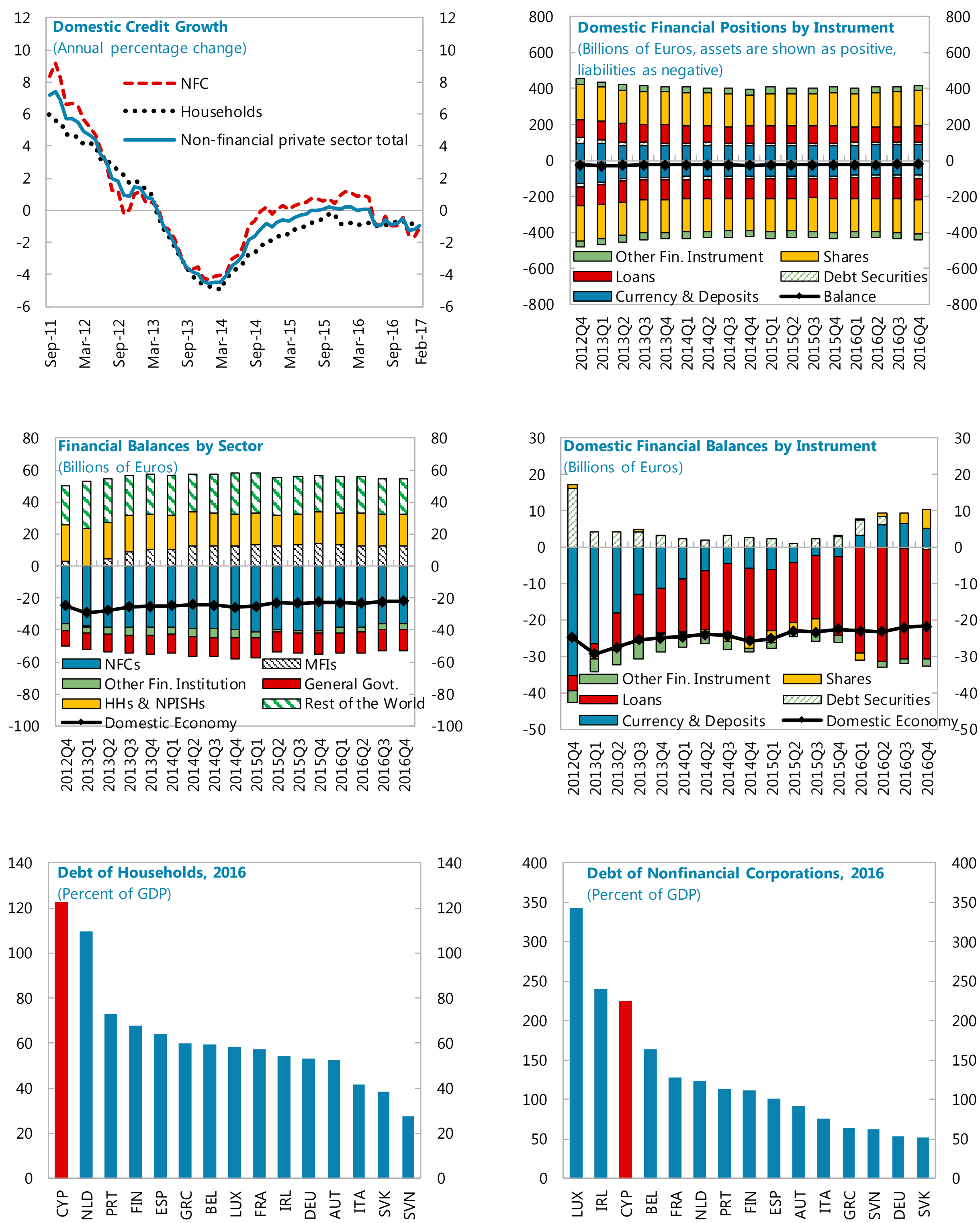
Sources: Bloomberg; Central Bank of Cyprus; and IMF staff estimates.

Figure 5. Cyprus: Banking Sector



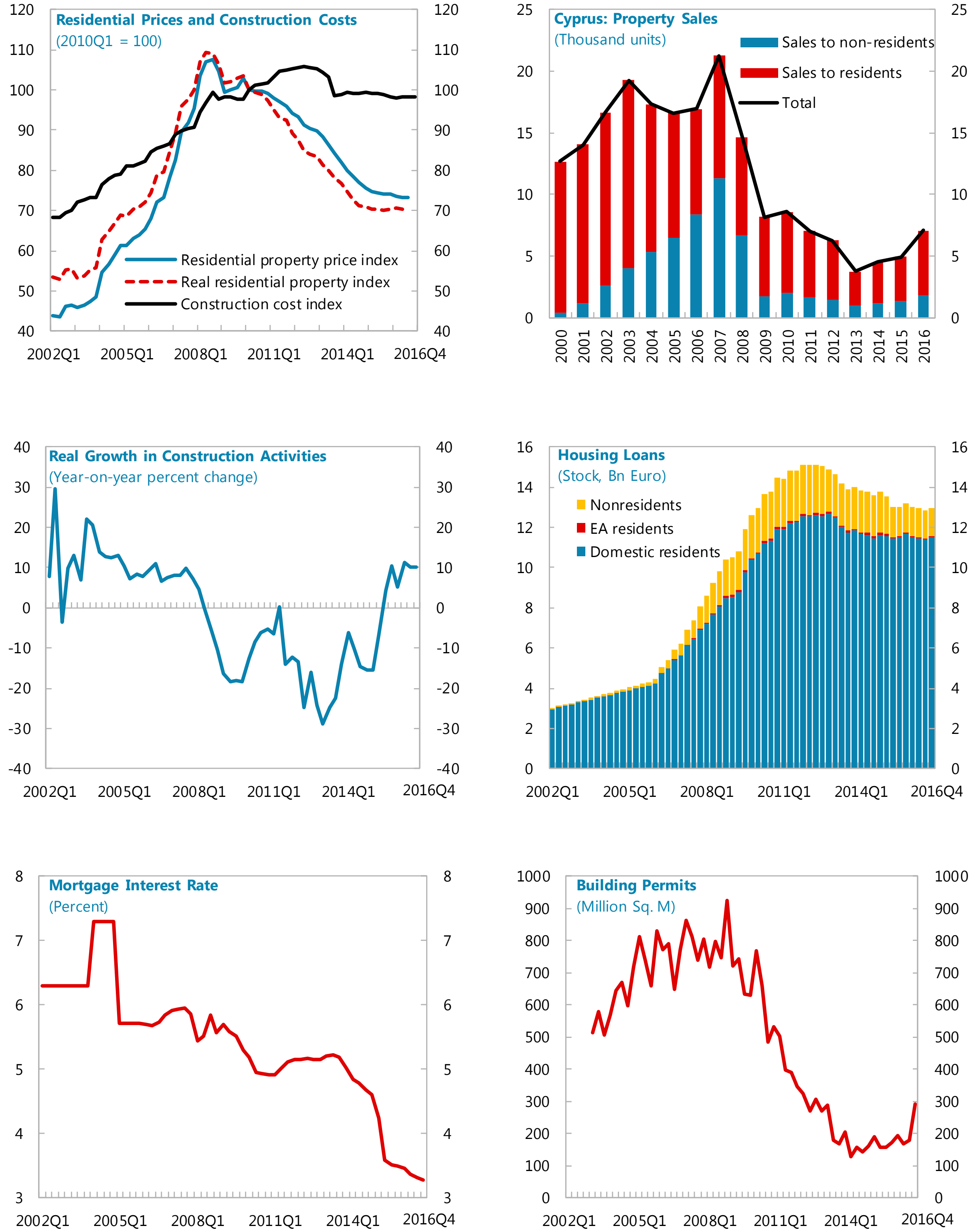
Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff estimates.
Notes: At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 6. Cyprus: Credit and Balance Sheets



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

Figure 7. Cyprus: Housing Market



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

Table 1. Cyprus: Selected Economic Indicators, 2014–22

	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections			
Real Economy				(Percent change, unless otherwise indicated)					
Real GDP	-1.5	1.7	2.8	2.7	2.5	2.2	2.1	2.1	2.1
Domestic demand	-1.5	3.0	3.9	1.4	3.9	2.4	2.1	2.2	2.2
Consumption	-1.2	1.4	2.0	2.0	1.8	1.7	1.8	1.8	1.8
Private consumption	0.7	1.9	2.9	2.3	1.7	1.7	1.8	1.8	1.8
Public consumption	-7.9	-0.6	-1.4	1.0	2.0	1.9	2.0	2.0	2.0
Fixed investment	-17.5	12.0	26.0	-4.5	15.0	5.5	3.6	3.7	3.7
Inventory accumulation 1/	2.2	0.3	-1.5	0.4	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-0.1	-1.3	-1.0	1.4	-1.4	-0.2	0.0	0.0	0.0
Exports of goods and services	4.2	0.0	3.6	2.2	5.0	2.7	2.7	2.7	2.7
Imports of goods and services	4.6	2.1	5.3	0.0	7.4	2.9	2.7	2.7	2.7
Potential GDP growth	0.2	0.4	0.7	1.0	1.3	1.5	1.7	1.9	1.9
Output gap (percent of potential GDP)	-6.6	-5.4	-3.4	-1.8	-0.7	0.0	0.4	0.6	0.8
HICP (period average)	-0.3	-1.5	-1.2	1.5	1.4	1.6	1.8	1.9	2.0
HICP (end of period)	-0.9	-0.6	0.0	1.5	1.4	1.6	1.8	1.9	1.9
Unemployment rate (EU standard, percent)	16.2	14.9	13.3	11.8	10.7	10.0	9.3	8.6	7.8
Employment growth (percent)	-0.6	-1.3	1.9	1.9	1.8	1.5	1.4	1.3	1.2
Public Finance				(Percent of GDP)					
General government balance	-0.2	-1.4	-0.3	0.6	-0.2	-0.1	0.0	-0.1	-0.3
Revenue	39.3	38.9	38.8	39.2	38.2	38.1	37.9	37.8	37.7
Expenditure	39.5	40.3	39.1	38.5	38.4	38.2	38.0	37.9	38.0
Primary Fiscal Balance	2.8	1.4	2.3	3.0	2.3	2.5	2.5	2.4	2.4
General government debt	107.1	107.5	107.8	106.8	105.1	98.7	94.2	91.7	86.9
Balance of Payments 2/				(Percent of GDP)					
Current account balance	-4.3	-2.9	-5.3	-3.2	-3.5	-3.2	-2.9	-2.8	-2.6
Trade Balance (goods and services)	2.1	0.3	0.0	1.2	1.0	1.1	1.3	1.4	1.6
Exports of goods and services	62.2	61.2	63.2	64.6	64.8	64.8	65.2	65.6	66.1
Imports of goods and services	60.1	60.9	63.2	63.4	63.8	63.7	63.9	64.2	64.4
Goods balance	-16.0	-18.0	-21.5	-20.5	-20.9	-20.8	-20.7	-20.6	-20.5
Services balance	18.1	18.3	21.5	21.7	21.9	21.8	21.9	22.0	22.1
Primary income, net	-3.6	-0.4	-2.7	-2.1	-2.3	-2.2	-2.1	-2.1	-2.1
Secondary income, net	-2.8	-2.9	-2.6	-2.3	-2.2	-2.1	-2.1	-2.1	-2.1
Capital account, net	0.8	0.3	0.2	0.5	0.5	0.5	0.4	0.3	0.3
Financial account, net	-7.1	2.0	-5.9	-2.7	-3.0	-2.7	-2.5	-2.5	-2.3
Direct investment	-8.0	48.4	5.8	-2.2	-2.2	-2.2	-2.2	-2.2	-2.3
Portfolio investment	-17.7	-11.7	-22.3	-3.3	-6.1	-3.0	-2.7	-5.5	-1.0
Other investment and financial derivatives	18.5	-34.6	10.8	2.8	5.3	2.5	2.4	5.3	1.0
Reserves (+ inflow; - outflow)	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Program financing	7.2	5.7	0.7	0.0	-0.3	-0.5	-0.8	-0.8	-0.7
Errors and omissions	-3.6	4.7	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Savings-Investment Balance									
National saving	7.4	10.4	11.5	12.4	14.2	15.1	15.7	16.2	16.7
Government	2.7	1.9	2.8	3.8	3.2	3.3	3.4	3.5	3.4
Non-government	4.7	8.5	8.7	8.6	11.1	11.8	12.3	12.7	13.3
Gross capital formation	11.7	13.3	16.8	15.6	17.7	18.3	18.7	19.0	19.3
Government	2.9	3.3	3.1	3.1	3.3	3.4	3.5	3.6	3.7
Private	8.8	10.0	13.7	12.5	14.4	14.9	15.2	15.4	15.6
Foreign saving	-4.3	-2.9	-5.3	-3.2	-3.5	-3.2	-2.9	-2.8	-2.6
Memorandum Item:									
Nominal GDP (billions of euros)	17.6	17.6	17.9	18.4	19.1	19.9	20.6	21.4	22.3

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

1/ Contribution to growth.

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

Table 2. Cyprus: Fiscal Developments and Projections, 2013–22 1/

(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
Revenue	37.5	39.3	38.9	38.8	39.2	38.2	38.1	37.9	37.8	37.7
Current revenue	37.5	39.3	38.8	38.6	38.9	38.0	37.9	37.7	37.6	37.5
Tax revenue	24.0	24.7	24.4	24.7	24.7	24.3	24.2	24.2	24.2	24.2
Indirect taxes	13.7	14.6	14.7	14.9	15.2	14.9	14.8	14.8	14.7	14.7
Direct taxes	10.3	10.1	9.7	9.8	9.4	9.4	9.4	9.4	9.4	9.4
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	7.6	8.2	8.4	8.5	8.58	8.5	8.8	8.8	8.7	8.6
Other current revenue	5.9	6.3	6.0	5.3	5.7	5.1	4.8	4.8	4.8	4.7
Capital revenue	0.0	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Expenditure	41.6	39.5	40.3	39.1	38.5	38.4	38.2	38.0	37.9	38.0
Current expenditure	38.7	36.6	37.0	36.1	35.4	35.0	34.8	34.5	34.3	34.3
Wages and salaries	14.2	13.1	12.6	12.6	12.7	12.5	12.4	12.4	12.4	12.4
Goods and services	4.2	3.7	3.9	3.6	3.5	3.5	3.4	3.3	3.3	3.2
Social Transfers	13.7	14.1	14.0	14.3	14.1	13.9	13.7	13.6	13.5	13.4
Subsidies	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Interest payments	2.5	3.0	2.8	2.6	2.4	2.5	2.6	2.5	2.5	2.7
Other current expenditure	3.6	2.2	3.3	2.4	2.1	2.1	2.1	2.1	2.1	2.1
Capital expenditure 2/	2.9	2.9	3.3	3.1	3.13	3.3	3.4	3.5	3.6	3.7
Overall balance 3/	-4.1	-0.2	-1.4	-0.3	0.6	-0.2	-0.1	0.0	-0.1	-0.3
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-4.1	-0.2	-1.3	-0.3	0.6	-0.2	-0.1	0.0	-0.1	-0.3
Net financial transactions	-4.5	-0.2	-1.3	-0.3	0.6	-0.2	-0.1	0.0	-0.1	-0.3
Net acquisition of financial assets	13.0	1.9	-1.0	-0.4	2.7	2.0	-2.4	-1.0	0.9	-1.6
Currency and deposits 4/	4.3	2.1	-1.1	-0.4	2.7	2.0	-2.4	-1.0	0.9	-1.6
Securities other than shares 4/	8.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	17.5	2.1	0.3	-0.1	2.1	2.1	-2.3	-0.9	1.0	-1.3
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-8.5	-4.6	-4.8	0.3	2.5	6.0	2.0	3.6	5.4	0.1
Loans	25.9	6.7	5.1	-0.3	-0.4	-3.9	-4.3	-4.5	-4.4	-1.4
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Output Gap	-5.0	-6.6	-5.4	-3.4	-1.8	-0.7	0.0	0.4	0.6	0.8
Primary balance 5/	-1.6	2.8	1.4	2.3	3.0	2.3	2.5	2.5	2.4	2.4
Primary balance (ESA2010) 5/ 6/	-2.8	2.6	2.7	3.0	2.8	2.3	2.5	2.5	2.4	2.4
Overall balance (ESA2010) 3/ 6/	-4.9	-0.2	-0.1	0.4	0.4	-0.2	-0.1	0.0	-0.1	-0.3
Cyclically adjusted primary balance	-0.4	4.5	3.0	3.3	3.6	2.5	2.5	2.4	2.2	2.1
Structural primary balance	0.7	4.4	4.4	3.4	2.9	2.5	2.5	2.4	2.2	2.1
Public debt	102.2	107.1	107.5	107.8	106.8	105.1	98.7	94.2	91.7	86.9
Public debt net of cash holding	98.0	101.3	103.7	102.2	98.7	95.3	91.7	88.4	85.3	82.4

Sources: Eurostat; and IMF staff estimates.

1/ Historical fiscal statistics and projections are reported on a cash basis; unless otherwise noted.

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

3/ The overall balances in 2014 and 2015 exclude recapitalizations of the cooperative sector of 1.5 and 0.175 billion euros respectively.

4/ The draw down of ESM bonds and the cash drawdown used to recapitalize the cooperative sector in 2014 and 2015 respectively are excluded from these lines consistent with the exclusion of the recapitalization operations of the cooperative sector in the overall and primary balance.

5/ The primary fiscal balances in 2014 and 2015 exclude recapitalizations of the cooperative sector of 1.5 and 0.175 billion euros respectively.

6/ On an accrual basis.

Table 3. Cyprus: General Government Gross Financing Requirements and Sources of Financing, 2017–22

(Millions of euros)

	2017	2018	2019	2020	2021	2022
			Projections			
Gross borrowing needs	637	1,276	2,162	1,970	1,587	2,189
Overall deficit	-115	34	17	10	23	68
Primary surplus	-562	-449	-503	-513	-521	-527
Interest payments	447	483	520	522	543	595
Amortization	752	1,241	2,145	1,961	1,564	2,121
Medium- and long-term	444	886	1,742	1,504	1,088	1,661
Foreign: of which	56	685	1,257	1,317	676	1,067
Russia	0	625	625	625	625	0
Domestic	388	201	485	187	413	595
Shor-term	300	300	300	300	300	300
EU and IMF	8	55	102	157	175	160
Gross financing sources	637	1,276	2,162	1,970	1,587	2,189
Privatization receipts	0	0	0	0	0	0
Market access	1,140	1,650	1,690	1,770	1,770	1,825
Medium- and long-term	840	1,350	1,390	1,470	1,470	1,525
Foreign	570	1,080	1,020	1,000	1,000	1,000
Domestic	270	270	370	470	470	525
Short-term	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0
Use of deposits 1/	-503	-374	472	200	-183	364
Net placement	388	409	-455	-191	206	-296
Medium and Long Term Debt	396	464	-352	-34	382	-136
Domestic Securities	-36	152	-30	370	147	22
Eurobonds	500	1,000	434	364	1,000	0
Domestic Loans	-82	-84	-85	-87	-89	-91
Foreign Loans	14	-605	-671	-681	-676	-67
Short term (Net increase)	0	0	0	0	0	0
EU and IMF	-8	-55	-102	-157	-175	-160
Memorandum item:						
Cash holding (eop)	1,497	1,872	1,400	1,200	1,383	1,019
General government debt (eop)	19,687	20,095	19,641	19,450	19,656	19,360
General government debt (eop, percent of GDP)	106.8	105.1	98.7	94.2	91.7	86.9
General government net debt (eop, percent of GDP)	98.7	95.3	91.7	88.4	85.3	82.4

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

2/ General government debt minus cash holding.

Table 4. Cyprus: Balance of Payments, 2013–22 1/

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
					(Millions of Euros)					
Current Account Balance	-896	-761	-514	-942	-595	-667	-642	-603	-601	-578
Trade Balance (Goods and Services)	330	361	59	0	213	192	212	262	304	361
Goods Balance	-2,939	-2,812	-3,167	-3,846	-3,785	-3,988	-4,130	-4,264	-4,413	-4,565
Exports	2,714	2,808	2,482	2,440	2,557	2,660	2,771	2,879	3,005	3,140
Imports	5,653	5,619	5,649	6,286	6,342	6,648	6,901	7,143	7,419	7,704
Services Balance	3,269	3,172	3,226	3,847	3,998	4,180	4,343	4,526	4,717	4,925
Exports	7,924	8,118	8,316	8,868	9,352	9,728	10,124	10,570	11,056	11,574
Imports	4,655	4,946	5,089	5,021	5,354	5,547	5,782	6,044	6,339	6,648
Primary Income	-851	-637	-62	-483	-386	-442	-433	-429	-451	-465
Secondary Income	-375	-484	-511	-460	-421	-417	-420	-437	-454	-473
Capital Account	255	147	49	37	95	97	107	83	72	76
Financial Account	-343	-1,251	356	-1,060	-500	-570	-534	-521	-529	-502
Direct Investment	-304	-1,397	8,528	1,037	-408	-425	-442	-461	-482	-504
Portfolio Investment	-12,695	-3,111	-2,066	-4,001	-603	-1,157	-595	-558	-1,173	-214
Financial Derivatives	-49	285	-877	345	35	35	35	35	35	35
Other Investment	12,741	2,966	-5,224	1,582	477	977	468	464	1,091	181
Reserves (+ inflows, - outflows)	-36	6	-5	-23	0	0	0	0	0	0
Errors and Omission	298	-637	820	-155	0	0	0	0	0	0
Program Financing	4,838	1,267	1,010	125	-8	-55	-102	-157	-175	-160
					(Percent of GDP)					
Current Account Balance	-4.9	-4.3	-2.9	-5.3	-3.2	-3.5	-3.2	-2.9	-2.8	-2.6
Trade Balance (Goods and Services)	1.8	2.1	0.3	0.0	1.2	1.0	1.1	1.3	1.4	1.6
Goods Balance	-16.2	-16.0	-18.0	-21.5	-20.5	-20.9	-20.8	-20.7	-20.6	-20.5
Exports	15.0	16.0	14.1	13.6	13.9	13.9	13.9	13.9	14.0	14.1
Imports	31.2	32.0	32.0	35.1	34.4	34.8	34.7	34.6	34.6	34.6
Services Balance	18.0	18.1	18.3	21.5	21.7	21.9	21.8	21.9	22.0	22.1
Exports	43.7	46.2	47.1	49.5	50.7	50.9	50.9	51.2	51.6	52.0
Imports	25.7	28.2	28.9	28.0	29.0	29.0	29.1	29.3	29.6	29.9
Primary Income	-4.7	-3.6	-0.4	-2.7	-2.1	-2.3	-2.2	-2.1	-2.1	-2.1
Secondary Income	-2.1	-2.8	-2.9	-2.6	-2.3	-2.2	-2.1	-2.1	-2.1	-2.1
Capital Account	1.4	0.8	0.3	0.2	0.5	0.5	0.5	0.4	0.3	0.3
Financial Account	-1.9	-7.1	2.0	-5.9	-2.7	-3.0	-2.7	-2.5	-2.5	-2.3
Direct Investment	-1.7	-8.0	48.4	5.8	-2.2	-2.2	-2.2	-2.2	-2.2	-2.3
Portfolio Investment	-70.1	-17.7	-11.7	-22.3	-3.3	-6.1	-3.0	-2.7	-5.5	-1.0
Financial Derivatives	-0.3	1.6	-5.0	1.9	0.2	0.2	0.2	0.2	0.2	0.2
Other Investment	70.3	16.9	-29.6	8.8	2.6	5.1	2.4	2.2	5.1	0.8
Reserves (+ inflows, - outflows)	-0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	1.6	-3.6	4.7	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Memo: Program Financing	26.7	7.2	5.7	0.7	0.0	-0.3	-0.5	-0.8	-0.8	-0.7

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

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

Table 5. Cyprus: External Financing Requirements and Sources, 2013–22 1/
(Millions of euros)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
GROSS FINANCING REQUIREMENTS	**70,884**	**52,200**	**45,211**	**46,306**	**46,470**	**48,366**	**50,388**	**52,068**	**52,979**	**54,790**
Current account deficit ("-" = CA surplus)	896	761	514	942	595	667	642	603	601	578
Medium- and long-term debt amortization	9,880	7,628	8,011	6,251	7,660	8,348	9,061	9,305	8,799	9,188
Public sector	1,458	678	1,339	232	208	840	1,484	1,651	1,073	1,387
Banks	4,089	1,392	1,146	887	773	779	785	793	800	808
Other private	4,333	5,557	5,527	5,133	6,679	6,729	6,791	6,861	6,926	6,993
Short-term debt amortization	60,108	43,812	36,686	39,113	38,208	39,297	40,584	42,003	43,403	44,865
Public sector	7,653	7,504	2,874	222	193	151	131	114	99	86
Central Bank	7,650	7,504	2,874	201	174	151	131	114	99	86
General government and SOEs	3	0	0	20	18	0	0	0	0	0
Banks	35,384	19,265	19,593	22,496	18,054	18,587	19,137	19,704	20,287	20,889
Other private	17,071	17,042	14,219	16,396	19,962	20,558	21,315	22,185	23,017	23,891
EU and IMF	0	0	0	0	8	55	102	157	175	160
SOURCES OF FINANCING	**66,046**	**50,933**	**44,201**	**46,181**	**46,470**	**48,366**	**50,388**	**52,068**	**52,979**	**54,790**
Capital account (net)	255	147	49	37	95	97	107	83	72	76
Foreign direct investment (net)	304	1,397	-8,528	-1,037	408	425	442	461	482	504
CYP investment abroad	-4,840	-1,789	15,759	5,520	5,813	6,047	6,295	6,565	6,864	7,182
Foreign investment in CYP	-4,536	-392	7,230	4,483	6,221	6,471	6,737	7,026	7,346	7,687
New borrowing and debt rollover	47,594	43,403	44,821	52,610	47,592	49,511	50,980	52,410	53,953	55,596
Medium and long-term borrowing	3,782	6,718	5,729	14,420	8,295	8,927	8,977	9,008	9,088	9,180
General government	26	910	2,062	1,125	570	1,080	1,020	1,000	1,000	1,000
Banks	-6,696	404	109	433	795	806	816	822	830	838
Other private	10,453	5,404	3,558	12,862	6,930	7,041	7,141	7,186	7,259	7,342
Short-term borrowing	43,811	36,686	39,093	38,190	39,297	40,584	42,003	43,403	44,865	46,416
Public sector	7,504	2,874	201	174	151	131	114	99	86	74
Central Bank	7,504	2,874	201	174	151	131	114	99	86	74
General government	0	0	0	0	0	0	0	0	0	0
Banks	19,265	19,593	22,496	18,054	18,587	19,137	19,704	20,287	20,889	21,509
Other private	17,042	14,219	16,396	19,962	20,558	21,315	22,185	23,017	23,891	24,833
Other	17,894	5,985	7,859	-5,429	-1,625	-1,666	-1,141	-886	-1,529	-1,386
Of which: Net errors and omissions	298	-637	820	-155	0	0	0	0	0	0
FINANCING GAP	**4,838**	**1,267**	**1,010**	**125**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	4,585	1,100	600	0	0	0	0	0	0	0
IMF	253	167	410	125	0	0	0	0	0	0
ROLLOVER RATES										
General government 1/	2%	134%	154%	447%	252%	129%	69%	61%	93%	72%
Central bank	98%	38%	7%	87%	87%	87%	87%	87%	87%	87%
Private	66%	92%	105%	114%	103%	104%	104%	104%	104%	104%
Banks	32%	97%	109%	79%	103%	103%	103%	103%	103%	103%
Non-financial corporates	128%	87%	101%	152%	103%	104%	104%	104%	104%	104%

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.
1/ External statistics were revised in line with the BPM6 methodology.

Table 6. Cyprus: Monetary Indicators, 2010–16
(Billions of euros, unless otherwise indicated, end of period)

	2010	2011	2012	2013	2014	2015	2016
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)							
Assets	135.0	131.4	128.1	90.3	91.1	91.0	86.4
Claims on Central Bank of Cyprus	2.3	2.9	3.9	2.7	4.2	7.2	9.0
Claims on Cypriot resident other MFIs	5.6	5.0	4.6	3.3	4.1	4.5	5.5
Claims on Cypriot resident non MFIs	54.0	58.2	60.6	55.0	53.5	54.1	48.0
General government	4.5	5.3	6.5	5.4	4.5	3.4	3.3
Private sector excluding brass plates 1/	46.5	48.6	49.3	46.5	45.2	44.5	41.9
Households	22.5	23.5	23.9	22.3	21.9	21.5	20.8
Non-financial corporations	23.3	24.1	24.4	23.4	21.8	21.9	19.9
Non-bank financial intermediaries	0.7	1.0	1.0	0.8	1.6	1.1	1.2
Brass plates	3.0	4.4	4.8	3.1	3.7	6.2	2.9
Claims on non-residents	69.3	61.3	55.9	25.3	25.6	21.6	19.1
Other assets	3.8	3.9	3.2	3.9	3.8	3.6	4.7
Liabilities	135.0	131.6	128.1	90.3	92.3	91.9	87.7
Liabilities to the Central Bank of Cyprus and Eurosystem	5.5	5.5	9.8	11.2	8.5	4.7	0.9
Liabilities to Cypriot resident other MFI	5.5	4.9	4.5	3.1	3.6	4.2	5.1
Deposits of Cypriot resident non MFIs	45.4	43.7	43.3	33.0	32.3	32.9	36.5
General government	0.5	0.5	0.5	0.4	0.5	0.5	1.0
Private sector excluding brass plates	36.8	37.4	37.5	29.9	29.3	29.9	32.4
Households	25.4	26.0	26.4	23.3	22.3	22.4	23.1
Non-financial corporations	6.7	6.7	5.7	3.9	3.8	4.6	5.7
Non-bank financial intermediaries	4.7	4.6	5.4	2.7	3.2	2.9	3.5
Brass plates	8.1	5.8	5.3	2.6	2.5	2.4	3.2
Deposits of non-residents	60.6	56.5	51.3	24.5	25.2	26.4	22.3
Debt securities	2.4	2.6	1.7	0.5	0.4	0.7	0.3
Capital and reserves	12.8	11.3	15.1	16.4	20.8	21.7	21.4
Other liabilities	2.8	7.1	2.4	1.6	1.5	1.3	1.3
Money and Credit							
General government sector credit, net 2/	5.2	5.3	7.2	5.5	4.3	3.6	2.9
Private sector credit excluding brass plates	46.5	48.6	49.3	46.5	45.3	45.1	42.6
Brass plates credit	3.0	4.4	4.8	3.1	3.7	6.2	2.9
Other items, net	-12.3	-11.8	-15.6	-15.1	-18.2	-19.1	-16.4
Cypriot resident broad money (M2)	46.6	45.0	44.6	34.5	34.1	35.0	38.1
Cypriot resident narrow money (M1)	10.6	11.1	11.5	10.4	11.4	12.8	15.1
				(Percent of GDP)			
General government sector credit, net	27.1	26.6	36.8	30.5	24.4	20.7	16.4
Private sector credit excluding brass plates	241.0	246.6	253.1	256.8	257.7	255.8	237.2
Brass plates credit	15.7	22.1	24.6	17.0	21.0	35.0	16.3
Cypriot resident broad money (M2)	241.2	228.0	229.3	190.2	194.1	198.2	212.1
Cypriot resident narrow money (M1)	55.2	56.4	59.0	57.4	65.1	72.8	83.9
				(Annual percentage change)			
General government sector credit, net	-1.6	0.4	36.2	-22.9	-22.2	-15.1	-19.4
Private sector credit excluding brass plates	8.8	4.6	1.3	-5.6	-2.7	-0.3	-5.6
Brass plates credit	2.3	44.0	9.9	-35.6	19.9	66.8	-52.7
Cypriot resident broad money (M2)	10.4	-3.4	-0.8	-22.8	-1.1	2.5	8.9
Cypriot resident narrow money (M1)	2.3	4.4	3.2	-9.4	10.0	12.3	17.2
Memorandum items:							
Deposits from Cypriot private sector excluding brass plates (y-o-y percent change)	6.5	1.7	0.3	-20.2	-2.0	2.1	8.1
Brass plates deposits (y-o-y percent change)	33.8	-28.3	-9.4	-50.3	-5.3	-1.8	31.3

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/ Includes CBC's net claims on general government.

Table 7. Cyprus: Financial Soundness Indicators, 2010–16 1/

(Percent, unless otherwise specified)

	2010	2011	2012	2013	2014	2015	2016:Q1	2016:Q4
Capital Adequacy								
Regulatory Capital ratio	12.4	12.1	7.3	14.0	15.4	16.5	16.3	...
Tier I capital ratio	10.9	11.0	6.3	12.8	14.6	15.9	15.8	...
Risk weighted assets (billions of euro)	80.3	51.7	71.0	45.0	45.6	40.5	40.3	...
Asset Quality								
Non-performing loans to total gross loans 2/	5.8	10.0	18.4	38.6	45.0	47.7	47.0	46.1
Non-performing loans to total gross loans (local operations) 3/	12.4	16.2	25.5	46.2	56.1	57.6	57.1	...
Provisions to nonperforming loans	45.3	41.8	38.7	29.6	31.1	37.2	36.5	...
Restructured loans classified as NPLs to total NPLs (Source: CBC)				22.9	33.9	40.1	41.2	40.8
Earnings and Profitability								
Return on assets 4/	0.6	-3.9	-3.7	-2.9	0.1	-0.8	0.7	...
Return on equity 4/	12.0	-59.4	-62.3	-39.8	0.8	-7.5	7.0	...
Interest margin to gross income ratio	74.3	83.7	76.8	82.7	78.3	76.4	82.0	...
Liquidity								
Liquid assets to total assets	29.1	22.3	19.6	18.6	15.5	25.3	24.9	...
Customer deposits to total (non-interbank) loans	94.5	81.7	81.5	69.9	73.6	83.6	84.4	...

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

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

2/ Observations up to 2016:Q1 are from IMF FSI. The 2016Q4 observation is from CBC, based on the European Banking Association's definition of NPLs. As of end 2014, banks report NPLs as per the EU's regulation on reporting NPLs and forborne exposures. The main changes with respect to the previous definition are that the minimum probation period for forborne loans remaining classified as NPLs has increased from 6 to 12 months.

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

4/ Non-annualized Q4 observations for each year.

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

(Millions of SDRs)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Disbursement	222.8	148.5	321.8	99.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total debt service	1.6	3.8	7.5	13.1	21.0	57.7	93.2	134.0	144.9	130.8	129.1	90.5	52.3	8.5
Repurchase	0.0	0.0	0.0	0.0	6.2	43.3	80.4	123.8	138.2	125.8	125.8	88.7	51.6	8.3
Charges	1.6	3.8	7.5	13.1	14.8	14.4	12.8	10.2	6.7	5.0	3.3	1.8	0.8	0.3
Total debt service, in percent of														
Quota	1.0	2.4	4.8	4.3	6.9	19.0	30.7	44.1	47.7	43.1	42.5	29.8	17.2	2.8
GDP	0.0	0.0	0.1	0.1	0.1	0.4	0.6	0.8	0.9	0.7	0.7	0.5	0.3	0.0
Exports of goods and services	0.0	0.0	0.1	0.1	0.2	0.6	0.9	1.3	1.3	1.1	1.1	0.7	0.4	0.1
Outstanding stock	222.8	371.3	693.0	792.0	785.8	742.5	662.1	538.3	400.1	274.3	148.5	59.8	8.2	0.0
In percent of quota	140.8	234.7	438.1	260.7	258.7	244.4	217.9	177.2	131.7	90.3	48.9	19.7	2.7	0.0
In percent of GDP	1.4	2.5	5.0	5.6	5.4	5.0	4.2	3.3	2.4	1.6	0.8	0.3	0.0	0.0
In percent of exports of goods and services	2.3	4.1	8.2	8.9	8.4	7.6	6.5	5.1	3.6	2.4	1.2	0.5	0.1	0.0

Source: IMF staff estimates.

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

Annex I. Fund Relations

(As of April 30, 2017)

Membership Status: Joined December 21, 1961; Article VIII

General Resources Account:	SDR Million	Percent of Quota
Quota	303.80	100.00
Fund holdings of currency	1,010.75	332.70
Reserve tranche position	85.06	28.00

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	132.80	100.00
Holdings	49.20	37.05

Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Extended arrangement	792.00	260.70

Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
EFF	5/15/13	3/6/16	891.0	792.00

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

	2017	2018	2019	2020	2021
Principal	6.19	43.31	80.44	123.75	138.19
Charges/Interest	12.14	15.92	14.21	11.48	7.74
Total	18.32	59.23	94.64	135.23	145.93

Exchange Rate Arrangement and Exchange Restrictions:

Cyprus is a member of the euro area, and its currency–the euro–floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4. The external restrictions introduced in 2013 in the wake of the banking crisis were fully eliminated, effective April 6, 2015. In accordance with the relevant regulations of the Council of the European Union, and solely for the preservation of national or international security, Cyprus maintains restrictive measures related to Afghanistan, Belarus, Bosnia and Herzegovina, Burundi, Central African Republic, the Democratic Republic of Congo, Côte D'Ivoire (Ivory Coast), Egypt, Eritrea, Republic of Guinea (Conakry), Guinea-Bissau, Haiti, the Islamic Republic of Iran, Iraq, Democratic People's Republic of Korea, Lebanon, Liberia, Libya (as amended, effective January 19, 2016), Myanmar, Russia, Somalia, South Sudan (as amended), Sudan, Syria, terrorist groups (foreign terrorist organizations, including Al-Qaida), Tunisia, Ukraine, Yemen, Yugoslavia (Serbia and Montenegro), and Zimbabwe.

Last article IV consultations and program relations:

The last Article IV consultation was concluded on July 30, 2014 (IMF Country Report No. 14/313). Article IV consultations with Cyprus were on a 24-month cycle during the Extended Arrangement.

Cyprus's three-year, SDR 891 million (293 percent of current quota) Extended Arrangement under the Extended Fund Facility (EFF) was approved by the IMF Executive Board on May 15, 2013. The Fund initiated post-program monitoring (PPM) on March 18, 2016, after the authorities cancelled the EFF arrangement on March 7, 2016, about two months before it was scheduled to expire and a few weeks following completion of the ninth (and penultimate planned) review. Disbursements totaled SDR 792 million (261 percent of quota and about €1 billion). The EFF arrangement was coordinated with the European Stability Mechanism (ESM), which disbursed €6.3 billion.

Annex II. Public Debt Sustainability Analysis

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

Baseline Scenario

Cyprus's public debt has peaked and is on a downward path. Public debt, at 107.8 percent of GDP at end-2016, remained broadly unchanged at the 2015 level. Beginning from 2017, public debt is projected to decline steadily to 86 percent of GDP by 2022, underpinned by a jump in the primary balance to 3 percent of GDP in 2017, followed by primary surpluses in the range of 2.3–2.5 percent of GDP during 2018–2022.

While public debt is sustainable, it is projected to decrease more slowly than previously envisaged. Public debt in 2016 was higher than forecast in the 9th EFF review (99.8 percent of GDP) reflecting more limited progress on privatization and further delay in the debt-to-asset swap with the Central Bank of Cyprus, which were projected to reduce debt by €0.8 billion and €0.6 billion, respectively. Additional cash buildup also added to the debt stock (but not to net debt). Looking ahead, the public debt ratio is projected to exceed the goal of just over 70 percent by 2022 that was envisaged in the 9th review under the baseline, and which was to have been achieved through a combination of asset transactions and a further increase in the primary surplus.

Despite the higher than anticipated debt path, gross public financing needs (GPFN) are expected to be manageable. GPFN will remain well below the benchmark for advanced economies (20 percent of GDP), peaking at just over half the benchmark in 2019. Building on previous strong market access, the authorities' plan to issue €0.5–1bn of medium or long-term Eurobonds each year. This will support the buildup of a sizable cash buffer during 2017–18, to be partially drawn down during 2019–20 to meet large scheduled amortizations.[1] Gross borrowing in excess of amortizations to finance cash accumulation raises gross—but not net—debt.

Risk Assessment

Cyprus's high public debt leaves it more vulnerable to macro-fiscal shocks. Under the baseline, Cyprus's public debt ratio is projected to remain above the benchmark for advanced economies (85 percent of GDP) throughout the medium term. Assuming that adverse shocks to growth and the

[1] Alternatively, gross borrowing in excess of amortization could be used to buy back outstanding debt, with no impact on gross or net debt. Deposit accumulation and debt buybacks may generally be viewed as equivalent.

primary balance are more likely than favorable ones, public debt to GDP could remain above 100 percent by 2022 with a probability of more than 40 percent.[2]

GPFN will remain contained even in the presence of sizable shocks. In the event of short-duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would peak at around 15 percent of GDP, still comfortably below the 20 percent benchmark.

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

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

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

- The sovereign spread relative to German bunds—an indicator of market perception—is around 320 basis points, below the lower risk-assessment benchmark. However, Cyprus's bonds remain at least one notch below investment grade even after a series of upgrades by major rating agencies during 2015–17.

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

Realism of Baseline Assumptions

GDP growth and fiscal outturns have surpassed staff's forecasts in recent years, in contrast to previous excessive optimism. Recent GDP growth and the fiscal balance have been stronger than expected, due in part to robust external demand and private financial inflows that have substituted for new bank lending. This over-performance occurred despite the sizable structural fiscal consolidation during the program (based on a counterfactual scenario with a fiscal multiplier of 0.75). In contrast, projection errors during 2012–13 indicate excessive optimism although these errors reflect difficult to foresee events (damage to the sole power plant in 2011 and the write-down of banks' holdings of Greek public debt in 2012).

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

Stress Tests

Although various macro-fiscal and contingent liability shocks would postpone debt reduction, the debt path would nonetheless remain bounded:

- **Growth shock.** A one standard deviation (3.4 percentage points) decrease in growth during 2018–19, accompanied by (i) a 25 bp rise in interest rates, and (ii) a decrease in inflation by 0.25 percentage points per percentage point reduction in GDP growth, would raise public debt by 14 percentage points to 112 percent of GDP by 2019, before declining to 100 percent of GDP by 2022.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.7 percent of GDP during 2018–19, or an increase in the real interest rate by 396 bp during 2018–22 would raise public debt marginally to around 90 percent of GDP by 2022.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 115 percent of GDP in 2019 before declining to 107 percent of GDP by 2022. Gross financing needs would peak at 17.6 percent of GDP in 2019—still below the 20 percent benchmark—before falling back.

- **Contingent liability shock.** A one-off 40 percent of GDP increase fiscal spending (corresponding to about 10 percent of banking sector assets), accompanied by weaker nominal GDP growth and higher interest rates, would push up public debt to about 163 percent of GDP, 64 percentage points of GDP higher than the baseline by 2022.[3] The attendant high level of GPFN and sharp increase in borrowing costs may preclude market access.

[3] Accompanying macroeconomic responses are: (i) a 1 standard deviation real GDP growth shock; (ii) a 0.25 percentage point decline in inflation for every 1 percentage point decline in growth; and (iii) an increase in interest rates by 25 bp for every 1 percent of GDP deterioration in primary balance.

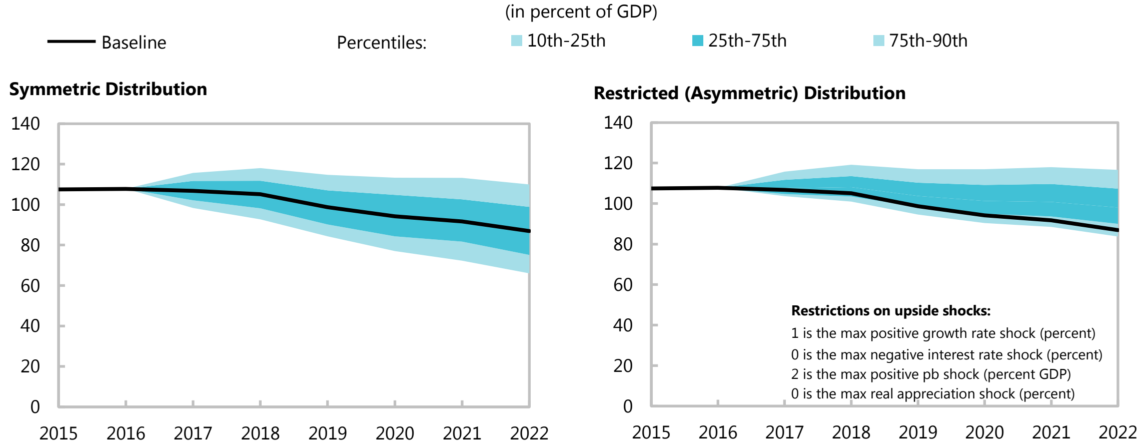
Cyprus Public DSA Risk Assessment

Heat Map

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

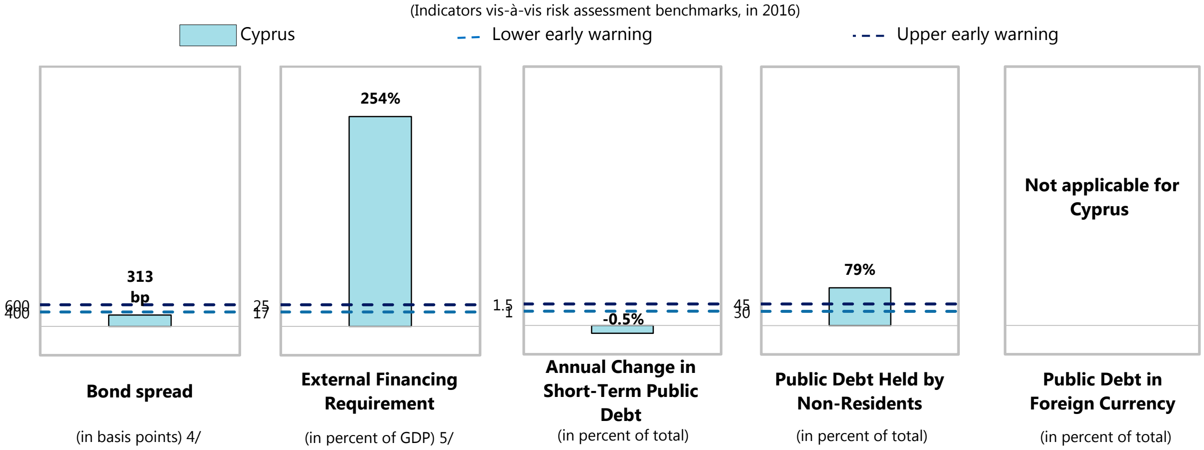
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

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

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

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

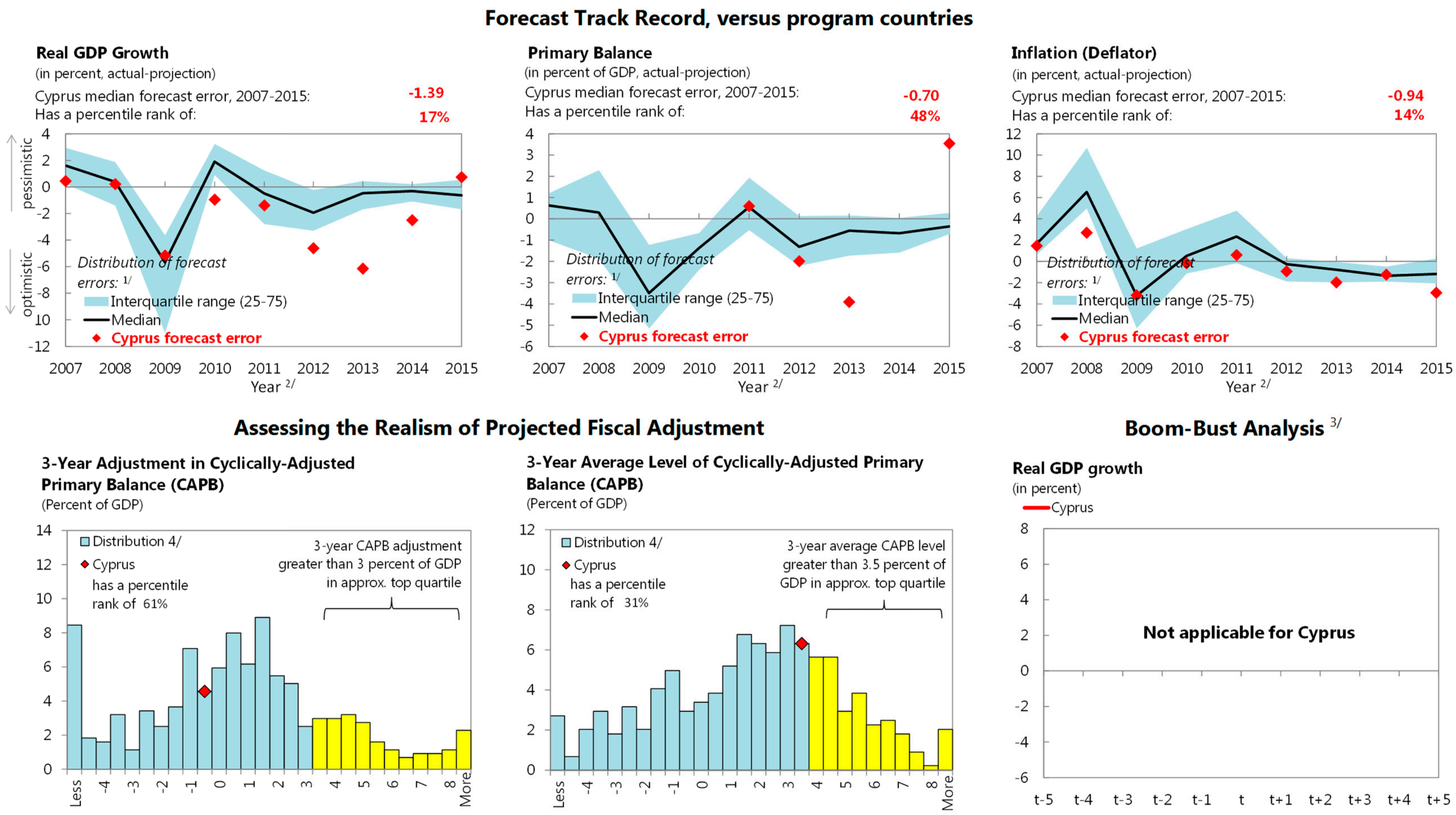
Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 18-Feb-17 through 19-May-17.

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

Cyprus Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Cyprus, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Cyprus Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

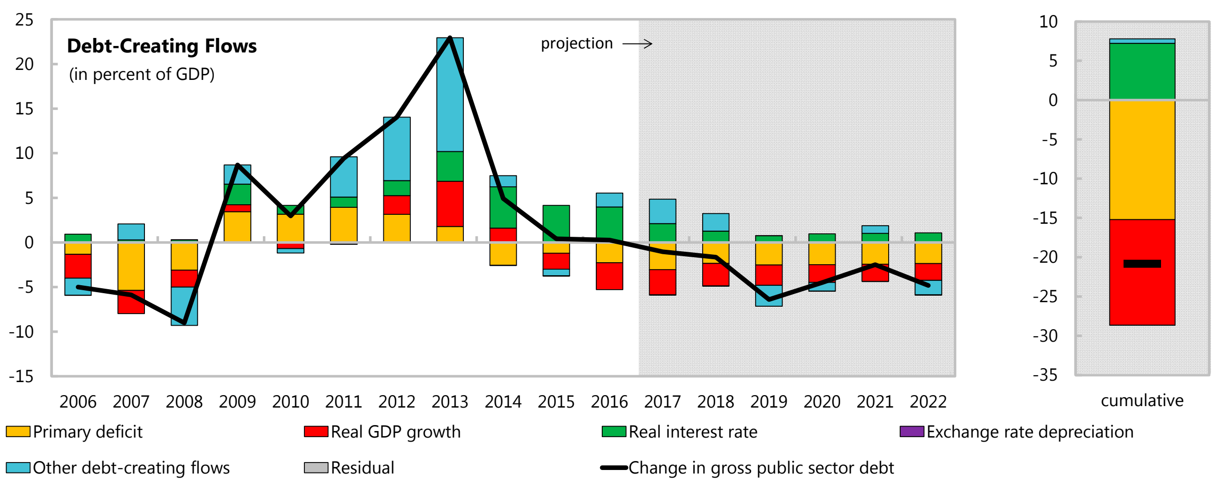
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	68.8	107.5	107.8	106.8	105.1	98.7	94.2	91.7	86.9
Public gross financing needs	12.8	19.4	9.8	3.4	6.7	10.9	9.6	7.4	9.8
Real GDP growth (in percent)	0.3	1.7	2.8	2.7	2.5	2.2	2.1	2.1	2.1
Inflation (GDP deflator, in percent)	1.7	-1.3	-1.3	0.3	1.2	1.8	1.6	1.6	1.8
Nominal GDP growth (in percent)	2.1	0.4	1.5	3.0	3.7	4.1	3.7	3.8	3.9
Effective interest rate (in percent) [4]	4.3	2.6	2.4	2.3	2.5	2.6	2.7	2.8	3.0

As of May 19, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		282
5Y CDS (bp)		222
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	BB+	BB+
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	4.8	0.4	0.3	-1.0	-1.7	-6.4	-4.5	-2.5	-4.8	-20.9	-2.4
Identified debt-creating flows	4.8	0.4	0.3	-1.0	-1.7	-6.4	-4.5	-2.5	-4.8	-20.9	
Primary deficit	0.3	-1.2	-2.3	-3.0	-2.3	-2.5	-2.5	-2.4	-2.4	-15.2	
Primary (noninterest) revenue and grants	37.5	38.7	38.8	39.2	38.2	38.1	37.9	37.8	37.7	229.0	
Primary (noninterest) expenditure	37.8	37.5	36.6	36.1	35.8	35.6	35.5	35.4	35.3	213.8	
Automatic debt dynamics [5]	1.9	2.4	1.0	-0.7	-1.3	-1.5	-1.0	-0.9	-0.8	-6.2	
Interest rate/growth differential [6]	1.9	2.4	1.0	-0.7	-1.3	-1.5	-1.0	-0.9	-0.8	-6.2	
Of which: real interest rate	1.7	4.2	4.0	2.1	1.3	0.8	1.0	1.0	1.1	7.2	
Of which: real GDP growth	0.2	-1.8	-3.0	-2.8	-2.5	-2.3	-2.0	-1.9	-1.9	-13.5	
Exchange rate depreciation [7]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	2.5	-0.8	1.6	2.7	2.0	-2.4	-1.0	0.9	-1.6	0.6	
Privatization/Drawdown of Deposits (+	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	2.5	-0.8	1.6	2.7	2.0	-2.4	-1.0	0.9	-1.6	0.6	
Residual, including asset changes [8]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

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

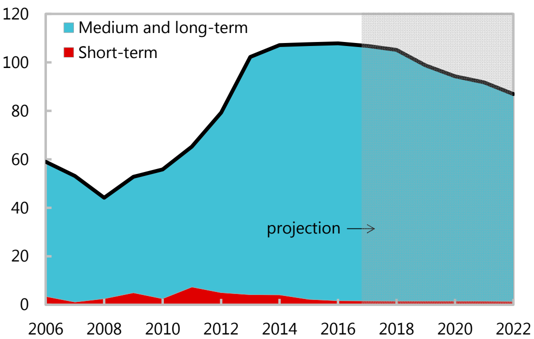
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

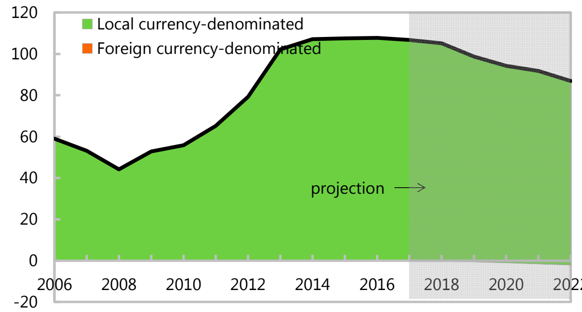
Cyprus Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



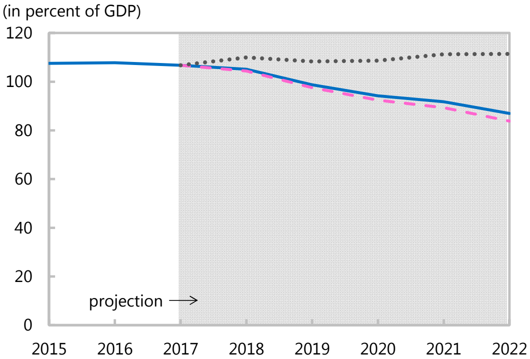
By Currency
(in percent of GDP)



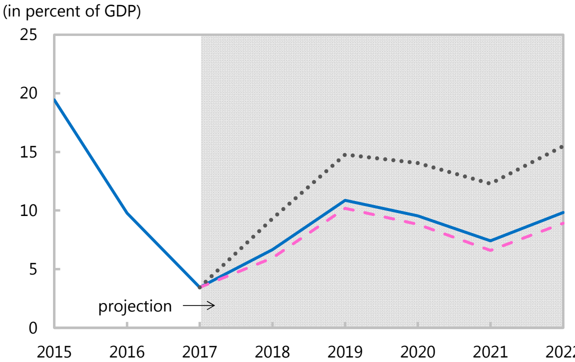
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

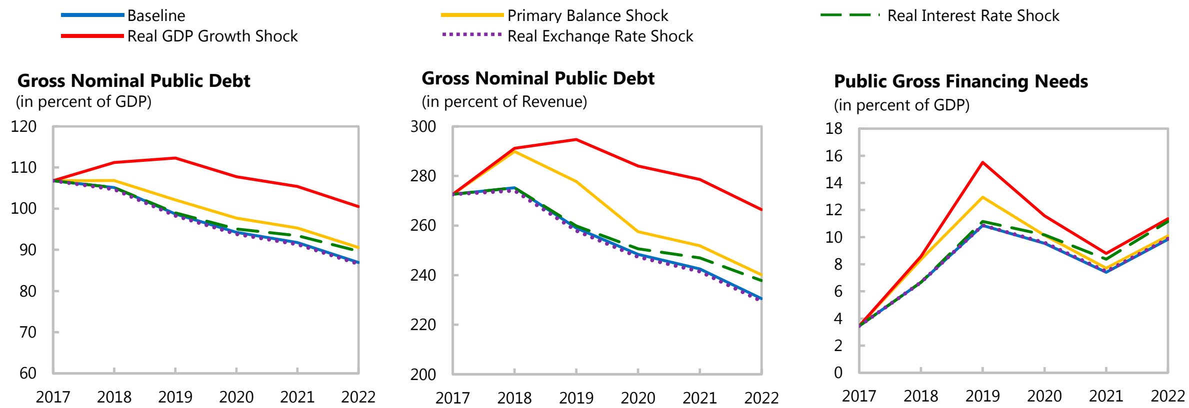
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.7	2.5	2.2	2.1	2.1	2.1
Inflation	0.3	1.2	1.8	1.6	1.6	1.8
Primary Balance	3.0	2.3	2.5	2.5	2.4	2.4
Effective interest rate	2.3	2.5	2.6	2.7	2.8	3.0
Constant Primary Balance Scenario						
Real GDP growth	2.7	2.5	2.2	2.1	2.1	2.1
Inflation	0.3	1.2	1.8	1.6	1.6	1.8
Primary Balance	3.0	3.0	3.0	3.0	3.0	3.0
Effective interest rate	2.3	2.5	2.6	2.7	2.8	3.0

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	2.7	0.2	0.2	0.2	0.2	0.2
Inflation	0.3	1.2	1.8	1.6	1.6	1.8
Primary Balance	3.0	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	2.3	2.5	2.8	3.0	3.4	3.8

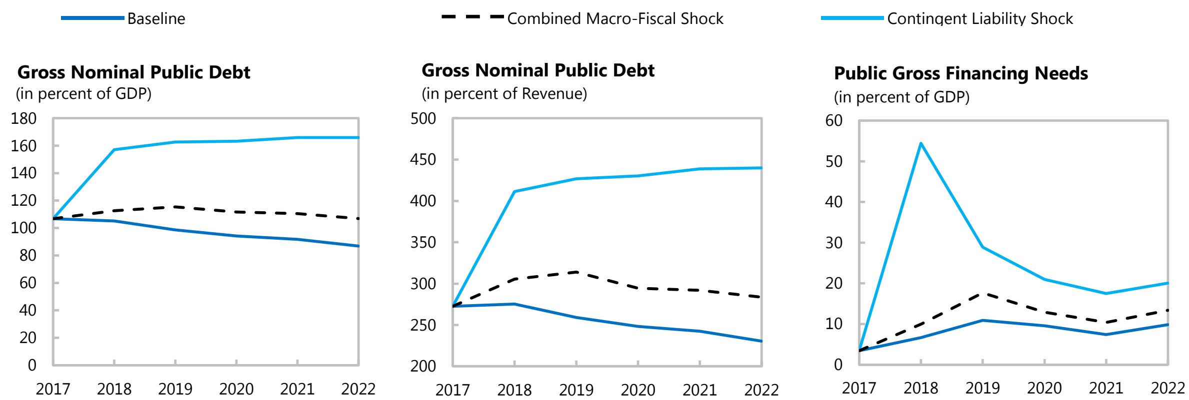
Source: IMF staff.

Cyprus Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2017	2018	2019	2020	2021	2022
Primary Balance Shock						
Real GDP growth	2.7	2.5	2.2	2.1	2.1	2.1
Inflation	0.3	1.2	1.8	1.6	1.6	1.8
Primary balance	3.0	0.7	0.8	2.5	2.4	2.4
Effective interest rate	2.3	2.5	2.6	2.8	2.9	3.1
Real Interest Rate Shock						
Real GDP growth	2.7	2.5	2.2	2.1	2.1	2.1
Inflation	0.3	1.2	1.8	1.6	1.6	1.8
Primary balance	3.0	2.3	2.5	2.5	2.4	2.4
Effective interest rate	2.3	2.5	2.9	3.2	3.7	4.3
Combined Shock						
Real GDP growth	2.7	-0.9	-1.1	2.1	2.1	2.1
Inflation	0.3	0.3	1.0	1.6	1.6	1.8
Primary balance	3.0	-0.5	-1.9	2.5	2.4	2.4
Effective interest rate	2.3	2.5	3.0	3.5	4.0	4.6

	2017	2018	2019	2020	2021	2022
Real GDP Growth Shock						
Real GDP growth	2.7	-0.9	-1.1	2.1	2.1	2.1
Inflation	0.3	0.3	1.0	1.6	1.6	1.8
Primary balance	3.0	0.8	-0.6	2.5	2.4	2.4
Effective interest rate	2.3	2.5	2.6	2.8	3.0	3.2
Real Exchange Rate Shock						
Real GDP growth	2.7	2.5	2.2	2.1	2.1	2.1
Inflation	0.3	1.6	1.8	1.6	1.6	1.8
Primary balance	3.0	2.3	2.5	2.5	2.4	2.4
Effective interest rate	2.3	2.5	2.6	2.7	2.8	3.0
Contingent Liability Shock						
Real GDP growth	2.7	-0.9	-1.1	2.1	2.1	2.1
Inflation	0.3	0.3	1.0	1.6	1.6	1.8
Primary balance	3.0	-44.9	2.5	2.5	2.4	2.4
Effective interest rate	2.3	2.6	6.7	6.4	6.4	6.5

Source: IMF staff.

Annex III. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Expected Impact of Risk on Repayment Capacity	Policy Response
Externally Sourced Risks		
High **Economic fragmentation and policy uncertainty:** • Cross-border integration could reverse • In Europe, policy uncertainty associated with post-Brexit arrangements could rise	Medium The Cypriot economy is heavily dependent on foreign demand—especially from the UK and Russia—for tourism and business services. Weaker external demand would adversely affect long-term growth and repayment capacity.	Seek to broaden sources of foreign demand beyond a narrow set of countries. Restart structural reforms to make economy more flexible and dynamics in response to demand shocks.
High **Tighter financial conditions:** • Long-term European interest rates could rise in response to higher US rates or less accommodative ECB policies. • Reduced correspondent banking relations could significantly curtail cross-border financial services.	Medium • Higher interest rates on Cypriot government borrowing would raise the cost of refinancing maturing official loans with market debt. • Reduced Cypriot access to foreign correspondents could weigh on the professional services sector and long-term growth.	• Undertake additional fiscal consolidation to reduce borrowing needs. • Limit scope for reduced correspondent banking relations by ensuring full compliance with international transparency and exchange of information agreements and AML/CFT standards.
Medium **European bank distress:** Strained balance sheets in some European banks could have knock-on effects for the wider banking sector and exposed sovereigns.	High Market pressure on other euro area banks with elevated NPLs could spill over to Cypriot banks, reigniting financial sector stress, with repercussions for public debt sustainability and capacity to repay.	Intensify efforts to reduce NPLs to limit potential need for additional capital and provisions. Undertake further fiscal consolidation to create precautionary headroom.
Domestically-Sourced Risks		
High **Post-crisis policy slippage:** Incomplete adherence to fiscal targets to secure debt moderation to a comfortable level and failure to carry through on the structural reform agenda.	Medium Potential growth would weaken and sovereign borrowing costs would rise, weakening public debt sustainability and capacity to repay.	Resist pressure for structural fiscal easing and decisively implement structural reforms to promote efficiency and competitiveness.
Medium **Slow progress on reducing NPLs:** Current resolution strategies could yield very slow NPL reduction, while weak bank profits amid low interest rates could limit capacity to boost capital and accumulate provisions.	Medium, High Scope for banks to expand lending in the longer run could be constrained by inadequate capital and provisions, retarding GDP growth (Medium). Confidence in banks could erode, creating a new bank-sovereign feedback loop, raising financing needs and borrowing costs, with repercussions for public debt and capacity to repay (High).	Intensify efforts to reduce NPLs to limit potential need for additional capital and provisions. Undertake further fiscal consolidation to create precautionary headroom.

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

Statement by Richard Doornbosch, Alternate Executive Director for Cyprus, and Jeske De Lint, Advisor to the Executive Director
June 7, 2017

We thank staff for the first post-program monitoring (PPM) discussions that followed the exit of the Extended Arrangement under the Extended Fund Facility (EFF). The economic recovery has been broad based and continues to strengthen. Nevertheless, there is no room for complacency and ambitious policies should be further pursued, with a focus on further public and private debt reduction and structural reforms that foster strong and sustainable long term growth.

Under the macroeconomic adjustment program, the Cyprus authorities have implemented significant reforms. These reforms aimed to address imbalances in the financial sector, to promote fiscal consolidation and to support competitiveness and sustainable and balanced growth. The results are noteworthy. In 2016, economic growth accelerated to 2.8%, which is expected to be sustained in the following years. More recent data, in particular the real GDP flash estimate for 2017Q1 (y-o-y growth of 3.3%) points to a further acceleration of economic activity. The resilience of the financial sector has improved considerably through inter alia strengthening of the regulatory and supervisory framework, a significant reduction in its size as a percentage to GDP and much healthier capital adequacy and solvency ratios. The excessive deficit in the general government sector has been corrected and public finances have been put on a sustainable path. In fact, a budget surplus of 0.4% of GDP and a primary surplus of 3% of GDP was achieved in 2016. Moreover, major reforms were implemented to address issues with social welfare, the state's pension schemes and public financial management.

In this context, the authorities have formally informed the Managing Director on May 30, 2017 of their intention to repay early part of the credit outstanding under the Extended Arrangement under the EFF. The successful completion of the macroeconomic adjustment program has reduced the cost of borrowing from the markets significantly. For the IMF credit outstanding exceeding 187.5% of quota, the basic rate of charge plus the surcharges clearly exceed the market rate of the Republic of Cyprus' bonds. An early repayment of the credit outstanding above 187.5% could be financed from existing excess cash reserves and therefore improves the debt sustainability profile of the Republic of Cyprus.

Even though with the early repayment the amount of credit outstanding will fall below the threshold for PPM, the authorities see merit in maintaining close monitoring of capacity to repay in the context of PPM until 2020. The authorities appreciate staff's assessment of Cyprus's repayment capacity and policy recommendations to enhance this capacity, and would welcome continuation of this monitoring during the first years after the

EFF arrangement. With staff's in-depth assessment and policy advice, the authorities will be able to further strengthen the recovery and enhance strong and durable economic growth.

The authorities expect that growth will overperform staff's forecasts. They project 3% for both 2017 and 2018 and beyond 2018 growth is expected to be around 2.75% (staff projects 2.7% for 2017 and 2.1% over the medium term). The recovery is expected to be broad-based and mainly driven by the implementation of important investment projects in transport, gaming, energy and higher education, as well as in tourism. The construction of the casino is expected to diversify the tourism product, further increasing the sector's growth prospects. Improvements in competitiveness, partly due to the significant decline in wages and unit labor costs in the last few years, have played a role in the strong performance of exports.

The authorities agree that faster progress with non-performing loans (NPLs) reduction is needed and are currently considering refinements to existing policies. Although the available data indicate that the level of NPLs was reduced by a sizable amount during the last two years, they remain high. This is notwithstanding intensified efforts to restructure them since the end of 2015. It should be noted that following a steep learning curve, both on the part of credit institutions and on the part of borrowers, more sustainable solutions are being offered. Both in terms of restructuring, by way of other tools being used, such as write-offs, split of loans, debt-to-asset swaps and by the solutions provided by the foreclosures and insolvency laws. The revision of the Business of Credit Institutions Law has provided flexibility to credit institutions to better manage properties acquired in satisfaction of debts, as to administer them and not to flood the market and thus negatively impact prices. Furthermore, credit institutions are also looking to external solutions such as joint ventures, outsourcing of the management of NPLs, or selling NPLs.

The Central Bank of Cyprus (CBC) is monitoring progress and developments in reducing NPLs, and stimulate and facilitate solutions to address this serious challenge. Several regulatory and supervisory reforms have been implemented, for example the enactment of legislation enabling to accelerate transfers of title deeds, and legislation on foreclosures and insolvency. As part of further legislative developments, the authorities are preparing for the introduction of a securitization law. In addition, the CBC assesses on a quarterly basis the credit-to-GDP gap as well as other macro-financial variables, and has the necessary macroprudential tools to prevent a new boom-bust cycle.

The fiscal strategy of the government is focused on reducing the level of public debt, without harming GDP growth. Fiscal policy is geared towards maintaining a high primary surplus over the medium term averaging 3% GDP. Any windfall revenue – and there was a sustained revenue overperformance over the last years - will be used to further reduce debt. The recommendation by staff for an additional fiscal effort of 0,5% percentage point GDP seems overly prescriptive and not needed to bring the debt level firmly on a downward path and thus meeting the requirements under the SGP. The authorities do agree that there is no room for complacency and are working hard to ensure the National Health Service, the public-sector wage bill and public sector pension costs do not pose risks to fiscal sustainability.

The authorities appreciate staff's recommendations on key structural reforms, which will be useful for the maintenance of the reform agenda. The Action Plan for Growth that was approved in February 2015 was updated in November 2016. This action plan includes around 70 targeted actions with specific timeframes aimed at enhancing the competitiveness of the economy, increasing productivity and unlocking investment potential. The modernization and reorganization of the courts is moving forward and a bill to establish a separate, dedicated commercial court will be submitted to parliament in the third quarter of 2017. There is some progress in selling several smaller state-owned assets. Larger scale privatizations and further streamlining of business procedures are expected to be intensified after the upcoming elections when the authorities will recalibrate the comprehensive reform agenda.