September 2010
IMF Country Report No. 10/291

Cyprus: 2010 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Cyprus

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 5, 2010, 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 August 9, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A statement by staff of the IMF on Cyprus

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 27, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Cyprus.

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

- Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with Cyprus
(In consultation with other departments)

Approved by Ajai Chopra and Thomas Dorsey

August 9, 2010

EXECUTIVE SUMMARY

Background. Economic conditions have stabilized, and the economy is projected to bottom out in 2010, giving way to a mild recovery in 2011 followed by stronger growth. However, global financial risks remain elevated and muted growth prospects in trading partners weigh on the outlook. The government has taken steps to stabilize the fiscal deficit, but further measures will be needed to reach the official deficit target for 2012 of 3 percent of GDP.

Challenges and staff views. The foremost policy challenge is to achieve the official fiscal consolidation targets so as to put debt ratios on a declining path and provide more space to guard against risks to the financial sector. Further old-age pension reform is also essential. Preserving financial sector stability through early detection of risks remains a top priority in light of the difficult economic and financial environment, and the supervision of cooperative credit societies needs to be strengthened as a matter of urgency. Structural reforms are needed to preserve competitiveness and enhance medium-term growth.

Authorities' views. The government largely shared the staff's assessment, while projecting growth to turn positive as soon as 2010 and being more confident that the fiscal targets can be met through general spending restraint and with less focus on the public payroll. The Central Bank of Cyprus (CBC) expressed confidence in the ability of banks to withstand pressures, and this is supported by stress test results. Moving to a single independent supervisor for all credit institutions—a much desirable objective—is not on the political agenda, but strengthening the supervision of cooperative credit societies seems feasible.

Mission team and interlocutors: B. Laurens (Head), W. McGrew, V. Flamini (all EUR) and M. Saiyid (MCM) visited Cyprus during June 25-July 5, 2010. Y. Friedman (OED) and a representative from the European Commission also attended. The mission met with Minister of Finance Stavrakis, Governor Orphanides, senior public sector and parliamentary officials, private banks and businesses, and labor unions. A press conference was held and the concluding statement published.

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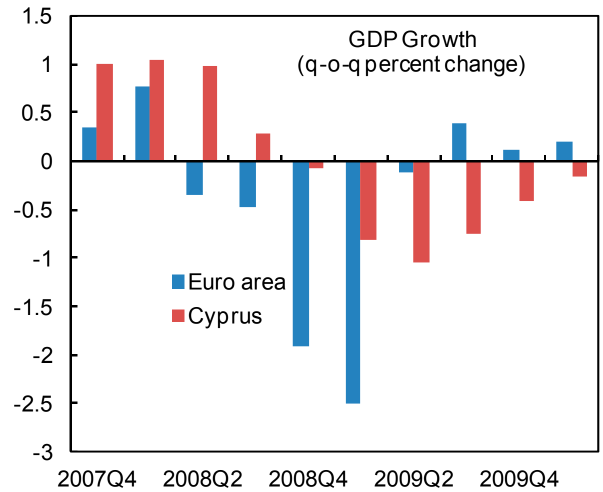
I. The Context: Macroeconomic Imbalances Building Up Prior To The Crisis[1]

1. **Cyprus is being affected by the global crisis with a lag, as it entered into recession in early-2009, about a year after the euro area as a whole**. In the wake of euro adoption in early 2008, domestic consumption remained strong, buttressed by buoyant credit growth—mainly channeled to a booming real estate market— and a relaxation in the fiscal stance (Box 1). The banking sector weathered the financial turmoil relatively unscathed due to limited exposure to complex securitized products, but as trade partners became increasingly affected by the global slowdown, the tourism and construction sectors contracted sharply. As a consequence, Cyprus entered a shallow recession in early 2009, just as the euro area as a whole was bottoming out (Figure 1).



Source: Eurostat

2. **Home-grown imbalances are set to weigh on the recovery**. Prior to the crisis, rapid credit growth drove private sector indebtedness up (Figure 2) and led to overheating.[2] Above euro-area average real wage and price dynamics exacerbated external imbalances and the related loss in competitiveness and necessary adjustment in saving patterns will moderate growth going forward. Meanwhile, tax revenue buoyancy during the upturn, especially related to asset prices, proved cyclical and the fiscal position took a sharp turn for the worse in 2009.

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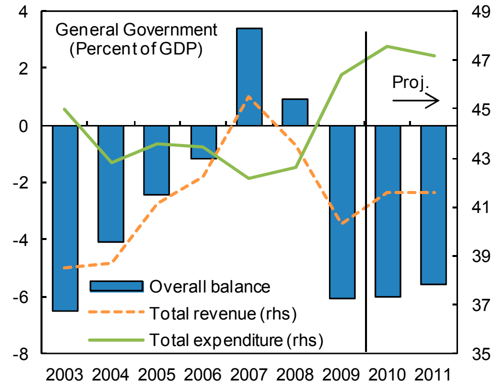
[1] This report reflects data until July 15, 2010 and discussions with the authorities of the Republic of Cyprus (ROC). It does not cover areas not under the effective control of the ROC and assumes no change in the status quo. Political development in the non-government controlled areas of Cyprus following the April 2010 victory of the presidential contender known as firm supporter of Turkish Cypriot independence has raised uncertainties regarding the outcome of the reunification talks.

[2] Households hold debt of about 130 percent of GDP at end-2009 is one of the highest levels in Western Europe, although their net asset position, boosted by rising real estate prices over the last 5 years, has remained strong. Looking forward, downward adjustment in housing prices particularly in coastal areas in 2010 and staff projection of no positive portfolio investments until 2012 may weigh on the net position. Corporate debt is also among the highest in Western Europe, having increased during the boom years, but a reversal was initiated as the economy entered recession. Private agents responded to the combination of falling asset prices and rising uncertainty by raising their saving rates from lows reached in 2008.

Box 1. Cyprus: Fiscal Developments in 2004–2009

During the period 2004-08, following EU accession and in preparation for euro adoption, Cyprus made significant progress in consolidating public finances turning an overall deficit of 6.3 percent of GDP in 2003 into surpluses of 3.4 and 0.9 percent respectively in 2007 and 2008. This translated into a parallel improvement of the structural balance, from a deficit of 7.6 percent in 2003 to a surplus of 2.2 percent in 2007. General government debt also declined from 68.9 to 48.4 percent of GDP in 2008. This virtuous path was supported by favorable cyclical conditions and tax-rich activities from the real estate sector. Sizable one-off deficit-reducing measures, especially between 2003 and 2005 also contributed to the adjustment. With regard to gross debt levels, a debt-reducing stock flow adjustment associated with the use of the sinking fund deposits led to a decline of debt levels by about 10 percent of GDP.



Sources: WEO; and Eurostat.

Most of the consolidation was reversed in 2009, following a 7 percent deterioration in the overall balance compared to 2008, pushing up gross debt to 56.2 percent of GDP. The increase in debt resulted from a 7.3 percent deterioration in the primary balance and a debt increasing snowball effect due to GDP contraction. Stock flow adjustments also contributed to the increase, following accumulation of government assets at the end of 2008 to meet financing needs in early 2009 (Table). Beside less favorable cyclical conditions, resulting in falling tax revenue and increasing expenditures due to the activation of the automatic stabilizers and public investment and the fading away of the asset boom, the reversal was the result of a highly expansionary expenditure policy. In addition to a deliberate fiscal stimulus through higher investment spending of 1.4 percent of GDP, higher wages and social transfers led to a 4.1 percent increase in total expenditure. However, a reduction in the overall surplus occurred already in 2008 –when the economy was still overheating– driven by a marked decrease in total revenues as the tax-rich real estate and tourism sectors were hit from the global crisis affecting the main foreign counterparts, namely UK and Russia.

Table. General Government Debt Decomposition

(Percent of GDP)

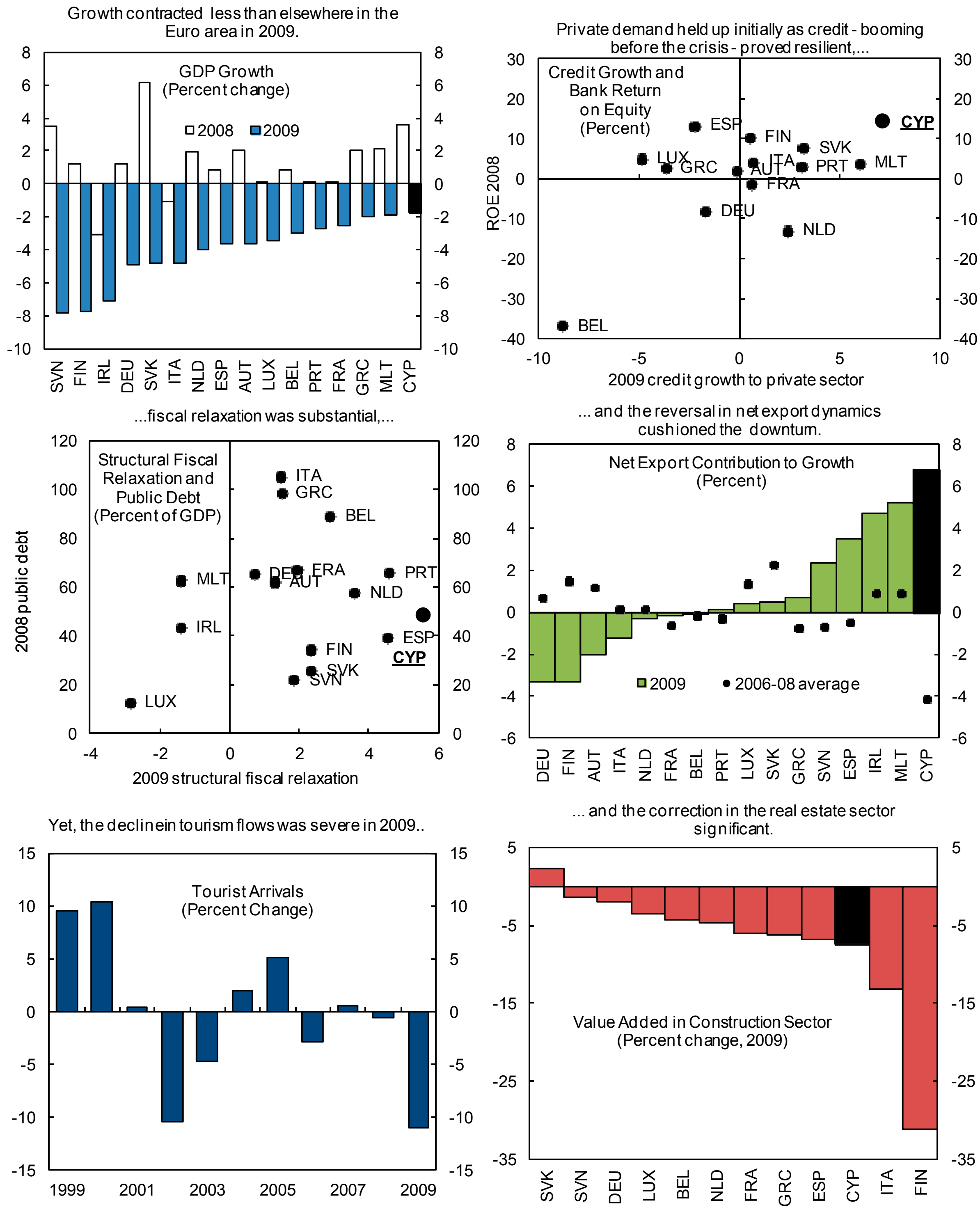
	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross public debt	68.9	70.2	69.1	64.6	58.3	48.4	56.2	61.1	64.5
Change in gross debt (1 = 2+3+4)	4.3	1.3	-1.1	-4.4	-6.3	-9.9	7.8	4.9	3.4
Primary balance (2)	3.1	0.8	-1.1	-2.1	-6.4	-3.7	3.6	3.7	3.2
Snowball effect (3)	-3.6	-4.2	-2.8	-3.8	-6.7	-5.6	4.2	0.0	-1.4
Interest expenditure	3.4	3.3	3.5	3.3	3.0	2.8	2.5	2.3	2.3
Real GDP growth	-1.9	-4.2	-3.9	-4.1	-5.1	-3.6	1.7	0.2	-1.8
Inflation (GDP deflator)	-5.1	-3.2	-2.4	-3.0	-4.6	-4.8	0.0	-2.5	-2.0
Stock flow adjustment (4)	4.8	4.6	2.8	1.5	6.8	-0.6	0.0	1.1	1.6

Sources: Eurostat; and IMF staff projections.

Note: The table shows contributions to the change in gross public debt according to the following decomposition: $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1+y_t}\right) + \frac{SF_t}{Y_t}$ Where *D, Y, PD* and *SF* indicate the stock of public debt, real GDP, the primary balance, and the stock flow adjustment respectively, and i and y are the cost of debt and nominal GDP growth.

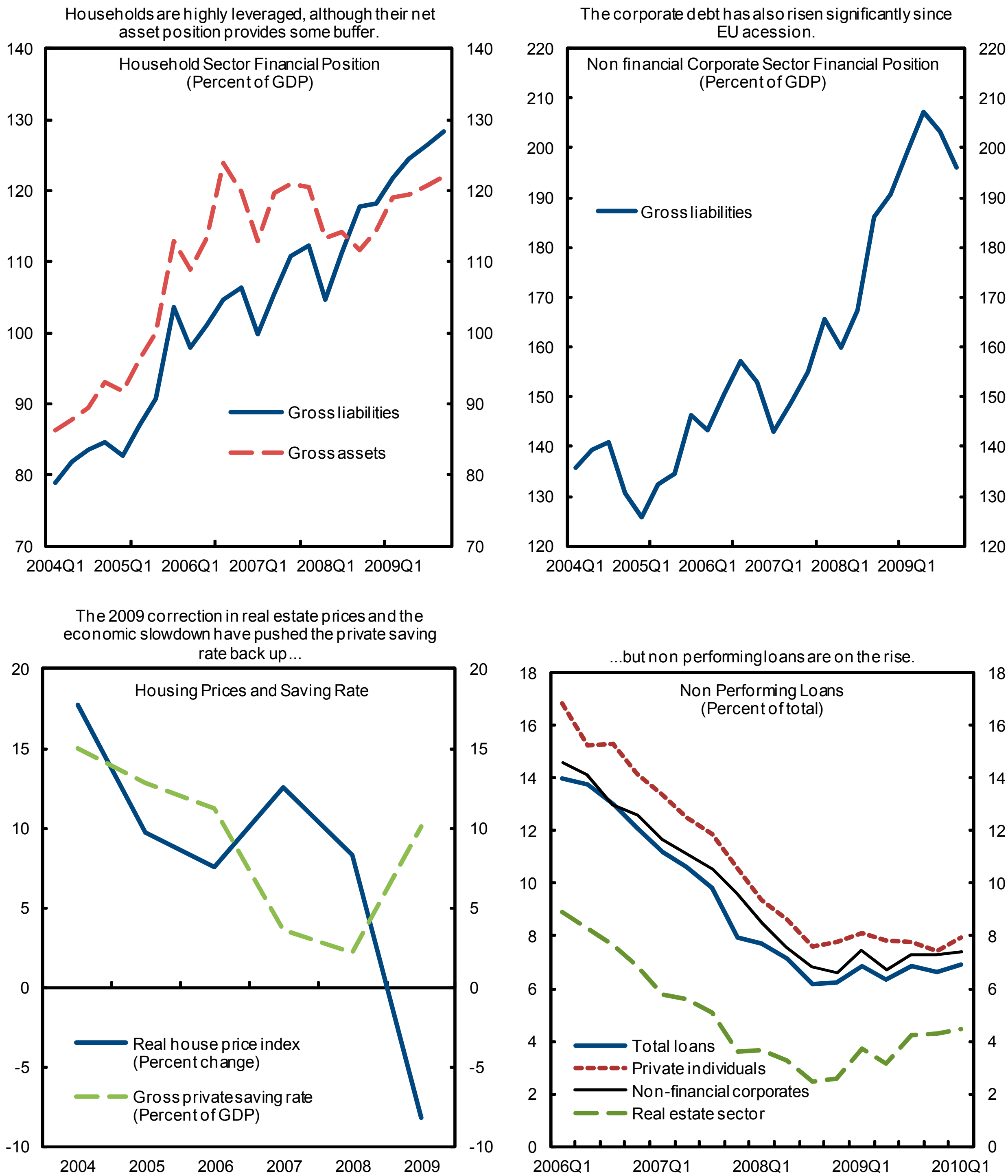
The April 2010 Stability Programme projects a reduction of the overall deficit to 2.5 percent of GDP by 2013. The consolidation is based on expenditure-reducing measures (i.e., a significant reduction in personnel and operational expenses and better targeting of social schemes) and the enhancement of revenues through improved tax compliance and a town planning amnesty. Some of the measures, however, still need to be agreed with stakeholders or have not yet been passed by the Parliament. On May 12, 2010 the European Commission initiated an Excessive Deficit Procedure (EDP) for Cyprus based on the consideration that the current deficit, although exceptional given the adverse cyclical conditions, cannot be considered temporary, and the debt ratio could not be considered as sufficiently diminishing and approaching the reference value of 60 percent at a satisfactory pace.

Figure 1. Cyprus' Relative Performance During the Crisis



Sources: IMF, *GFSR*; Central Bank of Cyprus; IMF, *WEO*; and Eurostat.

Figure 2. Cyprus: Household and Corporate Sector.



Sources: Central Bank of Cyprus; and IMF, WEO.

II. Recent Developments and the Outlook

A. Macroeconomic Developments

3. **The economic slowdown has only partially corrected existing imbalances** (Figure 3). After experiencing average growth of 4¼ percent over 2004-08, the economy contracted by 1.7 percent in 2009, weighed down by a correction in the real estate market and a sharp decline in the tourism sector. Private consumption growth, the main driver of the expansion in the recent past, evaporated, reflecting leveraged balance sheets, rising unemployment and slowing household credit growth. In the backdrop of weakening demand prospects and deteriorating financing conditions, fixed investment contracted sharply. The inventory cycle was particularly pronounced, as firms reacted with delay to the slowdown in trade partners' economies. Nonetheless, the domestic correction was partially cushioned by a substantial fiscal relaxation and the reversal in the net export contribution; the current account deficit moderated—although it remained high, at above 8 percent of GDP.

4. **Slack has emerged but cost dynamics have not fully responded to the recession** (Figures 4 and 5). Inflation moderated substantially to ¼ percent in 2009 from 4½ percent in 2008, as the economy slowed and oil prices plummeted. The labor market lost pace, with wage growth slowing down to 4.1 percent from 5.8 in 2008 and the unemployment rate rising by 1.7 percentages point to 5.3, although from a level substantially below the euro area average. While the output gap is estimated to have turned negative in the second quarter of 2009, a positive inflation differential with the euro area has reopened since the beginning of 2010 owing to price developments in the non tradable sectors. Real wage growth, which had exhibited significant buoyancy since 2004, moderated in 2009, but remained above euro area levels as wage contracts did not incorporate the entire drop in inflation due to the backward looking inflation-indexed wage adjustment mechanism (COLA, Box 2).

5. **The recovery has so far remained elusive, and staff projects slightly negative growth for 2010 to turn only moderately positive in 2011**. Short-term indicators suggest that the turnaround in activity has only started to materialize (Figure 6): the construction sector remains depressed; firms continue to be reluctant to invest, constrained both by soft orders and tighter lending conditions; and green shoots in the tourism sector and industrial production have only emerged recently.

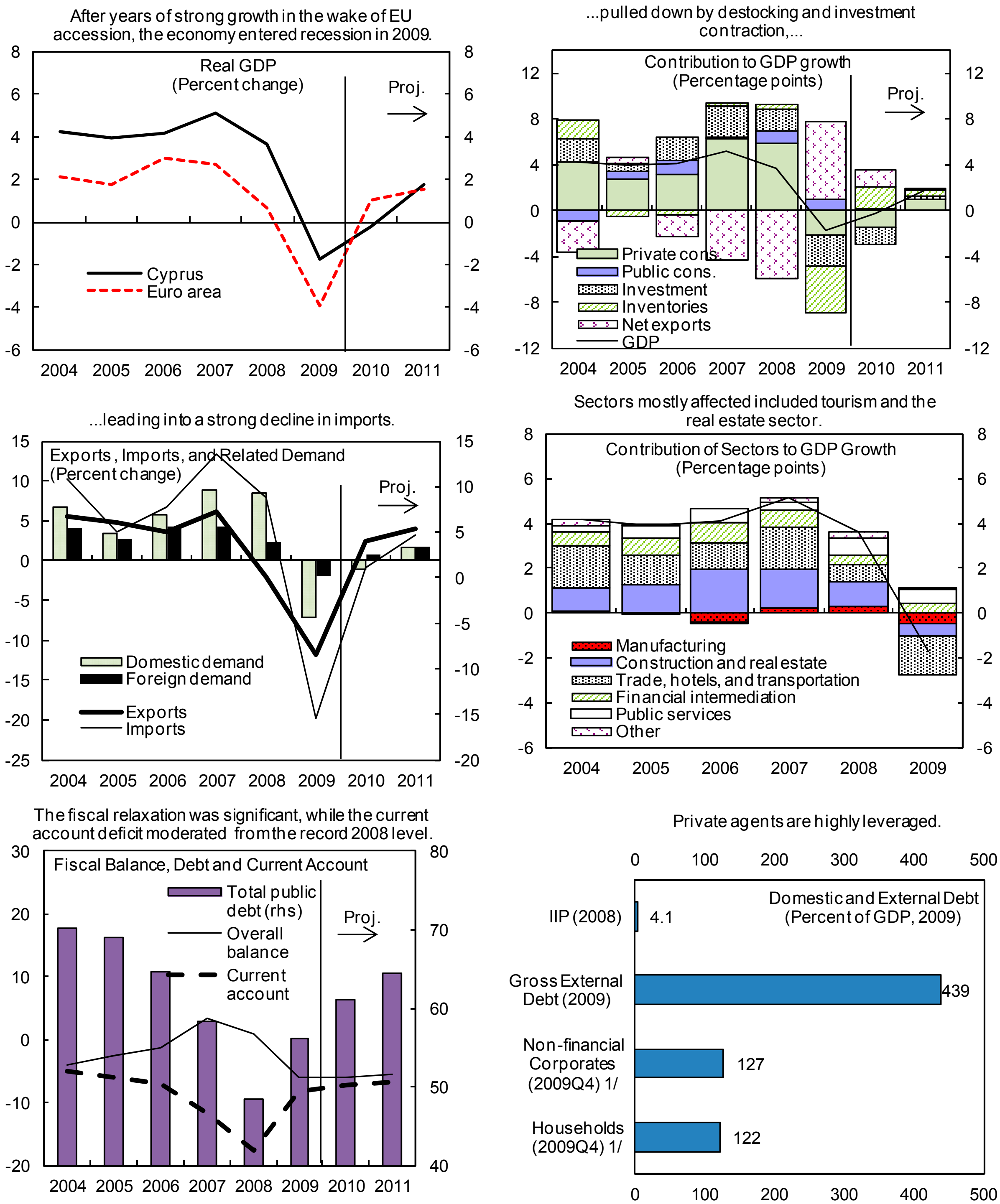
B. Public Sector

6. **The fiscal deficit widened sharply in 2009, mostly reflecting structural factors (Figure 7).** Expenditures rose by some 4 percent of GDP on the back of higher wages and salaries, social transfers, and investment spending. These increases were for the most

(Percent of GDP)	2008	2009	2010
Revenue	43.5	40.3	41.6
Expenditure	42.6	46.4	47.6
interest	2.8	2.5	2.3
Balance	0.9	-6.1	-6.3
Primary balance	3.7	-3.6	-3.7
Output gap	4.3	0.6	-1.3
Cyclical balance	1.7	0.2	-0.5
Cyclically adjusted PB	2.1	-3.8	-3.2
Fiscal impulse	-3.2	-5.9	0.6

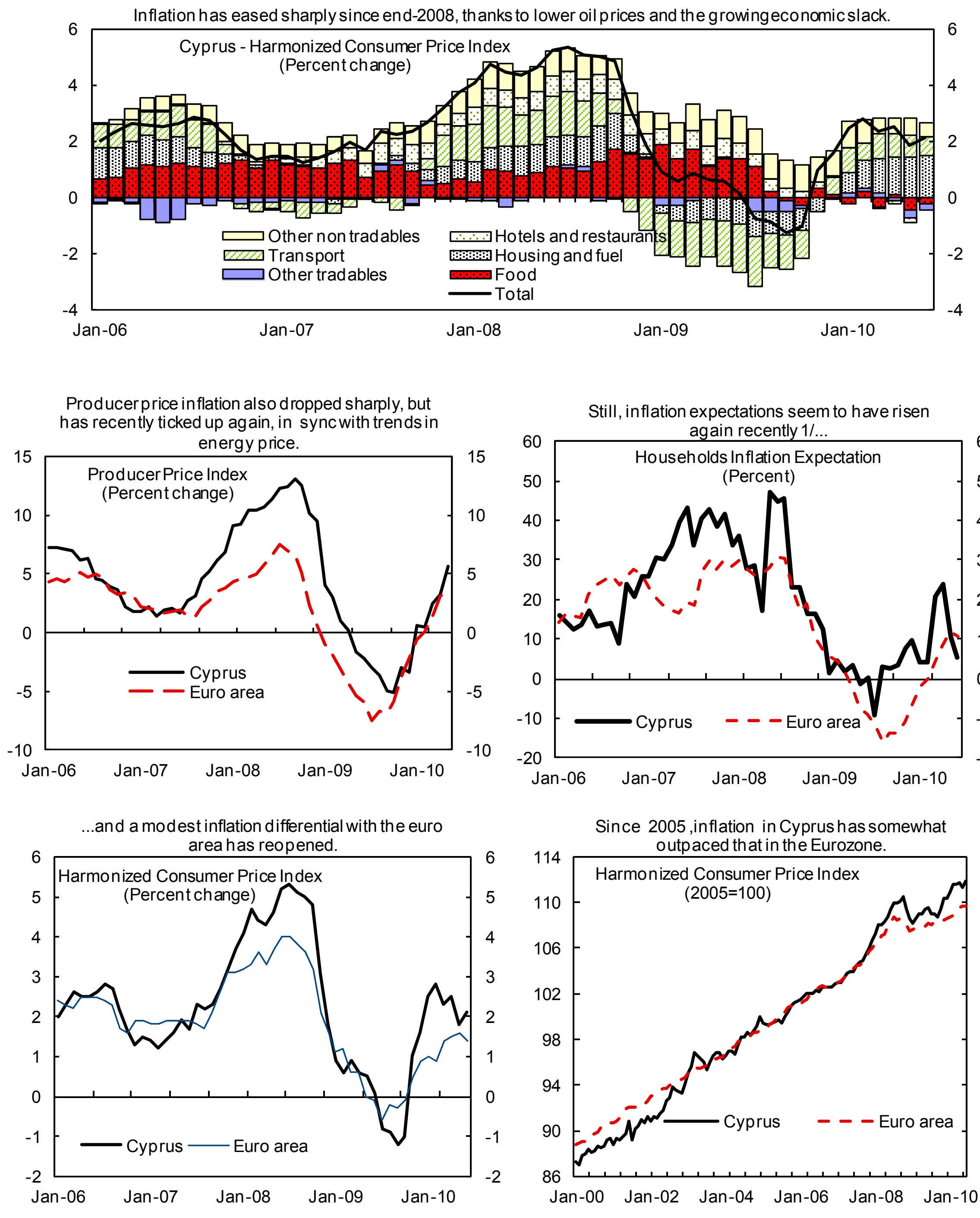
Source: WEO.

Figure 3. Cyprus: Economic Indicators, 2004-2011



Sources: Cystat; IMF WEO; and IMF staff estimates.
1/ Includes bank loans to domestic residents.

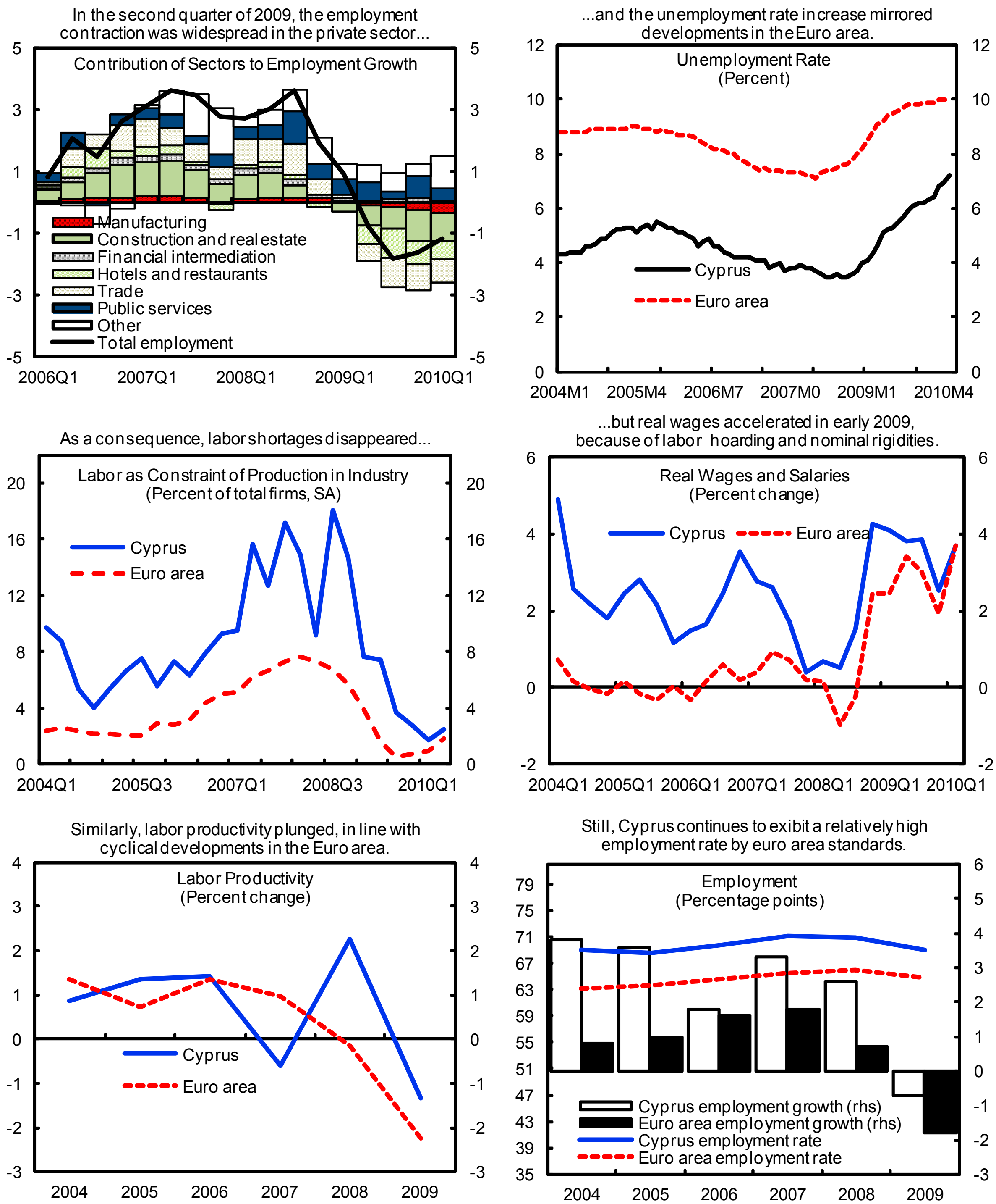
Figure 4. Cyprus: Price Developments



Sources: Eurostat; and European Commission, Consumer Survey.

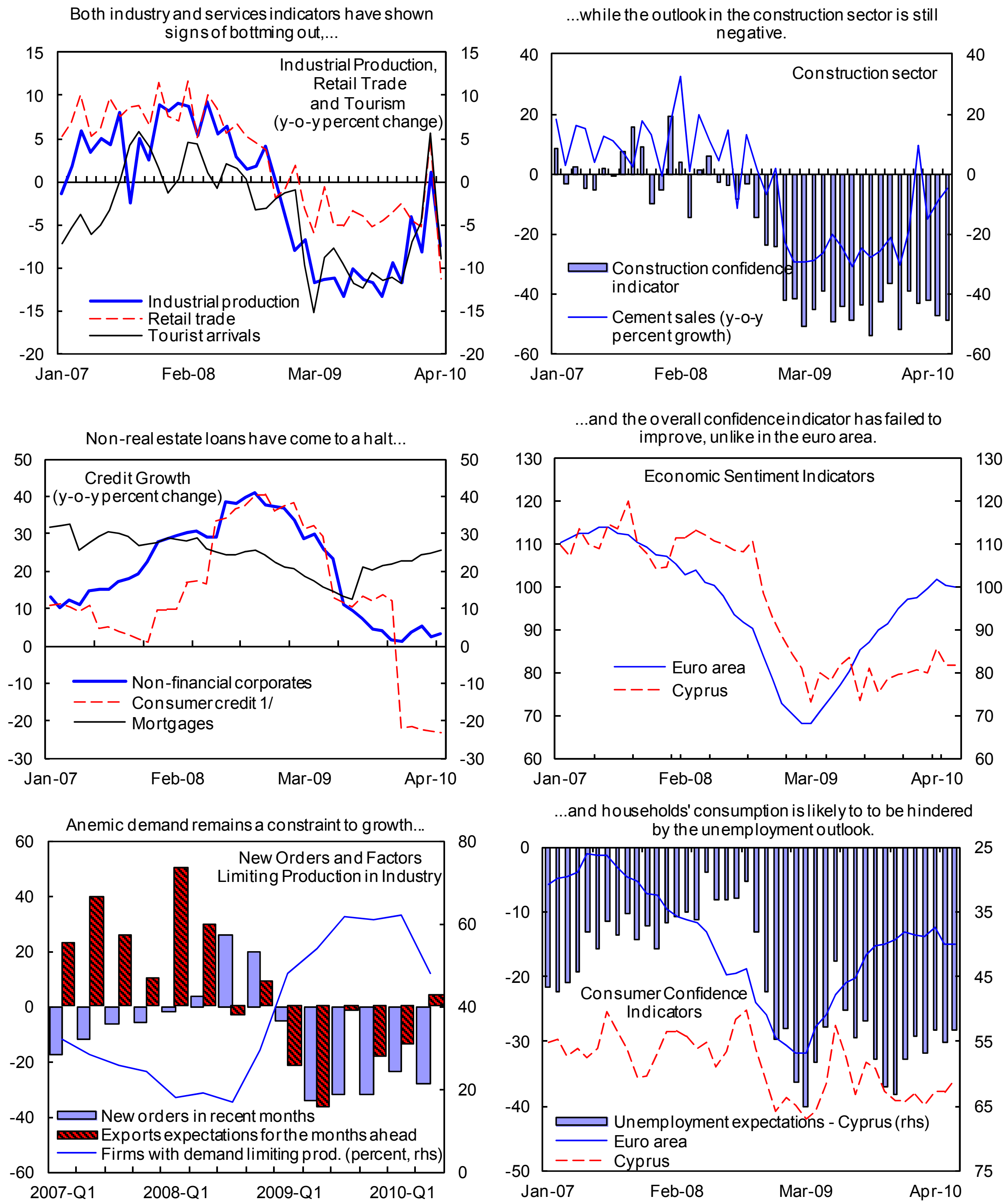
1/ Balances are the difference between positive and negative answering options, measured as a percent of total answers.

Figure 5. Cyprus: Labor Market



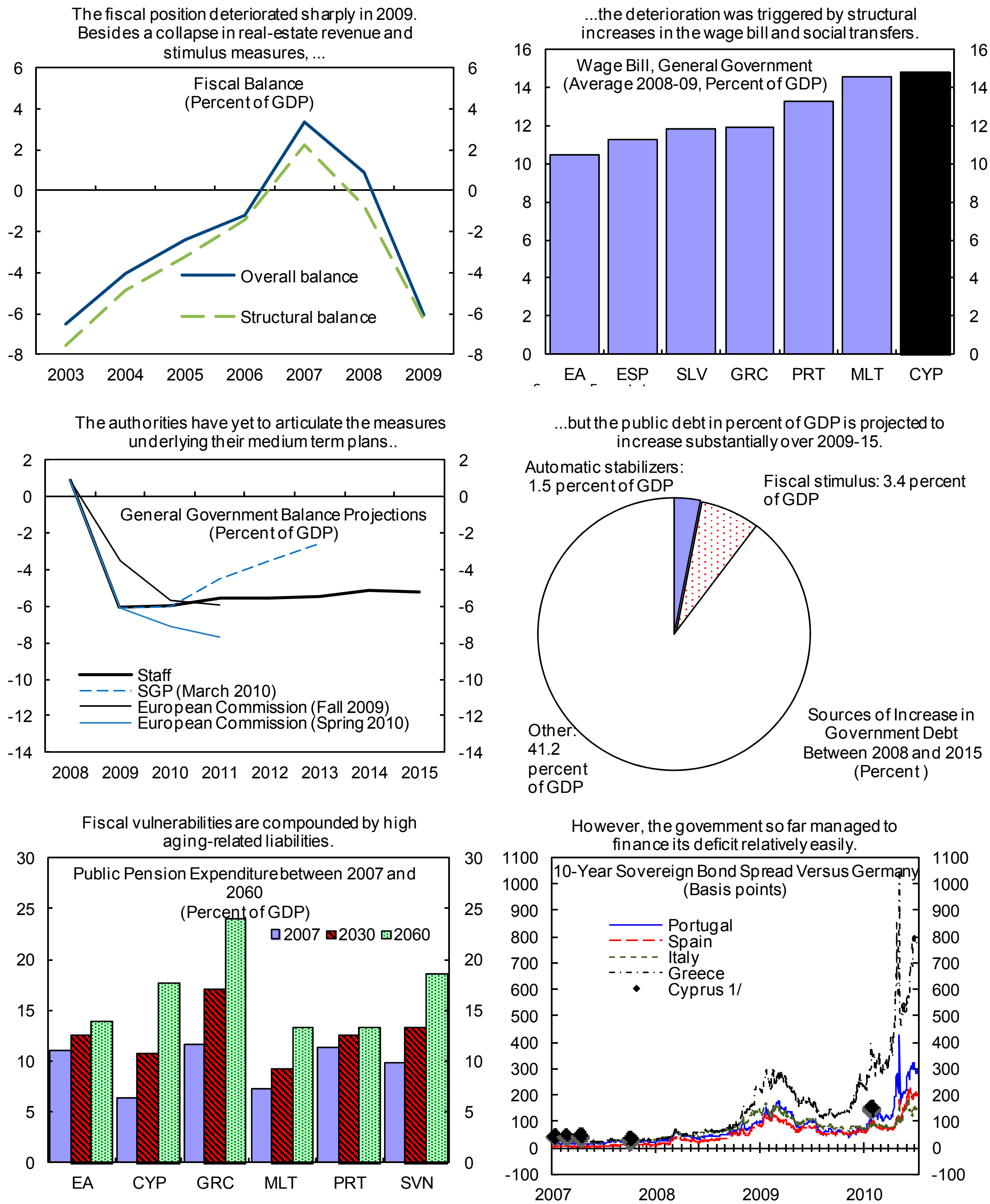
Sources: Eurostat; Cystat; IMF, WEO; and European Comission.

Figure 6. Cyprus: Short-Term Indicators



Sources: Cyprus Statistical Office; Central Bank of Cyprus, Cyprus Ministry of Finances, Eurostat, and European Commission.
1/ The substantial drop in consumer credit growth in January 2010 is due to a major reclassification from consumer credit to other lending causing the reported negative rate for consumer loans. Taking this reclassification into account, consumer credit growth decelerated but remained positive, reaching 3.8 percent in June 2010.

Figure 7. Cyprus: Fiscal Sector



Sources: European Commission, *2009 Ageing Report;* Eurostat; IMF, WEO; Central Bank of Cyprus, Cyprus Ministry of Finance; and Bloomberg.
1/ Auction average yields.

Box 2. Cyprus: Cost-of-Living Allowance (COLA) System

An important element of the wage determination process in Cyprus is the cost-of-living allowance (COLA). Through COLA salaries in the public sector and many salaries in the private sector are linked to average CPI inflation (excluding excise tax increases since the second half of 1999) in the preceding six months twice a year, on January 1 and on July 1. The share of "COLA employees" in the private sector has been on a downward trend, in particular due to an increasing number of foreign workers not covered by the COLA; recent estimates by the Central Bank of Cyprus place at approximately 50 percent the overall share of such employees.

The COLA system is a fairly controversial issue in Cyprus, and it is only in times of real crisis, such as after the military conflict in 1974, that a temporary suspension of the COLA has been possible. COLA is strongly supported by the trade unions, and considered as having contributed to long-term contracts and labor market peace. On the other hand, employer organizations have argued that it has resulted in large increases in real wages and deterioration in competitiveness of domestic firms due to second round inflationary effects, and have expressed concerns that the system undermines flexibility and competitiveness as it impedes relative wage adjustments across firms and sectors in line with productivity differentials. The COLA also imparts inertia to the public sector wage bill, making it more difficult to reverse the excessive growth of public sector wages and salaries. Finally, while there is no firm evidence that COLA contributed to wage-prices spirals, this might have been a result of the prevailing stable inflationary environment of the last years.

The shortcomings of the COLA become more evident in the current low-growth economic environment. By linking wages to CPI rather than productivity, COLA undermines competitiveness and labor flexibility, in addition to exacerbating the level and persistence of price shocks. In addition, downward wages stickiness resulting from the COLA may become an impediment to the economy's ability to respond to the current low-growth environment. In particular, in the presence of long-duration wage contracts the COLA constrains the markets' ability to correct an overshooting of wages that may result from too optimistic an outlook at the time of the contract's inception.

part permanent rather than one-off or cyclical. Meanwhile revenues fell by 3 percent of GDP, reflecting the economic downturn and the unwinding of exceptional revenues associated with the real estate boom of preceding years. The result was a fiscal deficit of 6.1 percent of GDP—a 7 percent of GDP widening over 2008. The cyclically adjusted primary balance declined by some 6 percentage points in 2009, imparting a large fiscal stimulus.

7. **The government plans to reduce the deficit to 3 percent of GDP in 2012, consistent with its EU obligations.** Under the Excessive Deficit Procedure (EDP), the EU has asked Cyprus to bring its fiscal deficit down to 4.5 percent GDP in 2011 and 3 percent of GDP in 2012. Cyprus is due to report back to the EU in January 2011 on its plans for achieving this consolidation.

8. **The authorities have taken steps to stabilize the deficit, but additional and as yet unidentified measures will be needed to reach the fiscal targets.** The government has taken some initial steps toward consolidation, including reduction in public employment by 500 in 2010 with additional reductions planned for 2011–12, and zero general wage increase for public employees[3] in 2010–11 (its proposals for a temporary hike in the corporate income tax rate from 10 to 11 percent and higher property taxes were rejected by parliament). The budget will also benefit from the imposition of an excise tax on petroleum imports and the expiration in 2011 of temporary reductions in tourism sector VAT rates. While these measures will help to stabilize the deficit, further actions will be needed to reach the deficit targets for 2011 and 2012.

Annual Revenue Impact of Measures

(Millions of euros)

	2010	2011	2012
Revenue measures	80	231	241
VAT on food and pharmaceuticals	0	35	35
Tax relief for tourism sector expires	0	40	40
Excise on petroleum	40	75	75
Water pricing	0	10	10
Town planning amnesty	20	15	15
Tax avoidance/compliance	20	20	30
Tax relief for airports expires	0	36	36
Expenditure measures	-6	-38	-50
Employment decrease of 500	-6	-18	-30
Social payments targeting	0	-20	-20
		(Percent GDP)	
Projected deficit with measures	6.0	5.6	5.5
Deficit target	6.0	4.5	3.0
Additional measures needed to reach targets		1.1	2.5

Sources: Ministry of Finance; and IMF staff estimates.

9. **While the social security system is currently in surplus, despite the 2009 reform it is unsustainable over the long term (see Annex), and even in the medium term declining surpluses will put pressure elsewhere in the budget.** The social security system surplus is currently 3-4 percent of GDP, as contributions by employers, workers, and the government exceed outlays. Over the coming decades to 2060, pension outlays are projected to rise by some 10 percentage points as the system matures and demographic changes play out. Unless other area of government spending are curtailed, this would raise total government spending to some 60 percent of GDP in 2060—a very high level that could be sustained only with a heavy increase in the tax burden.

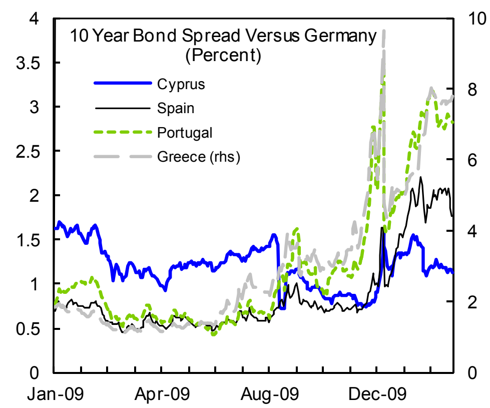
[3] General wage increases agreed in collective agreements are independent from COLA adjustments.

10. **Pressures in Euro zone sovereign debt markets have spilled over to some extent to Cyprus, but the risk of imminent financing pressures appears contained**. There has been a modest widening of credit spreads over the past year, though by less than Greece, Portugal, and Spain. Also, adverse market conditions led the authorities to postpone until late 2010 a European Medium Term Note (EMTN) issuance originally planned for the summer. The authorities do not view sovereign funding pressures as a significant risk, in light of a relatively light amortization schedule. They are also confident that, if external markets remain difficult, they can issue domestic debt to the local financial sector. Staff broadly share this assessment, although access to domestic funding sources could become more difficult if risks to the financial sector from exposure to Greek assets (Box 3) and to the local real estate market materialize.

Public Debt Rollover Requirements
(Millions of euros)

	2010 1/	2011	2012	2013
Domestic	317	875	597	63
Short-term	300	250	0	0
Long-term	17	625	597	63
External	496	24	550	1,530
Short-term	471	0	0	0
Long-term	25	24	550	1,530
TOTAL	813	899	1,147	1,593
Percent of GDP	5	5	6	8

Sources: Ministry of Finance; and IMF staff estimates.
1/ August-December



Sources: Bloomberg; and IMF staff calculations.

C. Financial Sector

11. **Cyprus' banking sector—the core of the financial sector—is complex owing to its role as an international and regional financial center. It poses risks by virtue of its size and concentration, but its capitalization appears adequate**. Only a small number of commercial banks have Cyprus as their home country; the rest are branches or subsidiaries of foreign banks (predominantly from Greece). Local banks, banks whose home country is Cyprus, have assets equivalent to 639 percent of GDP; three of them incorporated locally but operating internationally dominate the sector. The risk-weighted capital adequacy ratio (CAR) of the commercial banking system is adequate (11.9 percent at the end of March 2010), but profitability has declined due to low interest margins (partly induced by competition on deposit rates with Greek banks and, more recently with cooperative credit societies, Figure 8), mark-to-market losses on assets, and provisions for non-performing loans (NPLs).

Cyprus: Banking System Structure
(Millions of euros, unless noted otherwise) 1/

	Assets	% of GDP
Total banking system	**176,339**	**1041**
EU branches	1,188	7
Non EU branches	5,996	35
Subsidiaries of foreign banks	60,873	359
Local banks	108,282	639
of which: coops	*15,886*	*94*
of which: commercial banks	*92,396*	*545*

Source: Central Bank of Cyprus.
1/ As of end of May, 2010.

Box 3. Cyprus: Spillovers from Greece

While the Cypriot economy is exposed to developments in Greece through several channels the main spillovers will be felt through the banks' balance sheets.

- ***Trade channel***. Greece is Cyprus's third-largest tourism market and the largest market for exports of goods. However, the trade effects are expected to be limited given that Greece only accounted for 6.2% of tourist arrivals in 2009 and while it accounted for 18 to 20 percent of total exports, exports of goods account for less than 6 percent of GDP.
- ***Interest rate spreads channel***. Greek banks have a significant and growing presence in Cyprus. As they have had to compete with the high interest rates offered by their own government for funds, they have increased interest rates on deposits, both in Greece and in Cyprus. In order to maintain market share, the Cypriot banks have also had to respond with higher rates, which has contributed to higher deposit rates in Cyprus compared with the euro zone average.
- ***Banking sector channel***. The main spillovers will be felt through the banks' balance sheets in view of the high level of cross-border activities. As of end of 2009 overseas operations of Bank of Cyprus, Marfin Popular Bank and Hellenic Bank represented 45 percent, 63 percent and 24 percent of their consolidated group assets, respectively. Moreover, loans and advances granted by these banks to Greek customers reached 38 percent, 53 percent, and 22 percent of total group loans, respectively, corresponding to direct lending of €23 billion. Additionally, local commercial banks were holding €5.5 billion of Greek government bonds and €0.5 billion of Greek bank bonds as of March 2010. Furthermore, subsidiaries of foreign, mostly Greek, banks have high exposures to Greece as well: these are €1.3 billion in direct loans, €6.6 billion of Greek government bonds and €6.5 billion in Greek bank bonds. Finally, local commercial banks have €1.5 billion worth of interbank exposure to Greece, while subsidiaries of foreign banks have €11 billion of such exposure representing placements with their parents. Overall gross exposure to Greece, not including interbank loans, is estimated to be 260 percent of GDP.

Staff estimates suggest that under an adverse scenario cumulative losses on Greek exposure for local banks could be of the order of €2.0 billion (equivalent to about 12 percent of GDP and 30 percent of equity) by 2013-2014. This estimate is based on cumulative loan losses in combination with market losses on securities, based on the latest available CBC data with 23.5 percent of securities are held at fair value. For direct loans to Greek households and corporates, a cumulative loss is estimated as €1.6 billion, based on a projection that NPLs could double from the present level of 7 percent by 2013-2014, and assuming a recovery rate of 50 percent. For securities, mark-to-market (MTM) losses are estimated based on changes in pricing of Greek securities held at fair value over October 2009 through July 2010. Losses for subsidiaries of foreign, mostly Greek, banks on Greece exposure are estimated at a further €0.2 billion. These banks are only holding 1. 5 percent of securities at fair value.

Estimated Exposure of Local Commercial Banks to Greece 1/

	Holdings	Yield change Oct. 09 - Jul. 10 (bps)	Estimated Duration (yrs)	Estimated Price Change (pct.of par)	Holdings at Fair Value (pct. of total)	MTM Loss Oct. 09 - July 10
Greek gov. bonds	5.5	750	4	30	23.5	0.4
Greek bank bonds	0.5	800	4	32	23.5	0.0
Total securities	6.0					0.4
		Current NPL (pct. of total)	Loss Given Default (pct. of par)	Cumulative Loss	Projected NPL 2013-14 (pct. of total)	Projected Cumulative Loss 2013-14
Direct loans	23.1	7	50	0.8	14	1.6
Total securities & loans	29.1	…	…	…	…	2.0

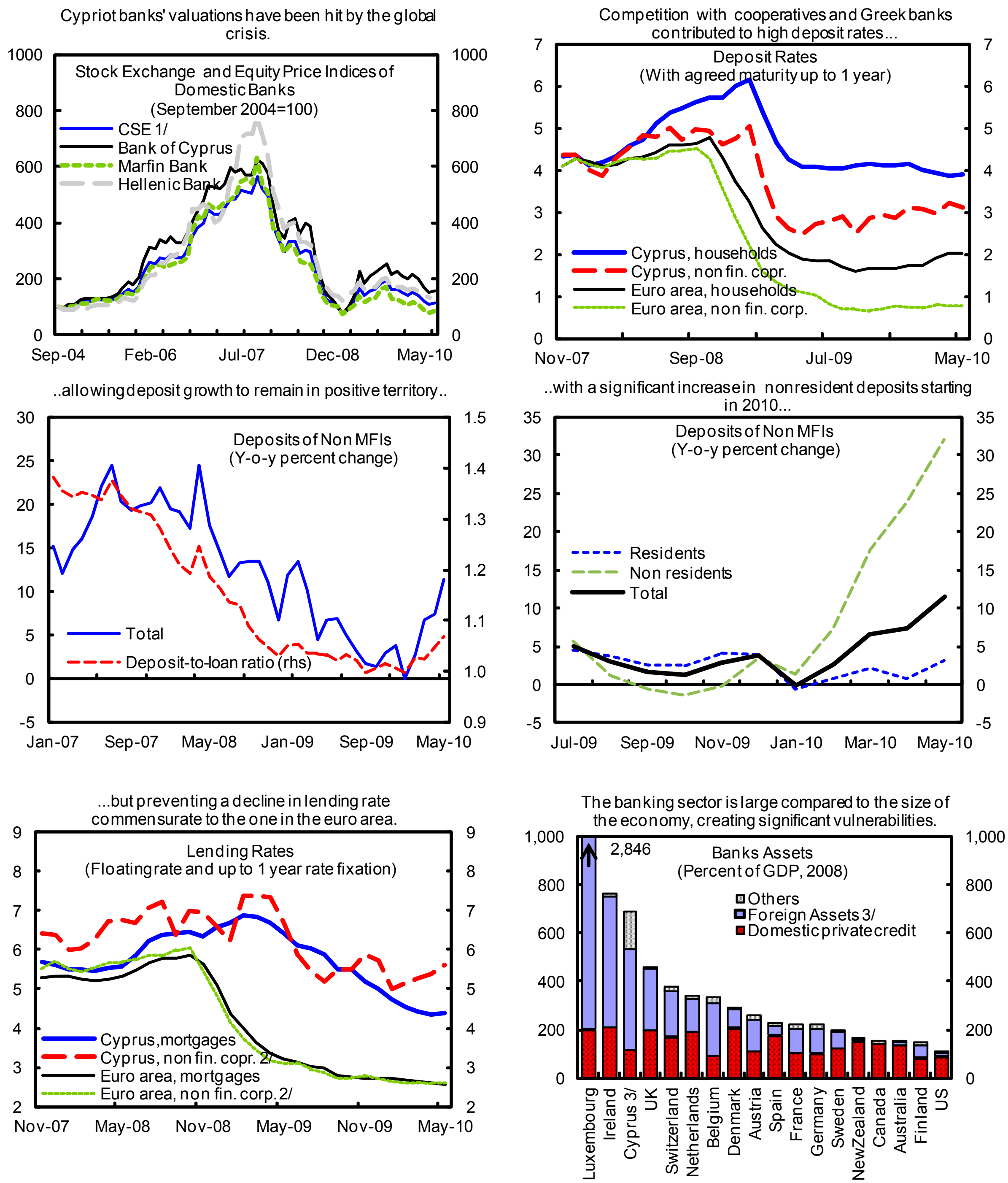
Sources: Central Bank of Cypus; dealer reports; and IMF staff estimates (July 2010).
1/ Excludes interbank loans. In billion of euros unless otherwise indicated.

Estimated Exposure of Cyprus Subsidiaries of Greek Banks to Greece 1/

	Holdings	Yield change Oct. 09 - Jul.y 10 (bps)	Estimated Duration (yrs)	Estimated Price Change (pct. of par)	Holdings at Fair Value (pct. of total)	MTM Loss Oct. 09 - May 10
Greek gov. bonds	6.6	750	4	30	1.5	0.0
Greek bank bonds	6.5	800	4	32	1.5	0.0
Total securities	13.1					0.1
		Current NPL (pct. of total)	Loss Given Default (pct. of par)	Cumulative Loss	Projected NPL 2013-14 (pct. of total)	Projected Total Loss 2013-14
Direct loans	1.3	7	50	0.0	14	0.1
Total securities & loans	14.4	…	…	…	…	0.2

Sources: Central Bank of Cypus; dealer reports; and IMF staff estimates (July 2010).
1/ Excludes interbank loans. In billion of euros unless otherwise indicated.

Figure 8. Cyprus: Financial Indicators



Sources: Bloomberg; Central Bank of Cyprus; ECB; IMF, IFS; and IMF staff calculations.
1/ Cyprus Stock Exchange.
2/ Average of rates for loans up to and over euro 1 million.
3/ Only non resident deposits for Cyprus.

12. **While the banking sector has continued to weather the crisis relatively well NPLs are rising.** Despite recent decline in profitability return on equity remains high compared to other euro area banking sectors. Liquidity ratios also appear comfortable. A business model with high reliance on retail deposits has helped to shield the sector from the global crisis and in recent months banks have gained non-resident deposits largely owing to weaker conditions in Greece. Nevertheless, negative growth in Cyprus has led to rising NPLs in commercial banks (4.9 percent at end March 2010 compared with 3.6 percent at end-2008), and they may rise further until growth resumes. Furthermore, exposure to Greece is significant (estimated to be at least as high as 260 percent of GDP) which creates additional pressure on NPLs. NPLs reported by cooperative banks (9.2 percent at end-March 2010) are higher, and weaker classification norms than for commercial banks strongly suggest that they are significantly understated.[4]

13. **In anticipation of deteriorating asset portfolios banks have acted defensively**. They have lowered dividend payout ratios, although the tax regime favors dividend payouts over retained earnings; cut operational costs, strengthened non-interest margins, and bolstered fee-based activities to support net income; increased loan loss provisions and tightened underwriting standards; and have been able to attract deposits from Greece owing to perceived safety of the banking system.

14. **The government has facilitated the securing of cheap ECB funding** by issuing to the banks close to €3.0 billion worth of bonds (equivalent to about 18 percent of GDP, but only 2 percent of the assets of eligible institutions) against high-quality collateral consisting of performing loans which must be replaced if they become non-performing. The bonds, which banks have pledged at the ECB in part to obtain cheap funding and lower their average cost of funds, are recorded as a securities lending transaction. In the event that the loss for the government becomes large, or if the scheme is extended beyond its original date, the bonds may have to be recorded in the government debt.

15. **Regular stress tests conducted by the CBC indicate that commercial banks have the capacity to absorb further shocks,[5] but the resilience of the cooperative credit**

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[4] NPLs in the cooperative credit societies are compiled on the basis of a 270-day rather than 90-day delinquency rate.

[5] In addition, stress tests on Bank of Cyprus and Marfin Popular Bank in the context of the 2010 EU-wide stress testing exercise showed that as a result of the assumed shock under the adverse scenario, the estimated consolidated Tier 1 capital ratio for Bank of Cyprus would change to 9.4 percent in 2011 compared to 10.5 percent as of end of 2009 and for Marfin Popular Bank it would change to 8.5 percent in 2011 compared to 9.4 percent as of end of 2009. An additional sovereign risk scenario would have a further impact of 1.4 percentage points on the estimated Tier 1 capital ratio of Bank of Cyprus, bringing it to 8.0 percent at the end of 2011 and 1.4 percentage points to 7.1 percent for Marfin Popular Bank. Published results include sovereign exposures of individual banks. Furthermore, Hellenic Bank, the third largest domestic bank, voluntarily carried out the stress test and has announced that its Tier 1 ratio would change to 8.9 percent compared to 9 percent at the end of

(continued…)

societies is harder to assess. According to the CBC, the average CAR would remain above the regulatory minimum even in the event of a doubling of NPLs and assuming a 50 percent recovery rate, which is slightly lower than current levels. On the other hand, stress tests carried out by the supervisor for cooperative credit societies are less stringent and results are difficult to compare with those for commercial banks due to the differences in the definition of NPLs, the size of the shocks, and recovery rate assumptions.

16. **Progress in strengthening financial supervision, crisis management and contingency planning has been uneven.** The deposit insurance schemes were strengthened in July 2009, placing them on a par with similar schemes in the EU; a number of improvements in the supervisory framework for commercial banks have been adopted; a draft law facilitating government intervention in case of a financial crisis is expected to be passed in early 2011. However, no progress was made regarding a previous Fund recommendation to move to one single independent supervisor for banks and cooperative credit societies.

D. External Position

17. **The current account deficit moderated to -8.3 of GDP in 2009 as the economy contracted, from a peak of -17.5 percent in 2008.** Although temporary and technical factors[6] partly explain the large headline numbers in 2008, the foreign trade figures in 2009 reflect the weakness of domestic import demand and lower global commodity prices as well as sluggish demand from Cyprus's main trading partners. As a result the goods trade deficit improved substantially and the service trade surplus worsened. The value of imports for domestic consumptions fell by 21.1 percent with the steepest decline recorded by transport equipment, fuels, and intermediate goods, reflecting a decline in car registration and lower international oil prices compared to 2008. Total exports fell by 11.9 percent, with construction and information services accounting for most of the drop in the services balance while insurance and financial services increased.

18. **Persistent current account deficits point to competitiveness problems while the reliance on short-term bank-related inflows to finance the deficit is a source of macro-financial vulnerabilities**. While Cyprus' market share in the export of services has remained broadly constant, large surpluses in the service sectors have only partially offset persistently large goods trade deficits. The rapid rise in labor cost has hurt manufacturing production more than the services sector. Bank related inflows, including non-resident deposits with resident financial institutions, have been the main source of financing of the current account

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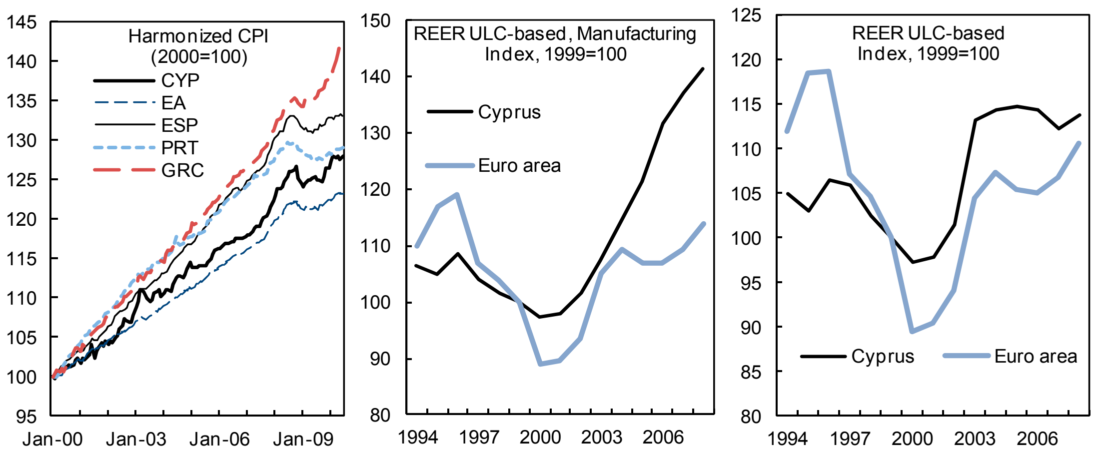
2009; after additional sovereign risk scenario it would decrease to 8.3 percent. Finally, all the Greek banks operating through subsidiaries in Cyprus have passed the stress tests.

[6] About one-third of the headline current account deficit can be attributed to temporary and technical factors, e.g. drought-related water imports, higher reinvested profits (with an FDI counterpart in the financial account), and a one-time increase in car imports following the reduction in excise tax to EU levels ahead of euro entry.

deficit, thus making the external position highly vulnerable to a shift in market sentiment towards Cyprus.

19. **Although Cyprus real exchange rate appreciation follows the trend in Southern Europe (Figure 9), it was particularly harmful for the manufacturing exports and also affected the tourism industry.** Wages have outstripped productivity gains in recent years, leading to an appreciation in the ULC-based real exchange rate and pricing Cypriot goods out of international markets. However, wage increases reflect to some extent the labor shortages and low unemployment rates that prevailed before the crisis. Tourism exports are also on a declining trend, reflecting comparatively high prices, heavy dependence on a weakened British market and increased competition from other destinations in the Mediterranean. However, other services sectors, including finance and shipping, continue to be competitive and profitable.



Source: European Commission

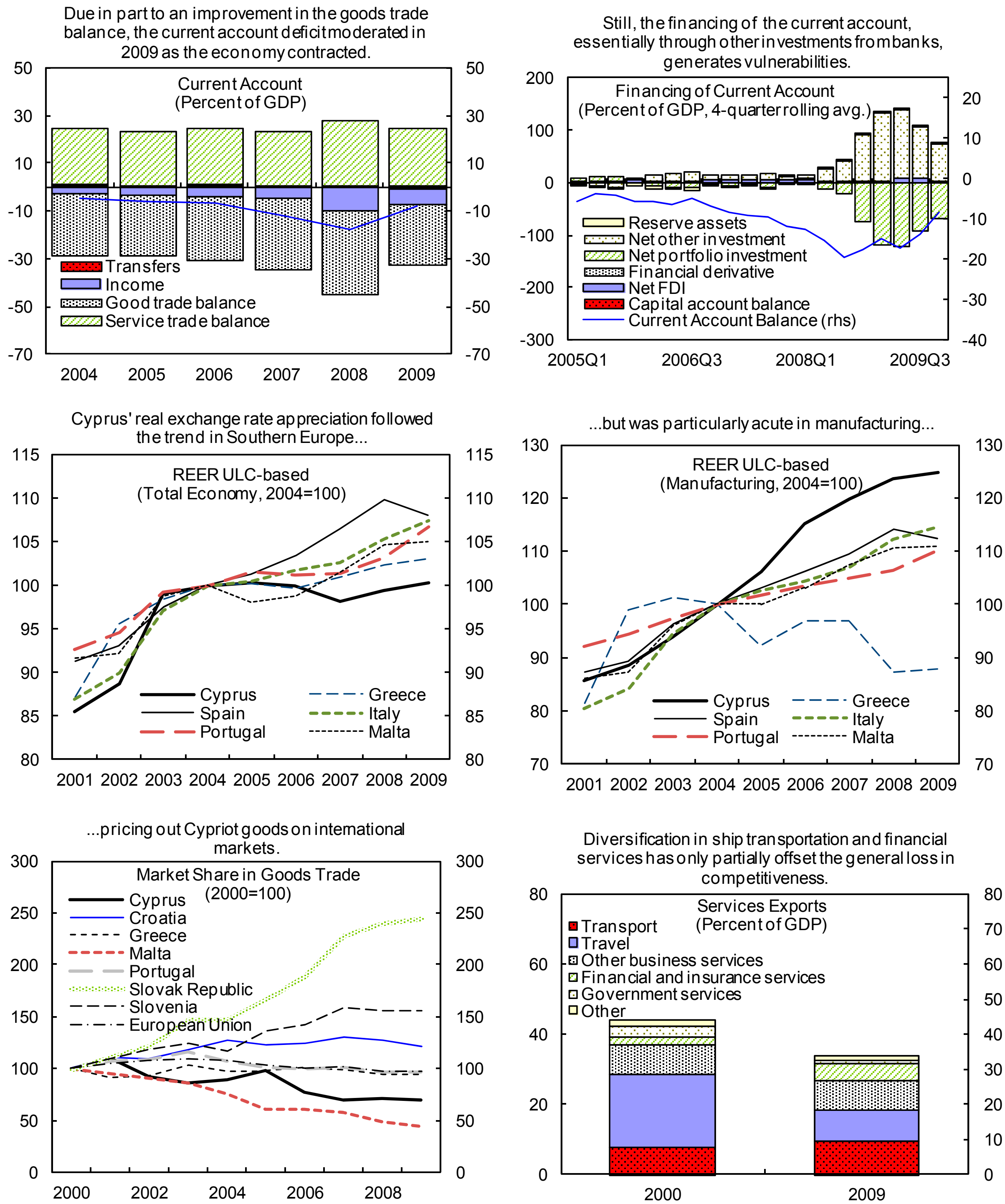
20. **CGER type estimates suggest that Cyprus is facing a competitive disadvantage, although there are mitigating factors.** All estimates indicate the same directional conclusion, with negative current account gaps and substantial exchange rate overvaluation, consistent with recent development in wages and the competitive deterioration in the manufacturing sector. However, the large current account swing in 2009 (from -17.5 to- 8.3 percent of GDP) suggests that significant current account adjustments can occur in Cyprus without major changes in the exchange rate (or slower growth relative to trading partners). Moreover, CGER type analysis needs to be interpreted with care for services exported-oriented economies, since service exports may be less responsive to exchange rate dynamics.

CGER-type Estimates

	Macroeconomic Balance	External Stability	Equilibrium Real Exchange Rate	Purchasing Power Parity
CAB gap 1/	-4.88	-5.77	n.a.	n.a.
REER gap 2/	17.94	21.23	12.11	11.86

Source: IMF staff estimates.
1/ Difference between actual current account balance (CAB) and the estimated equilibrium CAB in percent of GDP
2/ Percentage difference between the actual REER and the estimated equilibrium REER. A positive result suggest overvaluation.

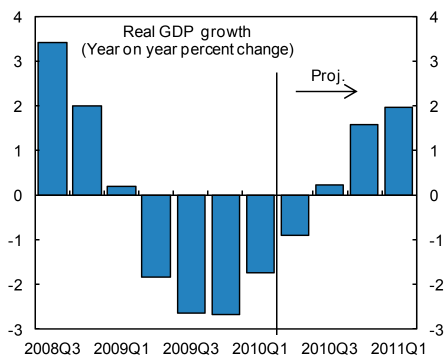
Figure 9. Cyprus: Competitiveness



Sources: Central Bank of Cyprus; IMF, *Driection of Trade Statistics*; and European Comission.

E. Outlook and Risks

21. **Modest growth is projected to resume in the second half of 2010**. Staff forecasts a further 0.2 percent contraction of activity in 2010, with below-potential growth returning in 2011. The Ministry of Finance (MoF) projects positive growth to resume in 2010 but the CBC is less sanguine. The domestic recovery is likely to be driven by the global economic upturn, private consumption and investment. Domestic demand growth would remain modest, though, as private balance sheets remain leveraged, leaving little buffer against future shocks. In particular, while households' debt servicing capacity remains relatively adequate, it could rapidly deteriorate if downside risks to growth and the labor market outlook were to materialize, and at the corporate level a combination of weak profits and high leverage is a source of vulnerability. As a consequence, demand for foreign goods is expected to remain subdued.



Sources: Eurostat; and IMF staff projections.

Real GDP (Percent change)

	2009	2010	2011
Staff	-1.7	-0.2	1.8
MoF April 2010 forecast (SGP)	-1.7	0.5	1.5
EC Spring 2010 forecast	-1.7	-0.4	1.3

Sources: Commission Services' spring 2010 forecasts; Stability Programme of Cyprus 2009-2013; and IMF staff projections.

22. **Inflation is projected to accelerate in 2010 driven by the higher cost of imported oil and commodity prices, against the backdrop of a still depressed domestic demand**. Despite a widening negative output gap in 2010, harmonized consumer price inflation is expected to increase to 2.2 percent due to a base effect, the increase in oil and commodity prices, rising health and education costs. Such factors, along with Cyprus' high dependency on imported energy will drive headline inflation higher in Cyprus than the expected level for the euro area. While the reopening of the inflation differential with the euro area (Figure 4) will erode the competitiveness of Cyprus, given last year's near zero inflation and the backward looking inflation-indexed wage adjustment mechanism, wage inflation should remain subdued in 2010.

23. **Staff forecasts the current account deficit to follow a gradually improving trend over the medium term after a realignment of more than 9 percent of GDP in 2009**. Although commodity prices will contribute to inflate imports in 2010, import volumes are projected to decrease due to declining domestic demand while the recovery in foreign demand will induce a turnaround in exports. If the exchange rate overvaluation persists, however, a shift from domestic to foreign goods and services, with consequent trade balance deterioration, cannot be ruled out. Unless market sentiment towards Cyprus were to deteriorate significantly, bank related short-term capital inflow can be expected to provide the necessary current account financing based on actual developments in the first quarter of 2010, where Cyprus benefited from increased short-term capital inflows, in particular from residents of the euro area. However, such a structurally precarious nature of current account financing reinforces the need for fiscal consolidation, as well as high capital buffers in the financial sector to anchor foreign investors' confidence.

24. **Medium-term growth may suffer from deterioration in potential output following the global crisis, and it is expected to remain sluggish.** Subdued private consumption and investment, in tandem with hesitant foreign demand for Cyprus' exports, will weigh on growth. Cyclical conditions are projected to feature negative output gaps until 2015 as growth return to its potential. The latter, however, is likely to have suffered from the fall in economic activity in 2009, reflecting a decrease in labor contribution and lower capital stocks as a result of obsolescence and the drop in investment. Unemployment, which climbed to 5.6 percent in 2009, is expected to rise to 7.8 in 2010 and stay above its historical average for some time. Fixed investment growth is forecasted to remain in negative territory this year after plummeting in 2009. Productivity, on the other hand, is unlikely to positively contribute to potential growth given its pro-cyclical nature and the already low levels of private investment on R&D in Cyprus due to the small size and service orientation of the economy.

25. **Staff sees downside risks to the outlook on account of five main risk factors.** First, the projected recovery for 2011 is vulnerable to spillovers from Greece due to the high exposure of the financial sector to Greek assets (about 260 percent of GDP). Second, the fiscal consolidation that is needed to reverse the structural deterioration will weigh on an already sluggish domestic demand. On the other hand, if the consolidation measures proposed by the government were not to materialize, increased levels of public debt in the current market environment could undermine investors' confidence about fiscal sustainability, in turn making it difficult for the government to finance the deficit. Third, a rebound in the tourism and construction sector (which contributed significantly to growth in recent years) could fail to materialize if the demand from UK and Russia residents remained tepid due to a weaker than anticipated recovery in these countries. Fourth, medium- and long-term growth prospects could weaken if the 2009 recession has structurally lowered potential growth, and Cyprus could be facing years of more subdued potential as well as actual growth. Finally, public debt levels could increase significantly if the government securities that have been issued to the banks had to be recorded in the government debt.

III. POLICY DISCUSSIONS

26. **The main policy priorities should be to stabilize public debt at a more prudent level and boost competitiveness, while safeguarding the stability of the financial sector**. Cyprus entered the crisis in a position of strength, including public debt below 50 percent of GDP and a positive net international investment position (IIP). But to continue to benefit from euro area membership and prepare for aging-related spending pressures will require reversing the recent structural deterioration in public finances, rebalancing the private saving – investment disparity, and addressing the structural causes of the competitiveness gap. Strong financial sector oversight and early detection of problems is also needed given the size of the banking sector in relation to the economy and a weakened outlook for the sector. Structural reforms are needed to preserve competitiveness and enhance medium-term growth.

A. Adopt a Credible Medium-Term Fiscal Consolidation Strategy

27. **Staff believe the authorities' goal of reducing the fiscal deficit to 4.5 percent of GDP in 2011 and 3 percent in 2012 is appropriate.** This consolidation is needed to minimize the risk that fiscal financing pressures will emerge, provide more space to guard against risks to the financial sector, and stabilize debt ratios. Further action will be needed to put debt ratios on a declining path.

- Public debt (56 percent of GDP in 2009) is moderate relative to the Euro area average (79 percent of GDP), but it has risen sharply over the past two years. Achieving the fiscal targets would stabilize debt at 63 percent of GDP in 2012. Further consolidation in future years would be needed to put it on a downward path.

- Although public financing pressures do not appear to be an imminent threat, the growing pressures in Euro area sovereign debt markets and the increased focus of investors on fiscal imbalances argue for decisive consolidation.

- The large size of the financial sector and risks to its balance sheet suggest the government should maintain fiscal space so that it is positioned to provide support to banks, if needed.

Structure of Public Expenditure, 2010

	Pct. of GDP	Pct. of total
Wages and salaries	15.8	33.3
Social transfers	14.4	30.2
Goods and services	5.6	11.8
Other current	4.8	10.2
Capital expenditure	4.6	9.7
Interest	2.3	4.8
Total	47.6	100.0

Sources: Ministry of Finance; and IMF staff estimates.

28. **To achieve the authorities' fiscal targets, staff advised that additional measures focus on public expenditure, in particular through reductions in the government wage bill and better targeting of social transfers**. The relatively large size of the public sector (close to 50 percent of GDP), the gradual increase of pension outlays as the system matures and the population ages, and the need to maintain a favorable tax regime to attract investment (Box 4) all argue for a focus on expenditure measures. Given the dominant share of government

wages and salaries and social transfers in the budget, these sectors will need to absorb the bulk of adjustment. Options that should be pursued include adjustments to the incremental salary step increase schedule and to the COLA for public workers; the introduction of contributions by government employees toward their unfunded pension benefits; reducing lower priority capital expenditure (which was boosted by 1.4 percent of GDP in 2009 as a stimulus measure and remains one percent of GDP above its pre-crisis level); and restraint on other goods and services. Finally, if expenditure measures are inadequate to close the gap, an increase in the VAT from 15 percent (the lowest in the EU) to 16 percent would contribute some 0.6 percent of GDP.

Impact of Possible Measures on 2012 Fiscal Balance
(Millions of euros)

Freeze COLA in 2011 and 2012	108
Freeze salary increments in 2011 and 2012	68
4 pct pension contribution for govt workers, 2012	70
5 pct reduction in goods and services, 2011 and 2012	49
Prioritize investment spending	70
VAT increase from 15 to 16 percent	90
TOTAL	455
Percent of GDP	2.5

Sources: Ministry of Finance; and IMF staff estimates.

29. **The authorities recognized the need for additional measures to reach their targets, but they had not yet formulated a specific strategy.** They also were more optimistic that consolidation could be met through general spending restraint, with less focus on the public payroll.

B. Enhance Early Detection of Problems in the Financial Sector

30. **The outlook for the financial sector has weakened.** There was broad agreement that commercial banks are exposed to further deterioration of loan portfolios in Cyprus and in foreign markets. However, stress test results suggest that they have the capacity to absorb further shocks. Furthermore, information provided by the systemically important commercial banks indicates that managers have incorporated in their business plans a significant increase in NPLs and are taking appropriate actions (see paragraph 13) in response to deteriorating market conditions which should support capacity for credit extension.

31. **Cooperative credit societies may be more at risk than commercial banks**. While they would only be affected by conditions in Cyprus, a combination of weak underwriting standards as evidenced by high NPLs using a weak definition, lower overall CAR, and significantly higher NPLs ratios net of provisions suggest that risks for the sector are higher than for commercial banks.

32. **The authorities are confident that the banks should be in a position to exit ECB funding smoothly.** They indicated that the use of the special government bonds had been limited to 7 percent of individual banks' customer deposits. They noted that the special government scheme was designed to help banks secure cheap ECB funding in the absence of covered bond legislation at a time when banks in other euro area countries had been able to use covered bonds to access funding from markets or the ECB. Covered bond legislation is expected to be passed in late 2010, allowing Cypriot banks to avail themselves from such funding sources and providing for an exit strategy to unconventional ECB funding.

Box 4. Cyprus: Tax Regime

Cyprus' favorable tax regime, together with an open stance toward foreign investors, is a key feature of the country's business model. It has been an important factor behind the transformation of the economy from an agricultural base in the 1960s, to an industrial base until the mid-1980s, and a services base economy thereafter, with services accounting for 79.3 percent of GDP in 2009. Key features of the tax regime are as follows:

- ***Personal income tax***. Cyprus has a personal income tax with a progressive rate structure. The top rate of personal income tax is low, at 30 percent, and the tax-free threshold for income is high, at €19,500. Capital gains, dividends, interest income and income from the sale of securities are exempt from income tax. Dividends and interest are taxed under the Special Contribution for the Defense of the Republic Law and a capital gain tax is levied on the realized profit from the disposal of immovable property in the Republic and/or securities.

- ***Corporate income tax.*** With a flat corporate tax rate of 10 percent, Cyprus (together with Bulgaria), has the lowest corporate tax rate in the EU. Seventy percent of undistributed corporate profits of year t-2 are subject to a 15% tax.

- ***Defense Contribution.*** All residents are subject to the Defense Contribution, which is applied with different rates on dividends, interest and rental payments.

- ***Value-added tax (VAT)***. In 2003 the standard VAT rate was raised to the EU minimum of 15 percent for most categories of goods and services. But in 2009 VAT on hotels and restaurants was reduced from 8 to 5 percent on a temporary basis and in 2010 the reduced rate still applies to hotels only; to alleviate the negative effects of the crisis on the tourism sector; airport landing fees levied on airline companies were decreased; and overnight stay fees levied by local authorities cancelled. VAT rate on certain locally produced labor intensive services was lowered to the reduced rate of 5% on a permanent basis. Under EU rules, Cyprus was due to introduce VAT on residential land during 2008 but has yet to implement the legislation. Cyprus is also due by 2011 to introduce the reduced VAT rate on foodstuffs and pharmaceutical that are currently zero rated.

- ***Social security contributions.*** Employers' social security contributions are due for the Social Security Fund, redundancy fund, central holiday fund and for the Human Resource Development Fund. Altogether, the employers' contribution rate amounts to 8.5 percent of gross wages. Employers must also pay a payroll tax (2 percent of gross wages) to the social cohesion fund, which is not deductable for corporate income purposes. Employees pay 6.8 percent of their salary and the self-employed pay 12.6 percent of their notional income. Social security contributions of employed and self-employed are augmented by a 4.3 percent payment of the state, although total contributions will rise by 1.3 percent every five years until 2039.

- ***Other features of the tax regime*** that have attracted foreign companies include the fact that Cyprus International Trusts, a type of offshore holding company, are exempt from tax in Cyprus, and there is no taxation on dividends for non-residents. A special tax regime applies to shipping companies.

- Cyprus a***lso has double taxation agreements*** with over 40 countries.

Source: staff analysis based on data from The Economist Intelligence Unit, Country Forecast Report, May 2010; and European Commission, Taxation trends in the European union, 2010 Edition.

33. **The authorities may wish to consider boosting the size of the deposit insurance facilities in view of the recent increase in coverage**. Given the increase in the size of insured deposits from €20,000 to €100,000 per depositor per bank, and the extension of coverage to deposits denominated in all currencies and to deposits of non-euro area residents, the present size of the deposit insurance facilities, €100 million for commercial banks and €20 for cooperative credit societies, are below a threshold of 1 percent of coverage provided, which is generally used as a guiding principle. The authorities have indicated that, in case of need, banks may be requested to pay additional capital, which would raise the size of the facility to 3 percent of coverage provided. However, the authorities may wish to take steps to bolster the size of the facility proactively.

34. **Staff and the authorities agreed that preserving the stability of the banking sector through continued strong supervision and early detection of risks should remain a top priority.** Given the large size of the banking sector relative to the economy if problems emerged they could escalate to systemic proportions with spillover to the economy and to public finances. Policies should therefore focus on addressing areas of potential concern early. The following points were noted:

- Ongoing initiatives for cross border cooperation with Greece and other Southeastern European supervisors should be pursued purposefully. In that context, supervisors should agree to procedural mechanisms for the coordination of cross-border resolution actions, including procedures for information sharing and rules to determine which jurisdiction's competent authorities would assume a lead role in resolving a particular cross-border bank.
- The draft law facilitating government intervention in case of a financial crisis submitted to Parliament should be passed as soon as possible; an operational manual spelling out the process to be followed in a crisis situation should be developed at the CBC.
- Measures to bolster the supervision and transparency of the cooperative credit societies are needed to help reduce risks and to ensure a level playing field in the financial sector. That should include aligning the definition of NPLs, and the stress test and financial reporting frameworks in place for cooperative credit societies with the regime applied to commercial banks. Ultimately, a single independent supervisor for all credit institutions operating in Cyprus would help achieve these objectives.

C. Implement Structural Reforms to Boost Competitiveness

35. **The authorities agreed with staff that growth of wages and labor costs in excess of productivity increases has reduced competitiveness, particularly in the manufacturing and tourism sectors**. They also acknowledged the need to reverse the steady growth of public sector wages and employment so as to protect the low tax environment needed to attract investment, and reduce wage pressures in the economy. Staff

also noted that wage settings mechanisms ensuring a closer link between wages and productivity development than currently provided by the COLA system should be promoted.

36. **Staff noted that measures to increase labor market flexibility, streamline the regulatory framework, reduce red tape and enhance the business climate would bolster potential growth over the medium term**. In particular, improving the functioning of the labor market through active labor market policies targeted to young workers and low skilled immigrants would help address the current increase in unemployment and support long-term growth potential, while measures to reduce the high gender pay gap would contribute to improve the overall business climate. The authorities' policy agenda in this regard includes measures to support employment, raise expenditure in R&D, increase the share of population having completed tertiary education, and reduce early school leavers. The authorities are also implementing measures to enhance energy efficiency.

IV. Staff Appraisal

37. **The foremost policy challenge is to reverse the large structural fiscal deficit that has emerged.** Cyprus compares favorably compared to other euro area countries (Box 5), in particular with relatively moderate public debt levels, but it must act forcefully to preserve this favorable legacy, protect debt sustainability, and provide more space to guard against risks to the financial sector. While the official fiscal target of a 3 percent of GDP deficit in 2012 is appropriate, the government needs to confront the hard choices required to realize this objective so as to stabilize debt ratios, and to build public support for the necessary measures. Further action will be needed to put debt ratios on a declining path over the medium term.

38. **Further reforms of the pension system are needed**. The 2009 reform was a first step, but absent more fundamental reforms, the pension system will be a growing strain on public finances. A lasting solution requires bringing outlays more in line with contributions, through lower replacement rates and higher retirement age.

39. **The banking sector remains sound for now, but risks have significantly risen.** This calls for continued efforts on the part of the authorities for early detection of problems, close cooperation with other supervisors, and enhanced contingency planning. The supervision and transparency of the cooperative credit societies need to be strengthened as a matter of urgency with a view to put in place a regulatory regime that is consistent with that for commercial banks. Until this is achieved, it will be difficult to assess the risks to the economy that the sector generates as well as the actions that may be warranted to mitigate those risks. Furthermore, ensuring a level playing field in the financial sector would help contain the potential for unhealthy competition for deposits, contribute to lowering deposits rates in Cyprus, and reduce the incentives for recourse to ECB liquidity.

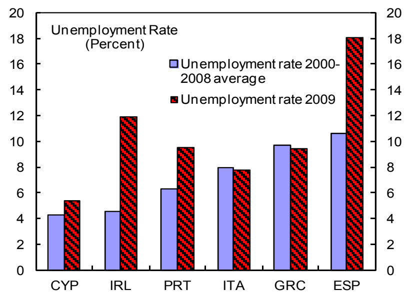
40. **Structural reform to preserve competitiveness will support the recovery and enhance growth potential.** A key part of this agenda will be restraining public sector wages

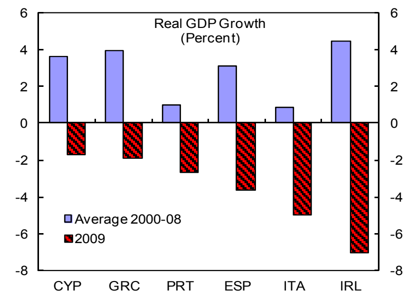
and employment. Ensuring real wage flexibility is also essential to deal with the current exchange rate overvaluation. Improving labor market functioning through active policies will help address the increase in unemployment.

41. **It is recommended that the next Article IV consultation take place on the standard 12-month cycle**.

Box 5. Cyprus: Comparison with Selected Euro Area Countries

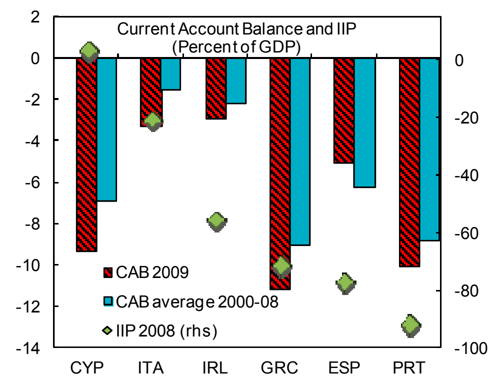
This box compares Cyprus to Euro area averages and other peripheral Euro area (EA) countries whose sovereign debt markets have come under stress. It concludes that Cyprus compares favorably on balance across several indicators of vulnerability.





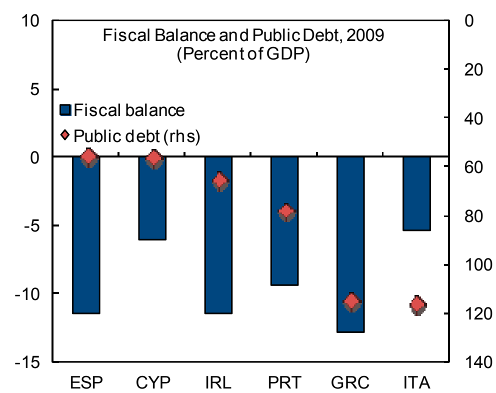
Sources: WEO; and IMF staff calculations.

Since 2000, including during the global financial crisis, Cyprus GDP growth and unemployment developments compared favorably with other countries in the Euro zone. Cyprus GDP growth has averaged 3.2 percent since 2000 against 1.4 percent in the overall EA and unemployment was at 4.4 percent compared to 8.4 in the EA. Even during the global financial crisis, Cyprus outperformed its peers: unemployment increased to 5.4 percent in 2009 from 3.7 in 2008, compared to 9.4 percent in the EA, and the decrease in real GDP was only 1.7 percent versus 4.1 in the EA.



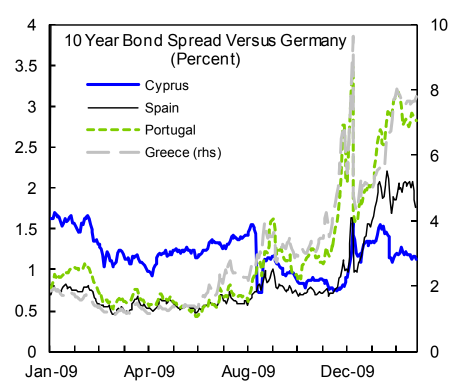
Sources: WEO; and IMF staff calculations.

Despite large current account deficits in international comparison, Cyprus IIP remains positive. Cyprus current account has recorded recurrent deficits over the last decade — -6.9 percent of GDP on average in 2000-08 versus -0.2 in the Euro zone — and it deteriorated significantly (to 17.5 percent of GDP) during the economic boom in 2008, and narrowed to 8.3 percent when the crisis hit Cyprus in 2009. While the current account deficit as a percent of GDP was high in international comparison in 2009 (-0.75 percent of GDP in the Euro zone), Cyprus IIP was still positive at 4 percent versus significantly negative IIPs in other EA countries.



Sources: WEO; and IMF staff calculations.

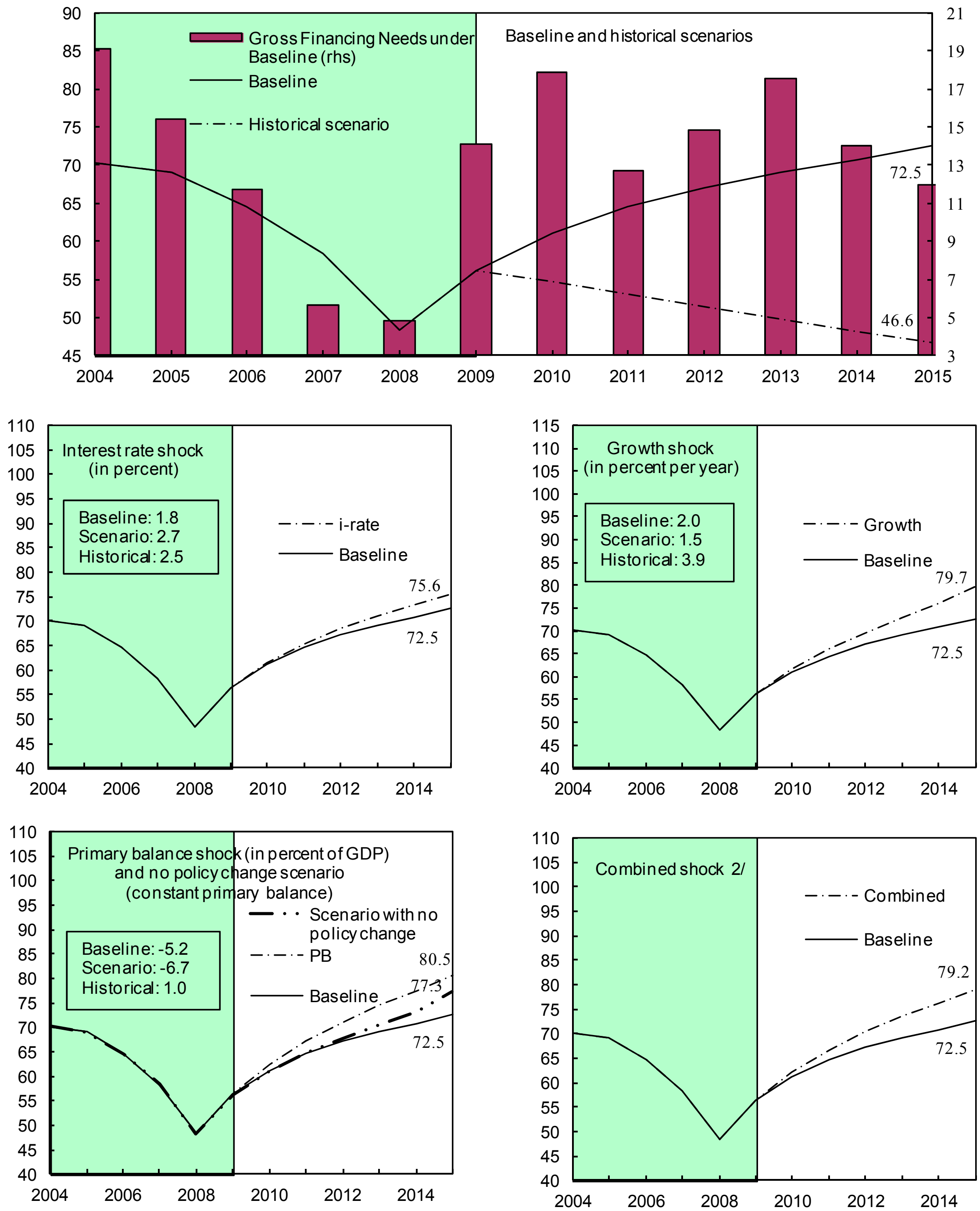
Relatively small fiscal deficits and moderate public debt levels differentiate Cyprus from some of the most vulnerable euro area countries. Although the fiscal deficit increased significantly in 2009 due to the rapid growth of government spending and the aftermath of the real estate boom, it is moderate compared to fiscal deficits in most EA countries. At 56 percent of GDP in 2009, public debt is also well below the EA average of 78.7, although on an increasing path due to projected primary deficits and slower GDP growth in coming years. Financing needs are also limited due to the small size of the economy.



Sources: Bloomberg; and IMF staff calculations.

All in all, Cyprus appears relatively robust compared to other peripheral EA countries. This assessment is consistent with market perceptions of the economy as reflected by comparatively low sovereign spreads.

Figure 10. Cyprus: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

Table 1. Cyprus: Selected Economic Indicators, 2005–2015

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
								Proj.			
Real Economy				(Percent change, unless otherwise indicated)							
Real GDP	3.9	4.1	5.1	3.6	-1.7	-0.2	1.8	2.5	2.9	2.9	3.0
Domestic demand	3.4	5.7	8.8	8.4	-7.0	-1.0	1.6	2.3	2.5	2.6	2.6
Consumption	4.0	5.2	7.4	8.0	-1.2	-1.7	1.1	1.8	2.0	2.1	2.0
Private consumption	4.2	4.6	9.4	8.4	-3.0	-2.2	1.3	2.1	2.3	2.3	2.2
Public consumption	3.4	7.3	0.3	6.2	5.8	0.3	0.4	0.7	0.9	1.1	1.1
Fixed investment	4.1	10.3	13.4	8.6	-12.0	-7.1	1.4	2.7	2.9	3.3	3.2
Inventory accumulation 1/	-0.6	-0.5	0.3	0.4	-4.0	1.9	0.5	0.3	0.4	0.3	0.4
Foreign balance 1/	0.5	-1.9	-4.4	-6.0	6.8	1.5	0.1	0.1	0.2	0.2	0.3
Exports of goods and services	4.9	3.5	6.1	-2.1	-11.8	2.4	3.9	4.1	4.6	4.9	5.2
Imports of goods and services	3.7	6.7	13.3	8.0	-19.8	-0.8	3.3	3.4	3.7	4.0	4.2
Potential GDP growth	3.3	3.2	2.8	2.3	1.9	1.7	1.9	2.2	2.5	2.8	2.8
Output gap (percent of potential GDP)	-0.3	0.7	2.9	4.3	0.6	-1.3	-1.4	-1.1	-0.7	-0.6	-0.3
HICP (period average)	2.0	2.2	2.2	4.4	0.2	2.2	2.3	2.5	2.5	2.4	2.2
HICP (end of period)	1.4	1.5	3.7	1.8	1.6	1.6	2.7	2.5	2.5	2.4	2.2
Unemployment rate EU stand. (percent)	5.3	4.6	4.0	3.6	5.3	7.8	7.5	7.1	6.6	6.1	5.7
Employment growth (percent)	2.5	2.7	5.8	1.3	0.3	0.5	1.1	1.4	1.7	2.1	2.0
Gross national savings (percent of GDP)	14.0	13.8	10.7	6.6	9.0	10.5	11.4	12.0	12.7	13.5	14.1
Gross capital formation (percent of GDP)	19.9	20.8	22.4	24.1	17.2	17.7	18.1	18.5	18.9	19.2	19.6
Public Finance						(Percent of GDP)					
General government balance 2/	-2.4	-1.2	3.4	0.9	-6.1	-6.0	-5.6	-5.5	-5.5	-5.2	-5.3
Revenue	41.2	42.2	45.5	43.5	40.3	41.6	41.6	41.6	41.7	42.1	42.2
Expenditure	43.6	43.4	42.2	42.6	46.4	47.6	47.2	47.2	47.2	47.3	47.5
General government debt	69.1	64.6	58.3	48.4	56.2	61.1	64.5	67.1	69.1	70.8	72.5
Balance of Payments						(Percent of GDP)					
Current account balance	-5.9	-7.0	-11.7	-17.5	-8.3	-7.2	-6.7	-6.5	-6.2	-5.8	-5.5
Trade Balance (goods and services)	-2.7	-4.0	-6.5	-7.4	-0.6	-1.5	-1.9	-1.8	-1.8	-1.4	-1.0
Exports of goods and services	48.2	47.1	47.2	55.8	50.5	50.9	51.2	51.7	52.1	53.1	53.8
Imports of goods and services	50.9	51.1	53.7	63.2	51.1	52.4	53.1	53.5	53.9	54.4	54.9
Goods balance	-25.4	-27.2	-29.7	-35.2	-25.0	-25.5	-26.0	-26.6	-27.2	-27.6	-27.8
Services balance	22.8	23.2	23.1	27.8	24.4	24.0	24.1	24.8	25.4	26.2	26.8
Income, net	-3.8	-4.1	-5.2	-9.7	-6.5	-6.2	-5.2	-5.1	-4.7	-4.7	-4.8
Transfers, net	0.5	1.1	0.0	-0.4	-1.2	0.5	0.4	0.4	0.3	0.3	0.3
Capital account, net	0.5	0.2	0.0	0.1	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Financial account, net	4.4	6.8	12.0	18.0	8.0	7.1	6.6	6.4	6.1	5.7	5.4
Direct investment	3.8	5.2	4.5	0.5	2.9	3.5	4.0	4.3	4.3	4.3	4.3
Portfolio investment	-0.9	-0.9	-2.0	-73.7	-67.0	-5.0	-1.5	0.3	0.3	0.3	0.3
Other investment	5.8	8.0	8.1	89.6	71.6	8.4	4.1	1.8	1.5	1.1	0.8
Reserves (- inflow; + outflow)	-4.3	-5.5	1.4	1.6	0.5	0.2	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.0	-0.1	-0.3	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Item:											
Nominal GDP (billions of euros)	13.5	14.4	15.9	17.2	16.9	17.3	18.0	18.9	19.9	21.0	22.1

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

1/ Contribution to grow th.

2/ Does not include special government bonds issued at the end of 2009 as a liquidity support measure fior the financial sector, in an amount equivalent to 18 percent of GDP.

Table 2. Cyprus: Fiscal Developments and Projections, 2005–2015
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
								Proj.			
Revenue	41.2	42.2	45.5	43.5	40.3	41.6	41.6	41.6	41.7	42.1	42.2
Current revenue	41.1	42.2	45.5	43.5	40.3	41.6	41.6	41.6	41.6	42.1	42.2
Tax revenue	27.0	28.4	33.1	31.3	26.3	27.2	27.2	27.2	27.2	27.2	27.2
Indirect taxes	16.9	17.6	19.4	18.4	15.0	15.5	15.5	15.5	15.5	15.5	15.5
Direct taxes	9.2	10.8	13.7	12.9	11.2	11.6	11.6	11.6	11.6	11.6	11.6
Other taxes (capital taxes)	0.9	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	8.3	7.8	7.5	7.7	9.3	9.6	9.6	9.6	9.6	10.1	10.2
Other current revenue	5.8	5.9	4.8	4.5	4.8	4.7	4.7	4.8	4.8	4.8	4.8
Capital revenue	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	43.6	43.4	42.2	42.6	46.4	47.6	47.2	47.2	47.2	47.3	47.5
Current expenditure	40.0	39.7	38.5	39.1	41.5	43.0	42.6	42.7	42.7	42.9	43.1
Wages and salaries	14.7	14.7	14.2	14.1	15.6	15.8	15.8	15.7	15.6	15.6	15.6
Goods and services	5.0	5.6	5.0	5.3	5.6	5.6	5.6	5.4	5.1	5.1	5.1
Social Transfers	12.8	12.3	11.5	12.1	13.8	14.4	14.8	15.0	15.3	15.5	15.8
Subsidies	0.7	0.5	0.4	0.4	0.1	0.4	0.4	0.4	0.4	0.4	0.4
Interest payments	3.5	3.3	3.0	2.8	2.5	2.3	2.3	2.4	2.6	2.6	2.5
Other current expenditure	3.3	3.3	4.3	4.5	3.9	4.4	3.6	3.7	3.7	3.7	3.7
Capital expenditure	3.6	3.7	3.7	3.5	4.9	4.6	4.6	4.5	4.4	4.4	4.4
Overall balance 1/	-2.4	-1.2	3.4	0.9	-6.1	-6.0	-5.6	-5.5	-5.5	-5.2	-5.3
Overall balance excl. one-offs	-3.3	-1.2	3.4	0.9	-6.1	-6.1	-5.7	-5.6	-5.5	-5.2	-5.3
Memorandum items:											
Cyclically adjusted overall balance	-2.3	-1.5	2.2	-0.7	-6.3	-5.5	-5.0	-5.1	-5.2	-5.0	-5.2
Cyclically adjusted overall balance, excl. one-offs	-3.2	-1.5	2.2	-0.7	-6.3	-5.6	-5.1	-5.2	-5.2	-5.0	-5.2
Cyclical balance	-0.1	0.3	1.1	1.7	0.2	-0.5	-0.6	-0.4	-0.3	-0.2	-0.1
Cyclically adjusted primary balance, excl. one-offs	0.3	1.8	5.3	2.1	-3.8	-3.3	-2.8	-2.8	-2.6	-2.4	-2.6
Primary balance	1.1	2.1	6.4	3.7	-3.6	-3.7	-3.2	-3.1	-2.9	-2.6	-2.7
One-offs	0.9	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Public debt	69.1	64.6	58.3	48.4	56.2	61.1	64.5	67.1	69.1	70.8	72.5

Sources: Eurostat, and IMF staff estimates.

1/ Does not include special government bonds issued at the end of 2009 as a liquidity support measure fior the financial sector, in an amount equivalent to 18 percent of GDP

Table 3. Cyprus: Balance of Payments, 2005–2015

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
								Proj.			
					(Percent of GDP)						
Current account balance	-5.9	-7.0	-11.7	-17.5	-8.3	-7.2	-6.7	-6.5	-6.2	-5.8	-5.5
Trade balance (goods and services)	-2.7	-4.0	-6.5	-7.4	-0.6	-1.5	-1.9	-1.8	-1.8	-1.4	-1.0
Goods balance	-25.4	-27.2	-29.7	-35.2	-25.0	-25.5	-26.0	-26.6	-27.2	-27.6	-27.8
Exports	9.3	7.7	6.8	8.4	8.8	8.6	8.4	8.1	7.9	7.9	7.8
Imports	-34.7	-34.9	-36.5	-43.6	-33.8	-34.1	-34.4	-34.7	-35.1	-35.5	-35.6
Services Balance	22.8	23.2	23.1	27.8	24.4	24.0	24.1	24.8	25.4	26.2	26.8
Exports	39.0	39.4	40.3	47.4	41.7	42.3	42.8	43.6	44.2	45.2	46.0
Imports	-16.2	-16.2	-17.2	-19.6	-17.3	-18.3	-18.7	-18.8	-18.8	-18.9	-19.3
Current income, net	-3.8	-4.1	-5.2	-9.7	-6.5	-6.2	-5.2	-5.1	-4.7	-4.7	-4.8
Current transfers, net	0.5	1.1	0.0	-0.4	-1.2	0.5	0.4	0.4	0.3	0.3	0.3
Private	0.4	0.6	0.1	0.2	-0.5	0.3	0.2	0.2	0.1	0.1	0.1
Public	0.1	0.6	-0.1	-0.6	-0.7	0.2	0.2	0.2	0.2	0.2	0.2
Capital account, net	0.5	0.2	0.0	0.1	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Financial account, net	4.4	6.8	12.0	18.0	8.0	7.1	6.6	6.4	6.1	5.7	5.4
Direct investment	3.8	5.2	4.5	0.5	2.9	3.5	4.0	4.3	4.3	4.3	4.3
Portfolio investment 1/	-0.9	-0.9	-2.0	-73.7	-67.0	-5.0	-1.5	0.3	0.3	0.3	0.3
Other investment 1/	5.8	8.0	8.1	89.6	71.6	8.4	4.1	1.8	1.5	1.1	0.8
Reserves (- inflow; + outflow)	-4.3	-5.5	1.4	1.6	0.5	0.2	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.0	-0.1	-0.3	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ 2008-09 data reflect the transitions between Greek banks and their subsidiaries in Cyprus.

Table 4. Cyprus: Financial Soundness Indicators , 2005–2010 1/

(Percent)

	2005	2006	2007	2008	2009	Mar-10
Commercial Banks						
Core Set						
Regulatory capital to risk-weighted assets	12.4	12.4	12.8	11.0	12.1	11.9
Regulatory Tier I capital to risk-weighted assets	10.0	10.8	10.4	8.3	9.5	10.3
Nonperforming loans net of provisions to capital 2/	34.8	20.4	9.0	16.2	23.5	25.8
Nonperforming loans to total gross loans 3/	7.1	5.4	3.4	3.6	4.5	4.9
Return on assets	0.8	1.4	2.3	1.2	0.8	0.7
Return on equity	14.1	25.5	37.3	16.4	14.0	14.6
Interest margin to gross income	66.2	66.1	55.9	67.9	66.7	72.2
Noninterest expenses to gross income	59.1	49.0	42.6	52.1	50.6	50.8
Liquid assets to total assets (broad measure)	…	…	…	36.5	40.0	39.5
Liquid assets to total assets (core measure)	29.5	31.1	29.5	27.6	30.6	29.8
Liquid assets to short-term liabilities (broad measure)	…	…	…	46.5	51.1	51.6
Liquid assets to short-term liabilities (core measure)	34.9	37.1	35.9	35.2	39.1	39.0
Net open position in foreign exchange to capital	2.0	2.1	1.4	0.8	1.0	1.5
Optional Indicators						
Trading income to total income	5.7	7.5	9.1	1.8	8.7	7.4
Personnel expenses to noninterest expenses	62.2	62.9	57.6	58.1	59.4	60.9
Customer deposits to total (non-interbank) loans	134.7	132.2	122.7	94.2	90.5	92.3
Cooperative Credit Societies						
Core set						
Regulatory capital to risk-weighted assets	12.10	13.80	…	…	10.03	…
Regulatory Tier I capital to risk-weighted assets	12.10	13.80	…	…	9.1	…
Nonperforming loans net of provisions to capital 4/	…	…	…	…	52.1	60.0
Nonperforming loans to total gross loans 4/	…	…	…	…	8.1	9.2
Return on assets	0.6	0.7	1.1	0.9	0.7	…
Return on equity	8.4	9.4	15.2	11.4	10.0	…
Interest margin to gross income	158.5	151.1	83.1	84.9	84.3	…
Non-interest expenses to gross income	135.0	115.6	42.5	53.1	62.3	…
Liquid assets to total assets	26.8	29.5	28.5	19.6	27.4	27.3
Liquid assets to short-term liabilities	28.7	26.5	30.8	21.4	29.6	29.5
Net open position in foreign exchange to capital	0.0	0.1	-0.2	-0.1	0.1	0.2
Optional indicators						
Personnel expenses to non-interest expenses	…	40.2	40.5	39.1	42.9	45.7
Customer deposits to total (non-interbank) loans	129.2	133.9	131.4	116.6	126.2	128.3
Spread between reference lending and deposit rates	1.8	1.9	1.7	1.6	1.7	
Residential real estate loans to total loans	32.0	32.0	35.2	36.4	36.3	36.7
Commercial real estate loans to total loans	17.5	17.3	16.5	16.9	17.7	18.6

Sources: Central Bank of Cyprus; and Authority for the Supervision and Development of Cooperative Credit Societies.

1/ Data for 2005 onwards are for deposit-takers compiled on a domestically-controlled, cross-border consolidation basis do not include the cooperative credit societies and foreign-controlled banks.

2/ Data for 2008 and onwards are for deposit-takers compiled on a cross-border and cross-sector for all domestically incorporated institutions. Due to methodological changes the data for 2008 and onwards is not comparable with historical data.

3/ The numbers are not fully comparable over time. The threshold for classifying loans as non-performing was changed from 6 months in arrears to 3 months in 2006. Data 2005 onwards are compiled according to the methodology and specifications provided in the IMF "Compilation Guide on Financial Soundness Indicators." The decline in nonperforming loan (NPL) ratios since 2005 reflects stricter lending criteria, repayments and write-offs of NPLs as well as denominator effects (growth in capital/loans).

4/ Non-performing loan data available only from 2009.

Annex 1. Cyprus Pension System [1]

Overview of the pension system

1. **The current pension system in Cyprus comprises the following schemes**: (i) the General Social Insurance Scheme; (ii) the Social Pension Scheme; (iii) the Special Allowance to pensioners; (iv) the Government Employees Pension Scheme; (v) Other Public Sector Employees Pension Schemes; and (vi) the Voluntary Provident Funds and other similar collective arrangements.

2. **The General Social Insurance Scheme was introduced in 1957 and since 1964 it imposes mandatory contributions to all individuals gainfully employed in the public and private sectors, including the self-employed**. Following a reform in 1980, the previous flat-rate contributions and benefits scheme has been replaced by an earnings-related insurance scheme. Annual contributions are deposited in a Social Security Fund (SSF) and surpluses are invested almost exclusively in non-tradable government securities which are not part of the public debt.

3. **Key features under the current General Social Insurance Scheme are as follows**:

- Universal pension benefits at age 65 for men and women. Early retirement is encouraged: full pension at the age of 63 years is possible when contributions reach a given threshold, bringing the effective overall retirement age to 63.6 years (57 years in the public sector).

- The level of pensions depends on the length of the contribution period and the level of insurable income. Benefits have two components: a basic and a supplementary pension based on the level of insurable earnings. The basic pension is indexed yearly to annual increase of the average insurable earnings; the supplementary is indexed to the CPI.

- Contribution rates differ according to categories of employees: 12.6 percent for employed persons, shared equally between the employer and the employee; 11.6 percent for the self-employed. In addition, the central government contributes the equivalent of 4 percent of pensionable earnings[2].

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[1] Prepared by Valentina Flamini (EUR). The Annex draws on: (i) European Commission (2009), “Pension Schemes and pension Projections in the EU-27 Member States ─2008-2060” Volume 1─Report. Occasional Papers 56, October 2009; and (ii) Cyprus (2009), “Republic of Cyprus Stability Programme 2009”.

[2] The March 2009 pension reform introduced the gradual increase of contributions by 1.3 percentage points (1 percent equally shared between employee and employer and 0.3 from the Government) every five years beginning in April 2009 until January 2039.

- Being at an early stage of its maturity, with a small number of pensioners, the system currently generates a surplus (the size of the SSF was in the order of 40.4 percent of GDP at the end of 2009). However, as the system matures, it will move into deficit and long-term sustainability is not ensured.

4. **Beside the General Social Insurance Scheme, supplementary schemes provide additional pension benefits to particular individuals:**

- The Social Pension Scheme provides pensions to those residents, of 65 years or more, who did not participate in the labor market and as a consequence have no pension income from the general Social Insurance Scheme. Social pensions are guaranteed as a percentage of the basic pensions and, as a consequence, are also indexed to earnings.

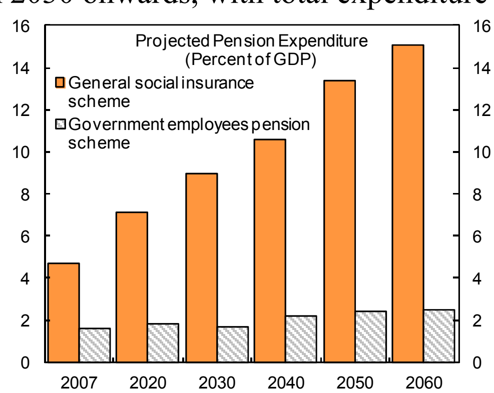
- A Special Allowance is payable to pensioners whose total pension income from the General Social Insurance Scheme does not exceed a minimum threshold per year.

- Beside the basic Social Insurance pension, public servants and semi-government employees are entitled to separate pension payments up to 50 percent of the last salary. This system is universal and fully financed by the employer side.

- Provident Funds provide defined contribution lump-sum benefits agreed within the framework of the free collective bargaining system and financed by joint contributions from employers and employees. Members usually receive their entitlements at the time of changing of employer.

Pension expenditure projections

5. **Spending is projected to increase significantly over the next 50 years (Figure and Table 1).**[3] The largest deterioration is projected to occur from 2030 onwards, with total expenditure rising from 6.3 percent of GDP in 2007 to 17.7 percent in 2060, and both old-age and early pension and other pension (i.e., invalidity and survivor's pension benefits) projected to increase. The increase in spending primarily comes from the general scheme and at a lesser extent from the scheme for government employees.



Source: European Comission.

[3] Projections are from the actuarial pension model of the Ministry of Labor and Social Insurance using Ageing Working Group generally agreed assumptions, as reported by European Commission (2009). No results are presented on occupational and private pensions due to lack of reliable data.

Table 1. Projected Gross Pension Spending

(Percent of GDP)

	2007	2020	2030	2040	2050	2060	Peak year
Total spending	6.3	8.9	10.8	12.8	15.5	17.7	2060
Old age and early pensions	4.8	6.7	8.2	10	12.4	14.2	2060
Otherpensions	1.4	2.2	2.6	2.8	3.1	3.5	2060

Source: European Commission.

6. **The increase in pension expenditure is mostly explained by the deterioration in the dependency ratio, and to a much less extent by an increased coverage ratio (Table 2)**. The latter is due to the expected increase in the percentage of females who meet qualifying conditions for receiving a pension at the age of 63 as a consequence of their greater contribution to the labor force and longer contribution periods. Out of the 11.4 percentage point increase in total pension expenditure, 10.8 points are due to the increase dependency ratio, and 1.6 points the coverage ratio. Offsetting this positive contribution is a negative one due to : (i) a small increase in the employment rate as a result of the high expected employment growth, particularly for females, in the first decade; and (ii) a marginal decrease in the benefit ratio, primarily due to the price indexation on benefits in the longer term ─in the first couple of decades, as the supplementary part of the social insurance scheme matures, the annual average level of new pensions is expected to increase at a rate higher than that of productivity.

$$\frac{Pension\ Exp.}{GDP} = \overbrace{\frac{Pop.65+}{Pop.15-64}}^{Dependency\ Ratio} * \overbrace{\frac{No.of Pensioners}{Pop.65+}}^{Coverage\ Ratio} * \overbrace{\frac{Pop.15-64}{Working\ Pop.}}^{1/Employment\ Rate} * \overbrace{\frac{Avg\ Pension}{\frac{GDP}{Working\ Pop.}}}^{Benefit\ Ratio}$$

Table 2. Factors Behind the Public Pension Expenditures Between 2007 and 2060

(Percent of GDP)

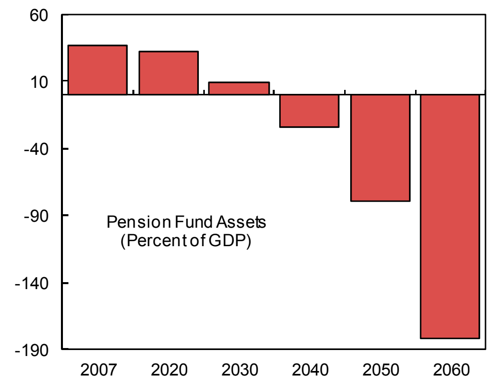
	2007-20	2020-30	2030-40	2040-50	2050-60	2007-60
Total spending	2.8	1.9	2.1	2.7	2.2	11.4
Dependency ratio	1.7	2	1.3	2.9	2.8	10.8
Coverage ratio	0.9	0.3	0.3	0.2	0	1.6
1/Employment rate	-0.5	0	0.1	0	0	-0.5
Benefit ratio	0.5	-0.4	0.3	-0.2	-0.5	-0.3

Source: European Commission.

7. **The increase in employment is mainly due to net immigration flows and the increase in the female participation, both sizeable over the period**. In line with this trend, a similar increase in the number of contributors will occur. However, the support ratio ─the ratio of the number of

contributors over the number of people aged more than 65— will decline significantly primarily due to the ageing effect.

8. **Reserves of the SSF are projected to turn negative from 2033 onwards**. Accumulating debt obligations will increase up to 182 percent of GDP by 2060. On a positive note, however, a factor relevant for the sustainability of Cyprus' pension system is the low level of social security contributions.



Source: European Comission.

Recent reforms

9. **Following extensive dialogue with the social partners, in 2009 the government took measures to strengthen the long-term financial sustainability of the pension system**. The measures aim primarily at increasing revenue through higher contributions and higher investment returns and, to a lesser extent, at reducing expenditure through stricter eligibility conditions to old-age pension, including: (i) gradual increase of contributions by 1.3 percentage points every five years beginning in April 2009 until January 2039; (ii) increase of the minimum contribution requirement from three to ten years of paid contributions; (iii) stricter eligibility conditions to receive unemployment benefits and old-age lump-sum payments; and (iv) increase of presumptive incomes of self employed workers in order to be more adjusted to their real incomes.

10. **Under the post-reform scenario, the April 2010 SGP forecasts that the SSF will hold assets over 10.1 percent of GDP in 2060, compared with liabilities of 182.1 percent under the pre-reform scenario.** Taking into account the adopted parametric reforms, the authorities estimate that pension spending will still increase considerably over the next 50 years, albeit by around 1 percentage point of GDP less than before the reform. However, revenues will also increase in line with the phased increase in social security contribution rates: according to the authorities' estimates, under the post reform scenario, total annual contributions will increase by 3.5 percent points of GDP.

INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2010 Consultation with Cyprus
(In Consultation with Other Departments)

August 9, 2010

Contents Page

Annex I. Cyprus: Fund Relations
(As of June 30, 2010)

I. Membership Status: Joined December 21, 1961; Article VIII

II. General Resources Account:	SDR Million	Percent Quota
Quota	139.60	100.00
Fund holdings of currency	111.29	79.72
Reserve Tranche Position	28.35	20.31

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	132.80	100.00
Holdings	119.37	89.89

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.02	0.04	0.04	0.04	0.04
Total	0.02	0.04	0.04	0.04	0.04

VII. Exchange Rate Arrangement: Cyprus adopted the euro on January 1, 2008. The currency floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current transactions.

VIII. Article IV Consultation: Cyprus is on a 12-month cycle. The previous Article IV consultation mission took place during June 18-29, 2009, and the staff report (CR/09/255) was discussed by the Executive Board on August 5, 2009.

IX. FSAP Participation and ROSCs: An FSAP mission took place during September 23 - October 6, 2008. The FSAP Technical Notes were published in May 2009 (CR/09/167 and CR/09/171); the Financial System Stability Assessment (FSSA) was published in October 2009 (CR/09/308).

X. Technical Assistance:

Dept.	**Purpose**	**Date**
MAE	Government debt management	February-March 1989
FAD	VAT training program	June-October 1992
MAE	Financial sector liberalization	November-December 1993

MAE	Reform of government securities	April-May 1994
STA	Special Data Dissemination Standard	August 1997
STA	Balance of Payments	March 1999
STA	Balance of Payments	May-July 2001
STA	Balance of Payments	November 2001-March 2002
STA	Balance of Payments	April-June 2002
FAD	Public Investment and PPPs	March-April 2006
FAD	Medium-term Budget Framework	May 2006
FAD	Medium-term Budget Framework	October 2007
STA	Special Data Dissemination Standard	May 2007
STA	Special Data Dissemination Standard	March 2009

XI. Resident Representative: None.

Annex II. Cyprus: Statistical Information

(As of July 15, 2010)

A. Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance.

National Accounts: The transition to the new European System of Accounts 1995 (ESA 1995) has complicated the analysis of national accounts and fiscal data. The new national accounts do not provide information on the disposable income of households, thus hindering the calculation of the household saving ratio.

Financial sector data: The currency-linked and indexed bonds held by nonresidents are classified as domestic instead of foreign liabilities.

External debt: The authorities have recently decided to include non-resident deposits in resident banks in gross external debt.

Other: The Central Bank has started to compile data on property prices and household sector assets in 2009.

B. Data Standards and Quality

Cyprus subscribed to the IMF's Special Data Dissemination Standard (SDDS) on December 1, 2009 and has posted the metadata on the Dissemination Standards Bulletin Board (DSBB). Cyprus' economic database is comprehensive and of generally good quality. Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a wide range of economic and financial data, as well as a calendar of dates for the main statistical releases. Cyprus is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the *European System of Accounts 1995* (*ESA95*). No data ROSC is available.

Cyprus: Table of Common Indicators Required for Surveillance
(As of July 15, 2010)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jun 2010	Jul 2010	M	M	M
Reserve/Base Money	Jun 2010	Jul 2010	M	M	M
Broad Money	Jun 2010	Jul 2010	M	M	M
Central Bank Balance Sheet	Jun 2010	Jul 2010	M	M	M
Consolidated Balance Sheet of the Banking System	Jun 2010	Jul 2010	M	M	M
Interest Rates[2]	Jun 2010	Jul 2010	M	M	M
Consumer Price Index	Jun 2010	Jul 2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2010	May 2010	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2010	Jun 2010	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2010	Apr 2010	Q	Q	Q
External Current Account Balance	Q1 2010	Apr 2010	Q	Q	Q
Exports and Imports of Goods and Services	Q1 2010	Apr 2010	Q	Q	Q
GDP/GNP	Q1 2010	May 2010	Q	Q	Q
Gross External Debt	Q1 2010	May 2010	Q	Q	Q
International Investment Position[6]	Q1 2010	Jun 2010	Q	Q	Q

1 Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2 Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3 Foreign, domestic bank, and domestic nonbank financing.
4 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5 Including currency and maturity composition.
6 Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7 Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by the Staff Representative on Cyprus
August 27, 2010

1. This statement provides information that has become available since the Staff Report was circulated to the Executive Board on August 9, 2010. This information does not alter the thrust of the staff appraisal.

2. **Real GDP increased in the second quarter of 2010** by 0.4 percent quarter-on-quarter. Furthermore, two successive upward revisions of the growth rate for the first quarter of 2010 have resulted in a real GDP increase for that quarter of 0.3 percent, compared to an initial estimated decline of 0.2 percent. In view of these developments, we now expect economic growth in 2010 to be flat instead of slightly negative.

3. **The Authority for the Supervision and Development of Cooperative Credit Societies** has indicated that from December 31, 2010 non-performing loans (NPLs) in cooperative credit societies will be compiled on the basis of a 90-day delinquency rate instead of the current 270-day rate, placing it on a par with the definition which applies to commercial banks. As of end 2009, NPLs in the cooperative credit societies sector on a 90-day delinquency rate reached 12 percent, against 8.1 percent on the basis of the 270-day definition.

4. **Other developments**:

- The HICP inflation for July 2010 reached 2.7 percent compared to 2.1 percent in June 2010 and -0.8 percent in July 2009.

- The unemployment rate increased to 7.3 percent in June 2010 from 7.1 in May.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/123
FOR IMMEDIATE RELEASE
September 2, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation with Cyprus

On August 27, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cyprus.[1]

Background

Following the economic downturn of 2009 when the global crisis began to affect Cyprus, the economy is projected to bottom out in 2010, giving way to a mild recovery in 2011 and stronger growth thereafter. After experiencing average growth of 4¼ percent over 2004-08, the economy contracted by 1.7 percent in 2009 as trade partners became increasingly affected by the global slowdown, leading to a sharp contraction of the tourism and construction sectors. Looking forward, increased unemployment along with decelerating consumer credit and the negative confidence shock will weigh on private consumption; investment is expected to be subdued due to continued weakness in the property market and construction sector; and public consumption will be restrained due to fiscal consolidation. Growth is expected to be flat in 2010, followed by a modest recovery in 2011 and a gradual acceleration in later years. The current account deficit, which was cut by more than half in 2009, will likely stabilize in 2010, and decline gradually toward more sustainable levels over the medium term.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The fiscal deficit widened sharply in 2009, mostly reflecting structural factors. In particular, expenditures rose sharply on the back of higher wages and salaries, social transfers, and investment spending. These increases were for the most part permanent rather than one-off or cyclical. Meanwhile revenues fell, reflecting the economic downturn and the unwinding of exceptional revenues associated with the real estate boom of the preceding years. The cyclically adjusted primary balance declined by some 6 percentage points in 2009, imparting a large fiscal stimulus and resulting in a fiscal deficit of 6.1 percent of gross domestic product (GDP). Consequently, Cyprus was placed under the Excessive Deficit Procedure of the European Union, which prompted the government to adopt a program of fiscal consolidation aimed at reducing the fiscal deficit to 4.5 percent of GDP in 2011 and below 3 percent in 2012. The government has already taken steps to stabilize the deficit in 2010; additional measures will be needed to reach the 2011 and 2012 fiscal targets.

The financial sector has continued to weather the impact of challenging regional and global market conditions relatively well due largely to a traditional business model for banks, which is based on lending mostly funded by deposits; relatively high banking system capital and liquidity; and strong supervision by the Central Bank of Cyprus (CBC). However, although the outlook for the sector has weakened somewhat over the past year owing to a deterioration of loans granted in Cyprus and in foreign markets (particularly Greece), stress tests suggest that they have the capacity to absorb further shocks. While cooperative credit societies would only be affected by conditions in Cyprus, a combination of weak underwriting standards and lower overall levels of capital suggests that risks for that sector are higher than for commercial banks.

In the absence of a legal framework for covered bonds in Cyprus, the government has facilitated banks' and co-operative credit societies' access to liquidity by issuing government bonds to them against high-liquidity collateral. Banks and co-operative credit societies have used these bonds to access funding by the European Central Bank (ECB), in part to lower their average cost of funds, at a time when deposit rates in Cyprus are higher than the euro zone average.

Growth of wages and labor costs in excess of productivity increases has eroded competitiveness particularly in the manufacturing and tourism sectors. Furthermore, the steady growth of public sector wages and employment poses risks for the low tax environment that is needed to attract investment and generates wage pressures in the economy. These developments point to the need to promote wage settings mechanisms which link wages to productivity developments rather than the current inflation-indexed wage adjustment mechanism, starting with the public sector.

Executive Board Assessment

Directors welcomed signs that the Cypriot economy is beginning to bottom out in 2010, leading to a modest recovery in 2011. The near-term outlook is still fragile as global financial risks remain elevated and growth prospects in trading partners muted, while a positive inflation differential with the euro area has reopened. Returning the economy to its potential growth depends critically on a credible fiscal consolidation, continued market confidence in the financial sector, and structural reforms to improve competitiveness and the business climate.

Directors agreed that the immediate policy challenge is to reverse the large structural fiscal deficit following the sizeable stimulus in 2009, with a view to preserving debt sustainability and creating fiscal space to guard against financial sector risks. They welcomed the government's commitment to reduce the deficit to below 3 percent of GDP by 2012, consistent with its EU obligations. Noting that this would require more forceful action, Directors encouraged the authorities to lay out specific measures to achieve their goal. Containing the wage bill and better targeting social transfers were seen as important elements. More fundamental reforms of the pension system would also be needed to lessen the burden on public finances, through lower replacement rates and higher retirement age.

Directors observed that the banking sector remains sound and retains a capacity to absorb further shocks, as suggested by stress test results, including those conducted in the context of the EU-wide exercise. However, risks have risen significantly both in Cyprus and in the region. In light of the relatively large size and external exposure of Cyprus' financial sector, these risks call for continued vigilance, close cooperation with foreign supervisors, and an enhanced framework for crisis management and contingency planning, including for cross-border banks. Consideration could be given to enlarging the deposit insurance facility. Directors also highlighted the urgency of strengthening the supervision and transparency of cooperative credit societies. The recent modification of the definition of nonperforming loans for cooperative credit societies was a welcome step toward aligning it to the norm in place for commercial banks. Directors encouraged further progress in creating a level playing field in the financial sector.

In light of the still large current account deficit, Directors stressed that structural reforms aimed at boosting competitiveness would be crucial for supporting the recovery and enhancing growth potential. Key priorities include restraining public sector wages and employment to free resources for the private sector, and phasing out the wage indexation system to allow wages to reflect productivity gains. Active labor market policies, aimed particularly at addressing skill mismatches, should help reduce unemployment.

Cyprus: Selected Economic Indicators, 2005–10

(Annual percentage change, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 1/
Real economy						
Gross domestic product	3.9	4.1	5.1	3.6	-1.7	0.0
Domestic demand (contribution to annual growth)	3.5	5.9	9.2	9.1	-7.9	-0.8
Harmonized index of consumer prices (period average)	2.0	2.2	2.2	4.4	0.2	2.2
Unemployment rate (percent)	5.3	4.6	4.0	3.6	5.3	7.8
Public finances (general government, percent of GDP)						
Overall balance	-2.4	-1.2	3.4	0.9	-6.1	-6.0
Primary balance	1.1	2.1	6.4	3.7	-3.6	-3.7
Gross public debt 2/	69.1	64.6	58.3	48.4	56.2	61.0
Interest rates (percent)						
Deposit rates 3/	3.8	3.4	3.4	4.8	3.7	…
Lending rates 4/	7.1	6.7	6.7	6.7	6.5	…
Balance of payments (percent of GDP)						
Trade balance (goods and services)	-2.7	-4.0	-6.5	-7.4	-0.6	-1.7
Current account balance	-5.9	-7.0	-11.7	-17.5	-8.3	-7.4
Fund Position (June 30, 2010)						
Holdings of Currency (percent of quota)						79.7
Holdings of SDR's (percent of allocation)						89.9
Quota (millions of SDR)						139.6
Exchange rates						
Exchange rate regime			Euro Area Member			
Present rate (August 4, 2010)			US$ 1.32 per euro			
Nominal effective exchange rate (2005=100)	100.0	100.5	101.2	104.8	108.0	…
Real effective exchange rate (CPI, 2005=100)	100.0	100.2	100.2	103.9	106.2	…

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

1/ Data for 2010 are projections.
2/ Excludes special government bonds issued at the end of 2009 as a liquidity support measure for the financial sector in an amount equivalent to 18 percent of GDP.
3/ Since 2008, data refer to the average of MFI interest rates on new-business deposits up to 1 year.
4/ Since 2008, data refer to the average of MFI interest rates on new-business loans up to 1 year .

Age Bakker, Executive Director for Cyprus, and Yoav Friedmann, Senior Advisor to Executive Director for Cyprus, submitted the following statement:

The Cypriot authorities would like to thank staff for fruitful discussions in Nicosia. The authorities share many of staff's views and broadly agree with the staff appraisal.

The hurricane that hit the global economy has only mildly affected Cyprus directly, but its repercussions for the Cypriot economy are significant and pose substantial challenges to the Cypriot policy makers. Preserving the pre-crisis potential growth in Cyprus requires a credible fiscal consolidation and structural reform package, which will maintain the confidence in the economy and Cyprus' competitiveness in the global markets. The authorities are aware of these challenges and are making their best efforts to achieve these goals within the Cypriot political environment.

The economy of Cyprus depends strongly on its external sector. In the long-run, its success depends on the ability to maintain competitiveness in the global markets (the supply side), while in the short-run, Cyprus' growth depends heavily on economic developments in its trading partners (the demand side). The recent developments in the EU and other trading partners leave uncertainty regarding the pace of recovery of the Cypriot economy in the coming months.

The Ministry of Finance projects positive growth for 2010, while the Central Bank of Cyprus (CBC), like staff, is less optimistic regarding the growth figure for 2010. For 2011, the Ministry of Finance growth projection (1.5 percent) and the CBC's growth projection (1.3 percent) are somewhat lower than staff's forecast, based on the assumption that some of the downside risks staff mentions in the report will materialize. That said, the authorities do not see fiscal consolidation as weighing on growth. Cyprus is a small open economy that suffered in the last two years a deteriorating structural fiscal balance. Hence, fiscal consolidation aimed at enhancing growth could have a confidence-boosting effect with a positive growth outcome even in the short run. There is increased confidence that negative spillover effects from Greece are now being contained owing importantly to the joint IMF – EU program concluded with Greece.

Fiscal Policy

The authorities are committed to reduce the fiscal deficit to 4.5 percent of GDP in 2011 and below 3 percent by 2012. Cyprus' track record shows that this goal can be achieved, although there is no political consensus yet on the necessary measures to achieve this. The authorities agree with staff that the new fiscal measures, to be spelled out as part of the 2011 budget, need to add up to around 2¾ percentage points of GDP over the next two years. They expect that a widespread consensus on the fiscal consolidation path will be reached as part of the budget approval process in parliament. The authorities plan to include measures on both the expenditure and revenue sides.

In light of the authorities' recognition that fiscal consolidation, going forward, is of utmost importance, and, in order to contain the 2010 fiscal deficit, the government began to restrain expenditures already at the beginning of 2010. The number of public sector employees was reduced in the first half of 2010 by 500 and is expected to be reduced by another 500 employees by the end of 2010. The government's goal is to reduce the total public sector employment by another 1000 employees per year in the following two years. The implementation of this decision is expected to have a significant effect on the total public sector wage bill. In addition to the efforts made to contain the total expenditure, the government imposed excise taxes on fuels at the minimum EU level prescribed by the acquis as of mid 2010. Stimulus measures that were part of the countercyclical policy in 2009 will be withdrawn in 2011, in line with the ECOFIN and European Council Decisions.

Results of the government efforts to reduce the deficit in 2010 can already be seen. The fiscal deficit for 2010 is now projected by the Ministry of Finance to be at most 6 percent of GDP, lower than the 7 percent projected in the budget under a no policy change scenario. This mainly reflects the reduction in intermediate consumption, a freeze in general contractual wages and salaries, a reduction in public sector employment, and a one-off Central Bank dividend income.

Fiscal consolidation efforts focus also on dealing with the medium to long-term challenges. One of the important challenges for Cyprus, as for many other countries in Europe and elsewhere, is to address the issue of population ageing. The authorities realize that the long-term trends may develop a large burden on the fiscal budget, and hence gradual steps to reduce this burden need to be taken. One such reform is the 2009 reform of the social security benefit scheme. According to the reform there will be a gradual increase of the contribution rate over the next 30 years, and an increase in the required years of contribution in order to become eligible for the old-age pension or the old-age lump-sum. A limit on the number of education/training credits that can be granted was also imposed. The reform is estimated to extend the actuarial equilibrium by at least thirty years.

Inflation

Cyprus' 12-month harmonized consumer price index inflation remains low (2.7 percent in July 2010), but since November 2009 it has been somewhat higher than in the euro area. The re-opening of the inflation gap between Cyprus and the euro area in 2010 reflects the imposition of excise taxes on fuels and increases in electricity prices in Cyprus, and the fact that economic activity in the euro area remained subdued. Excluding energy, inflation in Cyprus during the 12 months to July 2010 was 0.1 percentage point lower on average than in the euro area.

Particularly in view of its importance in affecting competitiveness, inflation is being monitored closely by the authorities. Even though, as the staff point out, services exports, which are important for Cyprus, may be less responsive to exchange rate dynamics, recent developments in the current account deficit underline the need to improve Cyprus' competitiveness as well as the role of fiscal consolidation and structural reforms.

The Financial Sector

Resilience of the Financial Sector

The banking sector is sound and resilient and remained profitable despite the global crisis. As banks are broadly based on a traditional banking business model, the rise in NPLs was the main channel through which the crisis negatively affected the banks. The Cypriot banks did not invest in “toxic assets” and, in fact, the confidence in the healthy banking sector and the deterioration of some economies in the region, have led to a continued growth in non-resident deposits in Cypriot banks. Anticipating the rise in potential losses due to the rise in NPLs, banks have reduced the share of profits distributed as dividends from around 50 percent before the crisis to about 30 percent in 2009. Stress tests conducted by the CBC, and in the context of the EU-wide exercise, show that the banks can withstand a significant increase in NPLs arising from further deterioration in economic activity, including spillover effects from Greece. Furthermore, CBC conducts, twice a year, stress tests under scenarios involving withdrawals of a high percentage of both resident and non-resident deposits. It is also noted that Cypriot banks are not dependent on interbank markets funding.

Sound Banking Supervision

Comfortable capital buffers and a high liquidity position of the banks is a result of internal practices as well as banking supervision requirements. Cyprus’ large banking sector dictates a strict banking regulatory framework and a proactive banking supervision to ensure the banks’ health and resilience to shocks. Three examples of this framework are a) the 20 percent liquidity requirement for all euro customer deposits plus other short term (up to 12 months) euro obligations, in addition to the maximum mismatch ratios for maturity time bands, up to 7 days and up to 1 month, calculated on a contractual basis; b) the 70 percent liquidity requirement on foreign currency deposits (these are mainly from non-residents); and c) strict limits on banks’ open positions in foreign exchange.

The banking supervision closely monitors the banks’ assets and liabilities portfolios and promptly reacts to changes that raise the banks’ vulnerabilities to shocks. An example of such prudent response is the imposition of a maximum LTV ratio of 70% for property financing (80% for the permanent residence) that was triggered by the increase in such financing by the banks since 2003. Also the banking supervision is currently considering ways to address the issue of liquidity requirements for non-resident deposits in euro. That was triggered by the recent sharp increase in these deposits which mainly reflects temporary weaknesses in the economic situation of neighboring countries but also the use of euro as a deposit currency by those non-resident depositors that in the past were using exclusively foreign currencies.

Covered Bond Legislation

The covered bond legislation, which would facilitate in making liquid the illiquid bank assets, is expected to be passed by the end of the year. In the interim, and in order to enhance liquidity in the economy, the government issued close to €3.0 billion worth of bonds to the banks that could be used as collateral for obtaining liquidity via the Eurosystem monetary operations. The bonds were issued to the banks against a fee and collateral with a haircut, which depends on the quality of the collateral. The government as well as the CBC see the risk of having to record the special government bonds as part of the government debt as negligible, as the risk for the government that the bonds will not be returned is very small due to the arrangements in place for the valuation and substitution of the assets provided in exchange for the special government bonds.

FSAP recommendations

The authorities have been making many efforts to fulfill the 2008 FSAP recommendations, and indeed, many key recommendations were achieved. Regarding the recommendation to unify the banking supervision authorities, the Ministry of Finance agrees that this may have some advantages on the banking supervision in Cyprus, however, it is of the view that the consensus in Cyprus is for maintaining the status quo. The CBC, like staff, is of the view that unifying the banking supervision authorities would significantly strengthen banking supervision and enhance the financial stability of the banking sector, especially during a time of financial turmoil. In the current framework, commercial banks are supervised by the Bank Supervision and Regulation Department at the central bank and the cooperative credit societies are supervised by the Co-operatives Societies' Supervision and Development Authority (CSSDA). The regulation framework is almost fully harmonized, and the CSSDA is committed to adopting the CBC's definition of NPLs by the end of this year. The CBC and the CSSDA closely collaborate and jointly monitor (on-site and off-site) individual co-operative banks. That said, it is noted that the CBC in not empowered to supervise directly individual cooperative credit institutions and cannot take remedial action against individual institutions.

Contingency Planning

Contingency planning is crucial in enhancing confidence in the financial sector. To enable a swift government intervention in case of an insolvent bank, a draft law setting up a comprehensive framework of such an intervention was prepared and submitted to the parliament for approval. Establishment of the framework would enable the Cypriot Council of Ministers, taking into account the opinion of the Governor of the CBC, and with the approval of the parliament, to implement measures intended to address liquidity or insolvency problems affecting financial institutions. It is agreed that parliament will examine such a request by the Council of Ministers in a speedy procedure.

Regarding the staff recommendation to seek written commitments from other regional supervisors regarding their responsibilities in a crisis, there are extensive provisions in the EU directives on home / host banking supervision cooperation both in normal and in crisis situations, and the issue of crisis management arrangements for failing cross border banks in EU is currently debated. Therefore, at the current stage, the bank supervisory authority is of the view that it is premature to raise such an issue.

Exposure to Greece

While staff estimates the overall exposure of the banking system to Greece (not including interbank loans) to be at a high level, we note that a large part of the exposure to Greece cited relates to Greek subsidiaries and are the result of transactions booked in Cyprus for tax reasons. These transactions are fully financed by the parent banks and, should a loss arise, it will be borne by the parent banks (through a set-off against the amount currently due to them).