February 2007
IMF Country Report No. 07/76

Cyprus: 2006 Article IV Consultation—Staff Report; 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 the2006 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 6, 2006, 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 January 11, 2007. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 26, 2007 discussion of the staff report that concluded the Article IV consultation; and

- 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Cyprus

Approved by Alessandro Leipold and Anthony Boote

January 11, 2007

Executive Summary

Background: The economic outlook is favorable, and euro adoption in 2008 is within Cyprus's grasp. Economic growth has rebounded (3½ –4 percent) from a lull in 2002–03. Inflation has recently receded, reflecting euro appreciation and lower oil prices, but remains the one Maastricht criterion that requires continued vigilance. The fiscal deficit was cut sharply to under 2½ percent of GDP in 2005 and an estimated 1.9 percent of GDP in 2006.

Policy issues

- The key short-term objective is to ensure smooth euro adoption in 2008. The authorities intend to keep policies aligned with the Maastricht criteria and allay concerns about the rounding up of prices during conversion. It will be important to keep inflation in check by encouraging wage moderation and securing greater fiscal consolidation than envisaged in the 2007 budget.
- Effecting high-quality fiscal adjustment in the medium term will depend on the ability to rationalize, prioritize, and control public expenditure, including investment. The authorities plan to introduce a medium-term budget framework and a proper legal framework and institutional setting for PPPs, both important steps.
- Pension reform is urgent and is on the government agenda. Besides raising the retirement age back to 65, periodic automatic adjustments should be built in to ensure that the system keeps up with demographic trends. The planned National Health Insurance System will likely require user fees and means testing to limit potential abuse and cost increases.
- Supervisors are appropriately closely monitoring credit and house price developments to contain risks to the financial sector. The supervision of cooperative credit institutions should be unified with that of commercial banks.
- Sustaining growth requires further structural reform to safeguard external competitiveness. The authorities emphasize progress already made and the importance of human capital and R&D, and stress their commitment to promote domestic competition. The staff supports these objectives and argues also for a redesigned wage setting mechanism.

Contents Page

I. INTRODUCTION[1]

1. **As the easternmost country in the EU, Cyprus is well placed to emerge as a gateway to the East and a hub of business operations in the region**. The thriving Cypriot economy is testimony to the government's implementation of reforms and pursuit of prudent policies, in line with Fund advice (text table). The goal of adopting the euro has galvanized the collective will to place the fiscal accounts on a strong footing and reform the economy. However, success in the euro area will require safeguarding external competitiveness and confronting medium-term challenges.

Cyprus: Response to Previous Fund Advice

Policy Area	Staff Recommendation in Previous Article IV Consultations	Implementation
Fiscal Policy	Pursue fiscal adjustment, including through expenditure containment; reform health care and pension systems to mitigate the fiscal impact of demographic transition; adopt an explicit medium-term fiscal framework.	The fiscal deficit was cut sharply to under 2 percent of GDP in 2006. A medium-term fiscal framework, shaped by Fund advice, will be fully implemented in the 2008 budget. Steps have also been taken to address aging-related expenditure pressures, but further pension reform is needed.
Financial Sector	Monitor the financial system's exposure to the real estate market; ensure effective supervision of the cooperative sector; consolidate supervisory functions.	The authorities have been monitoring financial market developments closely. Some financial sector reforms were implemented, including increasing the capital base of cooperative credit institutions (CCIs). The coordination among supervisory bodies has been enhanced, but there is room for further improvement by unifying the supervision of CCIs and commercial banks.
Structural Policies	Reform the wage-setting mechanism to reduce real wage rigidities; enhance competitivenss, including through corporate governance reform in public enterprises and privatization	Backward-looking wage indexation remains entrenched. By contrast, progress has been made in liberalizing the air travel, electricity, and telecommunications sectors, but key product markets are still dominated by state-owned incumbents.

II. ECONOMIC BACKGROUND

2. **Economic activity has recovered from a relatively weak performance in 2002–03** (Table 1). Declines in interest rates and strong capital inflows associated with Cyprus's accession to the EU in May 2004 spurred growth in private consumption and investment, while recovering tourist receipts have reduced the external drag on the economy (text table). Cyprus has consequently made further progress on real convergence with its European partners. Employment growth has remained strong and unemployment ranks among the lowest in the EU. An open labor market and booming employment opportunities have attracted a growing number of low skilled foreign workers. This has

Cyprus: Contribution to Real GDP Growth, 2001–06
(Annual percent change)

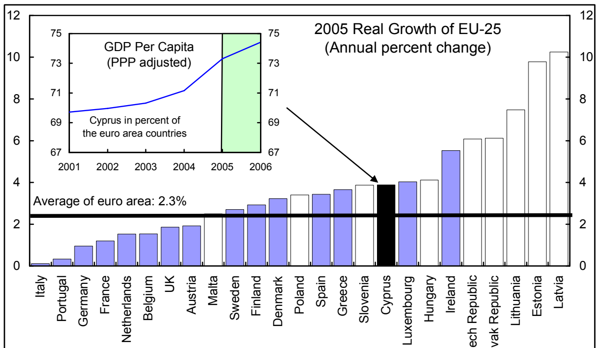
	2001	2002	2003	2004	2005	2006
GDP	4.0	2.0	1.8	4.2	3.9	3.7
Domestic demand	3.4	4.2	1.7	6.6	3.2	5.2
Consumption	4.6	1.8	2.4	3.0	3.7	4.4
Gross fixed capital formation	0.5	1.4	0.2	1.8	0.5	1.0
Machinery and equipment	0.4	-0.4	0.3	0.5	-0.2	…
Construction	0.4	0.7	1.1	1.2	0.8	…
Transport equipment	-0.2	1.1	-1.1	0.1	-0.1	…
Changes in inventories	-1.7	1.0	-0.9	1.8	-1.0	-0.2
Net exports	0.6	-2.2	0.1	-2.4	0.7	-1.5
Total exports	3.4	-2.7	-0.4	2.6	2.4	1.5
Total imports	-2.8	0.5	0.5	-5.0	-1.7	-3.0

Source: Statistical Service of Cyprus.

[1] This report reflects the discussions with the government of the Republic of Cyprus, the recognized member country. It does not cover the areas of the Republic of Cyprus not under the effective control of the government of the Republic of Cyprus and assumes no change in the status quo. Mission details and statistical information are included in the informational annexes.

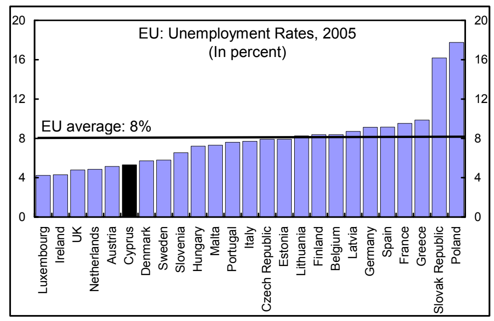
contributed to lower real wage increases[2] despite pervasive backward-looking cost of living allowances (COLAs) and upward pressure stemming from seniority-based wage increases in the public sector.[3]

Economic growth has been strong.



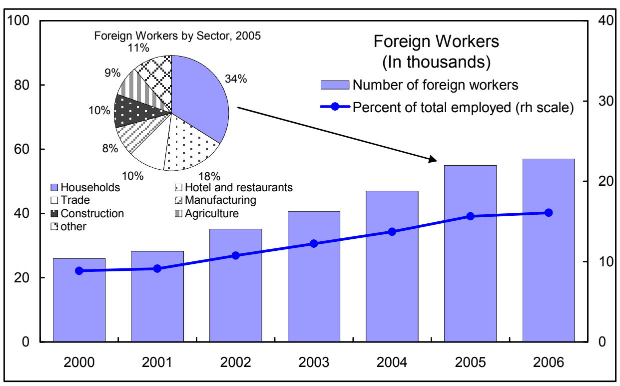
Source: IMF, *World Economic Outlook*.

Unemployment is low.



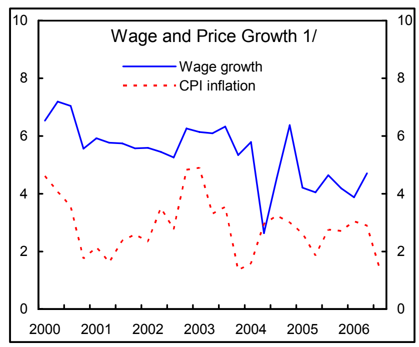
Source: IMF, *World Economic Outlook.*

Employment opportunities are attracting foreign workers.



Source: Ministry of Labor and Social Insurance.

Inflation is contained, but real wage growth remains high.



Sources: Eurostat; and IMF, *International Financial Statistics*.
1/ Quarterly year-on-year rates.

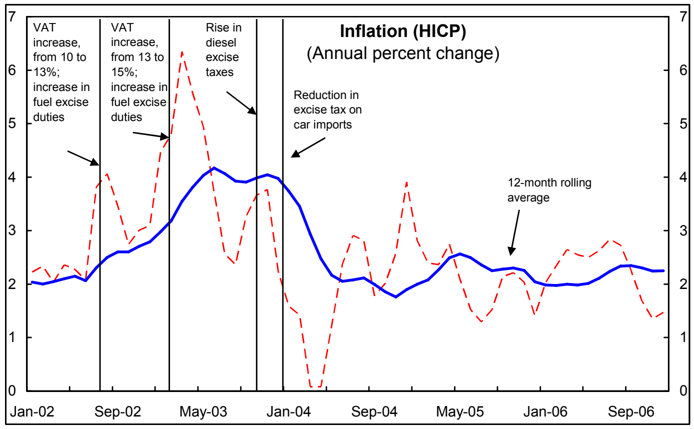
3. **Inflation has slowed**. The moderation (to around 2 percent) in 2004–05 was driven by (i) the waning impact of previous tax rate hikes related to the EU harmonization of minimum tax rates; (ii) a decline in the excise tax rate on cars in late 2003; (iii) increased competition in the telecommunications and air transportation sectors; and (iv) on the external side, euro appreciation. More recently, 12-month HICP inflation increased through the first seven months of 2006, but then declined rapidly to 1.5 percent in December, reflecting lower oil prices and euro appreciation. The November 2006 reduction in excise taxes on cars is expected to exercise further moderating influence.

---

[2] Still, these remain high and averaged about 4 percent in 2004–06. See Michael and others (2005) for an assessment of the impact of foreign workers on wages.

[3] See the 2004 staff report, IMF Country Report 05/106 , available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=18148.0.

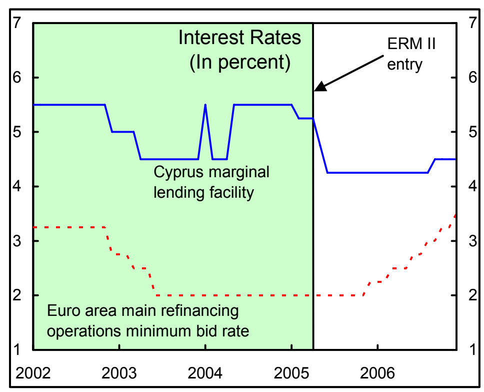
Inflation slowed in 2004-05.



Sources: Eurostat; and IMF staff.

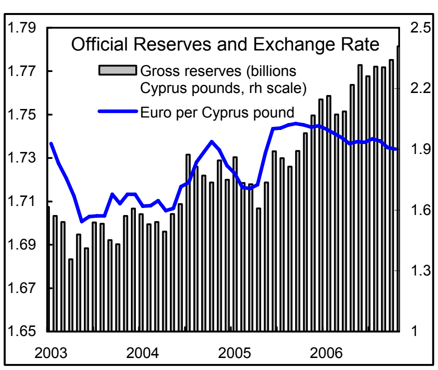
4. **Before inflation started falling, on September 1 the Central Bank of Cyprus (CBC) increased interest rates by 25 basis points to counteract inflationary pressures and strong credit expansion** (Figure 1 and Table 2). This hike followed three consecutive rate cuts, for a total of 125 basis points in 2005 (text figure), responding to strong capital inflows related to Cyprus's participation in ERM2. Although interest rate differentials against the euro area have fallen significantly, the exchange rate had traded close to the (unofficial) upper band of plus 2.25 percent above the central parity of 1£C = €1.7086. Fueled by low interest rates and strong capital inflows, private sector credit growth increased to more than 15 percent in October from about 6 percent in 2004–05.

The policy rate recently edged up.



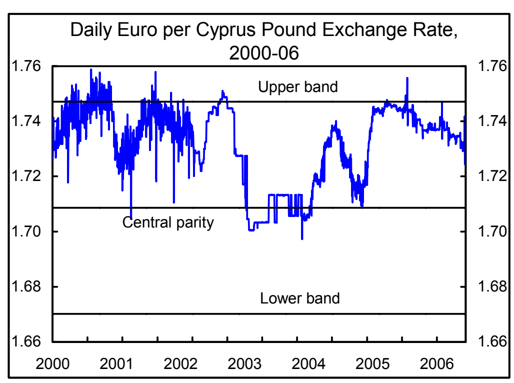
Source: IMF, *International Financial Statistics*.

Reserves have risen.



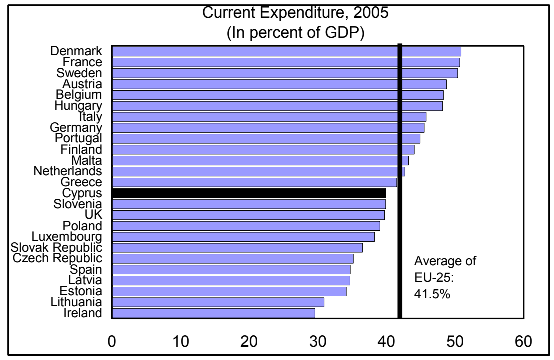
Sources: Central Bank of Cyprus; and Bloomberg.

The pound has traded in a narrow range.



Source: Bloomberg.

5. **The fiscal deficit was cut in half to under 2½ percent of GDP in 2003–05** (Table 3 and Figure 2). As a result, in July 2006, Cyprus became the first new EU member to have its excessive deficit procedure abrogated. Data through September 2006 suggest that the deficit was on track to fall under 2 percent of GDP in 2006, notwithstanding a supplementary budget (about 1 percent of GDP) due to health care expenditure overruns.[4] Almost three-quarters of the 2003–05 fiscal improvement reflected increased revenues, mostly from one-off measures, including a tax amnesty for undeclared income that yielded ¾ percent of GDP in 2004 and nearly 1 percent of GDP in 2005. This, however, is also thought to have contributed to future tax base widening. Fiscal adjustment also benefited from tight expenditure control, which has combined moderation in public sector wage increases with ceilings on the growth of public consumption and investment expenditures.



Source: European Commission.

6. **Rising energy costs (text table) and robust domestic demand have led to a widening of the current account deficit in 2004–06, to over 6 percent of GDP** (Figure 3 and Table 4). Nonenergy imports surged in 2004—prompted by a sharp increase in investment and a reduction in excise duties on cars in 2003—and recorded robust growth in 2005-06. Pressure on export margins continued (text table), though less so than earlier in the decade. Recent declines in competitiveness—as the real exchange rate has appreciated—have contributed to the decline in the export market share of goods, but services exports have held their ground (Figure 4). The surplus in the services balance (as a share of GDP) was little changed in 2004–06, as a sluggish tourism sector was offset by some improvement in the nontourism services balance.

Cyprus: Impact of Oil Prices on the Current Account Balance, 2004–06

	2004	2005	2006
Oil imports (millions of Cyprus pounds)	303.0	466.9	576.3
Price of oil per barrel (Cyprus pounds)	17.7	24.7	29.6
Impact on the current account deficit (in percent of GDP)	0.5	1.5	1.1

Source: Cyprus authorities; and IMF staff estimates.

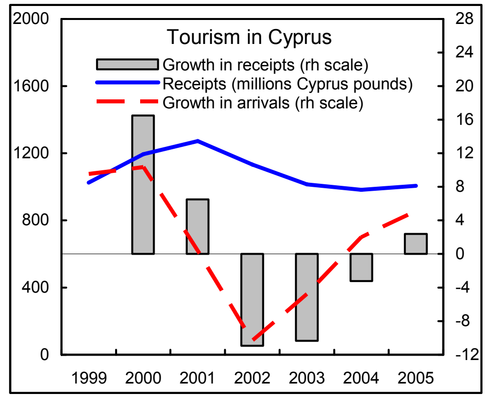
[4] Subsequently, preliminary data in mid-December suggested that the fiscal deficit could decline further. Staff will review these data and a supplement to the staff report will be issued as needed.

Cyprus: Export Margin, 2002–05
(Year-on-year rate of change)

	2002	2003	2004	2005
Export margin	-7.2	-6.5	-0.3	-1.2
Exports deflator	-1.6	-0.2	4.1	2.8
Unit labor cost	5.5	6.3	4.4	4.1
Relative profitability of exports 1/	-2.8	-5.2	0.8	0.4
Exports deflator	-1.6	-0.2	4.1	2.8
GDP deflator	1.2	5.1	3.3	2.4

Source: IMF, *World Economic Outlook.*
1/ Assumes a common unit labor cost for the economy.

Tourism is slowly recovering.



Source: Statistical Service of Cyprus.

7. **Three decades of division have left Cyprus with an economic development gap**. Publicly available data for the areas of the Republic of Cyprus not under the effective control of the the government of the Republic of Cyprus (NGCAs) suggest that the GDP per capita was less than half that of the government-controlled areas (GCAs) in 2005 (text table).[5] The growth performance of the areas of the Republic of Cyprus not under the effective control of the government has reflected a complex interaction of spillover effects from the Turkish economy, economic policy choices and political decisions.

Cyprus: Comparison of Selected Economic Indicators
(2005, unless otherwise indicated)

	GCA	NGCA
GDP per capita (in US$)	22,127	10,314
Labor productivity (in US$), 2004	46,073	16,464
Tourist arrivals (thousands), 2004	2,349	599
Trade balance (in percent of GDP)	-25.0	-52.0
General govt. expenditure (in percent of GDP)	43.6	48.9
CPI inflation (y-o-y), Nov. 2006	1.1	19.5

Sources: Statistical Service of Cyprus; State Planning Organization (NGCA).

8. **Despite all parties' stated interest, a solution to the Cyprus problem remains elusive**. A divided Cyprus entered the EU in 2004 after the failure of the "Annan Plan" for reunification. Following a two-year hiatus in face-to-face talks, the leaders of the Greek Cypriot (G/C) and Turkish Cypriot (T/C) communities agreed in July 2006 to hold "technical discussions." These talks were intended to improve the day-to-day lives of all Cypriots, build mutual confidence, and prepare for a comprehensive political settlement of the Cyprus problem, but they have yet to bear fruit. In this difficult setting, staff has not been in a position to deliver nonfinancial Fund assistance, such as TA, to the T/C community, as suggested by Directors in concluding the 2004 Article IV consultation.

[5] These data do not account for intra-island differences in purchasing power and possibly a sizable informal sector in the areas not under the effective control of the government.

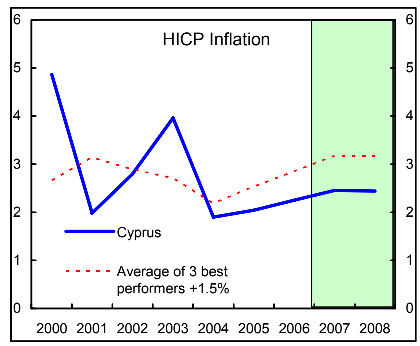
III. Policy Discussions

Cyprus continues to converge to euro area income levels and, by vigorously tackling fiscal imbalances, stands on the doorstep of EMU. The key objective now is to ensure that euro adoption proceeds smoothly, which requires maintaining low inflation and safeguarding fiscal consolidation. Besides addressing the fiscal costs of aging and other medium-term risks to the budget, sustaining economic growth and competitiveness requires continued efforts to strengthen the financial sector and implement structural reforms.

A. Economic Outlook

9. **There was agreement on the favorable economic outlook**. Activity is set to strengthen in 2007–08, sustaining employment growth, with a gradual slowing of domestic demand being more than offset by a broad-based recovery in services exports. The external current account deficit is envisaged to narrow gradually and continue to be financed by foreign direct investment, portfolio inflows, and bank borrowing (historically resilient to economic shocks). While staff saw inflation as hovering close to the Maastricht limit, the authorities expressed confidence that it would remain below this limit, and recent developments are encouraging in this respect. The authorities singled out the reduction in energy-related cost pressures, while the reduction in excise duties for cars would also hold down inflation in 2007, although it would have a smaller effect than the 2003 tax cuts and would be partially offset by the need to align VAT rates with EU directives.

Inflation will remain low.



Source: IMF, *World Economic Outlook*.

10. **Risks to this outlook appear balanced**. Declining oil prices were seen as boosting economic activity. The opening of Turkish ports to Cypriot vessels (text table), the prospects of which remain uncertain, could provide a further stimulus as transportation services account for almost 15 percent of total exports.[6] The authorities, however, were concerned that a further appreciation of the euro against the dollar could hamper the incipient recovery in Europe and hurt Cyprus's external competitiveness. Also, although the conflict in Lebanon earlier in the year had subsided with no appreciable adverse effects on

Cyprus: Merchant Shipping Fleets, 2000–02

	2000	2001	2002
Cyprus			
Share in world tonnage (in percent)	4.2	4.0	4.0
World ranking	6	6	6
Greece			
Share in world tonnage (in percent)	4.8	5.1	5.0
World ranking	5	4	4
Memo item:			
World gross registered tonnage	550,181	566,125	576,698

Source: UN and Lloyd's Register of Shipping, *World Fleet Statistics*.

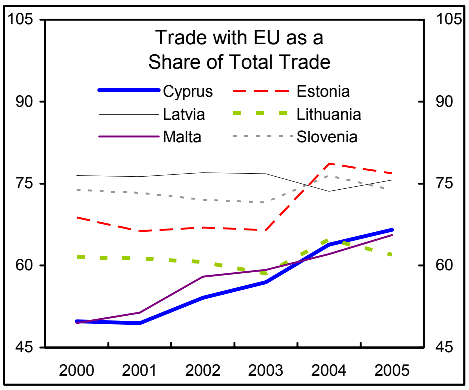
[6] Subsequent to the discussions, the EU partially suspended EU accession negotiations with Turkey in response the country's failure to open its ports and airports to Cypriot vessels.

Cyprus, the island remained exposed to regional geopolitical tensions.

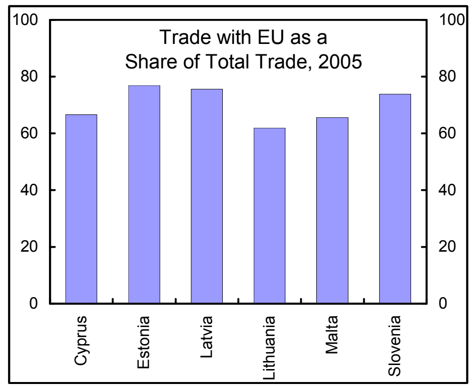
B. Adopting the Euro

11. **Cyprus is well placed to benefit from euro adoption**. The economy already benefited from lower interest rates and the removal of barriers to the free flow of goods and services, capital, and labor; the introduction of the euro would provide additional benefits by further reducing transaction costs and, possibly, long-run interest rates.

The economy is becoming more integrated with the EU.



Source: IMF, *Direction of Trade Statistics*.



Source: IMF, *Direction of Trade Statistics*.

12. **The authorities aim to enter the euro area on January 1, 2008 and plan to submit their euro-adoption petition in early 2007**. The recent track record of delivering on the fiscal front, as well as broad compliance with Maastricht criteria in 2005 (text table) helped reduce uncertainty about the timing of euro adoption (Figure 5). The authorities expect Cyprus to be assessed against the Maastricht criteria in the first half of 2007, and, subject to a positive assessment, the Cypriot pound exchange rate would be locked in as of mid-2007, with the lock-in rate being determined in line with the relevant Treaty provisions.

New EU Members and Maastricht Criteria, 2005
(In percent of GDP unless otherwise indicated)

	Fiscal balance	Public debt	Inflation (percent)
	2005	2005	2005
Cyprus	-2.4	69.2	2.0
Czech Republic	-2.1	25.6	1.8
Estonia	1.7	4.6	4.1
Hungary	-7.6	...	3.6
Latvia	-1.2	11.9	6.8
Lithuania	-1.2	18.7	2.7
Malta	-3.3	...	2.5
Poland	-3.9	47.7	2.1
Slovakia	-3.5	34.5	2.7

Source: IMF, *World Economic Outlook*.

13. **The authorities pointed to various studies suggesting that the exchange rate was broadly in line with its equilibrium level**.[7] Mindful of uncertainties in estimating the equilibrium real exchange rate, the mission agreed that the exchange rate appeared to be broadly in line with fundamentals (Box 1). However, it underscored the need to enhance productivity since there was little scope for any further loss of external competitiveness, and given that any such losses would be particularly difficult to recoup once in the euro zone. Also, staff's external debt sustainability analysis suggests that the current account deficit in the baseline scenario (based essentially on the authorities' Convergence Program) needs to be narrowed substantially to stabilize the external debt position (Table 5).

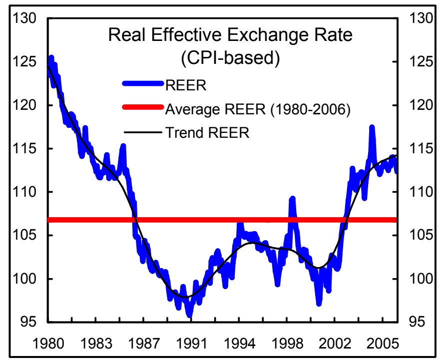
14. **The key short-term policy priority is therefore to ensure a smooth changeover to the euro**. A number of committees devoted to the task have been established, and draft laws to reform the institutional framework for monetary policy are expected to be adopted in early 2007. The mission supported the authorities' euro adoption plan, but noted the need to contain inflationary pressures and assuage the public's concern that prices might be rounded up when converted into euros. In welcoming the planned dual display of prices, it noted that vigorous domestic competition would be the most effective way to discipline retailers. Furthermore, to ensure that inflation remained in check, the mission called for continued wage moderation and faster fiscal consolidation than envisaged by the authorities.

[7] See Kyriacou and Papageorgiou, 2005 and forthcoming update.

Box 1. External Competitiveness

The Cypriot economy has coped well with declines in price and cost competitiveness since the early 1990s. Aside from the 2002-03 slump, economic growth has been robust, labor markets operate close to full employment, and strong FDI inflows indicate profitable business opportunities.

In part, this reflects the fact that the recent appreciation in the REER reversed earlier gains. Moreover, the rate of appreciation appears to be moderating. The ULC-based REER suggests more appreciation, owing to strong real wage increases (Figure 4).



Source: IMF, *Information Notice System*.

Estimates of the equilibrium exchange rate for the Cyprus pound suggest that the REER is broadly in line with its equilibrium level. Pattichis and others (2005) estimated that the Cyprus pound's exchange rate was slightly undervalued relative to its equilibrium rate in 2000. Since then, the REER of the pound has appreciated by about 15 percent. However, some of this appreciation reflects income convergence with the euro area, including Balassa-Samuelson effects, and exchange rate movements of the euro against other currencies. Kyriacou and Papageorgiou (2005) also concluded that the pound was in line with economic fundamentals in 2004.

In terms of business competitiveness, Cyprus compares favorably to most new member countries, but not with the rest of Europe (Figure 6).

C. Safeguarding Fiscal Consolidation

15. **The 2007 budget targets a further reduction in the fiscal deficit (to 1.6 percent of GDP), though at a slower pace than recently**. The authorities noted that, in a break with the past, the budget was free of one-off measures and focused on current expenditure adjustment. On the meager increase in the primary surplus, they noted that cost containment efforts would be partially offset by an increase in (other) transfers, primarily of a social nature. They also noted the need to offset the net effect on the budget of the termination of EU budgetary transfers amounting to 0.4 percent of GDP from 2007 onward. The mission stressed that more consolidation than foreseen in the budget was essential to safeguard the moderation of inflation, and that this could be achieved by avoiding supplementary budgets (rigorously applying the provision on this in the 2007 budget) and strengthening expenditure control mechanisms to observe budget limits.

Cyprus: The Convergence Program, 2006–10
(General government; in percent of GDP at market prices)

	2006	2007	2008	2009	2010	Adjustment 2007–10
General government balance	-1.9	-1.6	-0.7	-0.4	-0.1	1.5
Of which: One-off and other temporary measures	0.4	0.0	0.0	0.0	0.0	0.0
Revenue	42.1	42.3	42.4	42.3	42.1	-0.2
Of which: Tax and social contributions	*35.5*	35.7	36.0	36.5	36.7	1.0
Expenditure	44.0	43.9	43.1	42.7	42.2	-1.7
Primary expenditure	40.7	40.9	40.3	40.2	39.9	-1.0
Collective consumption	9.7	9.3	8.9	8.8	8.7	-0.6
Transfers other than in kind and subsidies	13.1	13.4	13.6	13.9	14.3	0.9
Gross fixed capital formation	3.5	3.5	3.4	3.1	3.1	-0.4
Other primary expenditure	14.4	14.7	14.4	14.4	13.8	-0.9
Interest expenditure	3.3	3.1	3.0	2.5	2.3	-0.8
Main measures 1/						
Revenue	0.2	0.5	0.4	0.4	…	
Termination of compensating grants on EU budget	…	-0.4	-0.4	-0.4	…	
Improving of collection	0.2	0.5	0.4	0.4	…	
Widening of VAT tax base	…	0.4	0.8	0.8	…	
Taxation of motor vehicles	…	…	-0.4	-0.4	…	
Expenditure	-1.1	-0.2	-1.1	-0.9	…	
Restrictive policy on employment growth in public secto	…	-0.1	-0.3	-0.4	…	
Decrease in interest expenditure	-0.1	-0.3	-0.5	-0.8	…	
Ceiling on growth rate of current expenditure	-0.8	0.3	-0.1	0.1	…	
Ceiling on growth rate of current transfers	…	-0.1	-0.1	…	…	
Public sector retirement measures	-0.2	0.2	-0.1	0.2	…	
Revised criteria for social benefits (Social security)	…	-0.2	0.0	…	…	
Memorandum items:						
General government balance excluding one-off and temporary measures	-1.5	-1.6	-0.7	-0.4	-0.1	1.5
General government gross debt	64.8	60.6	52.6	49.0	46.1	-14.5
Primary balance	1.4	1.5	2.3	2.1	2.2	0.7

Sources: Convergence Program 2006-2010, December 2006; EU Commission; and staff calculations.
1/ 2006 data from the Convergence Program 2005–09

16. **The Convergence Program** (CP) **targets fiscal balance by 2010**. The bulk of this adjustment is planned to result from reductions in current spending associated with expenditure containment measures already in place (text table). The CP envisages lowering the public debt to 46 percent of GDP by 2010; the staff's debt sustainability analysis suggests that debt projections are sensitive to certain shocks (Table 7 and Figure 7). The mission supported the authorities' medium-term fiscal consolidation plan, and stressed the importance of reining in current expenditures as a means to high-quality adjustment.

17. **The authorities are phasing in a medium-term budget framework (MTBF)**. Some elements were already included in the 2007 budget, notably the submission of 2007–09 budgets for line ministries and the prohibition of supplementary budgets, except in a national emergency. The MTBF, envisaged to be fully operational for the 2008 budget, will include a rolling three-year horizon and an institutional framework—shaped by advice from the Fund's Fiscal Affairs Department earlier in 2006—linking the medium-term targets to the annual budgetary process. The MTBF would establish expenditure ceilings for line ministries, and the National Lisbon Program (NLP) would govern the final allocation of expenditures, including the investment budget.

18. **The authorities have halted an ambitious public investment plan, envisaged to be carried out as a public-private partnership** (PPP). With the exception of a few projects already underway, all new projects in the public investment pipeline were recently suspended (text table). The authorities noted that time was needed to introduce a proper legal framework

for PPPs and the associated institutional reforms, including a gateway process (Table 6) and the creation of a dedicated PPP unit responsible for ex ante cost-benefit analyses and value-for-money assessments. Besides infusing investment projects with economic rationale, this would allow the authorities to prioritize projects and place them in the context of the MTBF. The authorities concurred that the reporting requirements for PPPs needed to be upgraded to protect the integrity and informational content of the government's financial statements.

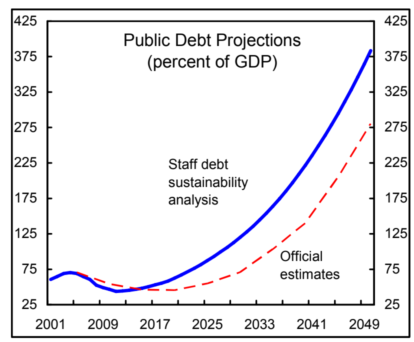
Cyprus: PPPs in the Current Pipeline of Projects (PoP), 2006

	Implementation 1/	Estimated Cost	
		CYP (millions)	Percent of 2006 GDP
Total estimated costs of pipeline of projects		1,695	**20.5**
Energy (Vasilikos Center)	2005-09	200	2.4
Roads		320	3.9
Nicosia Orbital Motorway	2006-09	240	2.9
Paphos-Polis Highway	2006-10	80	1
Airports		290	3.5
Larnaka International Airport (phase I)	2005-08	230	2.8
Paphos Interntional Airport (phase I)	2005-07	60	0.7
Marinas (Ayia Napa, Larnaka, Limassol and Paphos)	2005-09	175	2.1

Source: Planning Bureau, 2005 Pipeline of Projects.
1/ As of December 15, 2006 only the airport terminal projects had begun.

19. **The fiscal consequences of aging are the main threat to the long-run sustainability of fiscal accounts**. Gains in life expectancy and declines in fertility will give rise to an aging population (Figure 8). As the dependency ratio increases, public pension spending is projected to rise nearly 13 percent of GDP by 2050 (text table). In the absence of pension reform or complementary fiscal measures, the consequence would be an explosive increase in the debt-to-GDP ratio.[8]

Long-run debt will explode.



Source: Ministry of Finance; and staff calculations.

Cyprus: The Demographic Shock

	Old-Age Dependency Ratio 1/		Public Pension Expenditures		Peak Pension Expenditures	
	Change to 2050	2050	Change to 2050	2050	Peak Year	Value
Cyprus	14	27	12.9	19.8	2050	19.8
EU-25	13	30	2.2	12.8	2044	12.8
EU-15	13	30	2.3	12.9	2043	13.0
EU-10	16	29	0.3	11.1	2050	11.1

Source: Eurostat, and European Commission, The Aging Working Group.
1/ Ratio of dependents to total population where dependents are greater than 64 years of age.

[8] See the selected issues paper for this consultation for a discussion of the pay-as-you-go social security system and an assessment of the macroeconomic consequences of aging and parametric reforms.

20. **The authorities are formulating a two-staged strategy to meet this challenge**. The first wave of reforms includes tightening pension eligibility requirements—including those for a pension at age 63—increasing social security contributions, and reducing the supplementary pension relative to the basic pension. The second wave would further increase contribution rates and introduce additional parametric reforms.

21. **The mission stressed that, given the magnitude of the challenge, there was no alternative to deeper reforms of the social security system**. Specifically, it called for:

- Raising the effective retirement age back to 65 years for all employees.[9] Early retirement should be addressed in an actuarially neutral manner, with only limited exceptions made for particularly strenuous occupations.

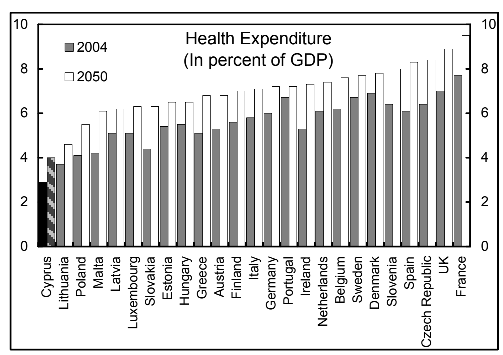
- Switching the indexation of all benefits to consumer prices from wages, which would contain pension expenditures; the authorities expressed concern, however, that it would increase poverty among pensioners.

- Introducing an explicit mechanism of periodic adjustments in the retirement age and/or pension benefits to automatically ensure the sustainability of the system in light of demographic changes.

The mission also noted the need to improve the alignment of pension benefits in the public sector with those in the private sector; staff estimates the former to be about 80 percent higher in net present value terms.

22. **Aging will also put pressure on health-care expenditures, but less so than in other European countries**. The National Health Insurance System (NHIS), to be introduced in 2008, would phase in much-needed competition in the provision of health care, which will continue to be free of charge. However, public hospitals will remain sheltered from competition for two to three years. The authorities intended to fund the additional costs of the NHIS through higher social security contributions. The mission noted that these reforms should be supported by introducing user fees, with means-tested exemptions, to limit potential abuse and contain costs.

Health spending is projected to be limited.



Source: European Commission, Aging Working Group.

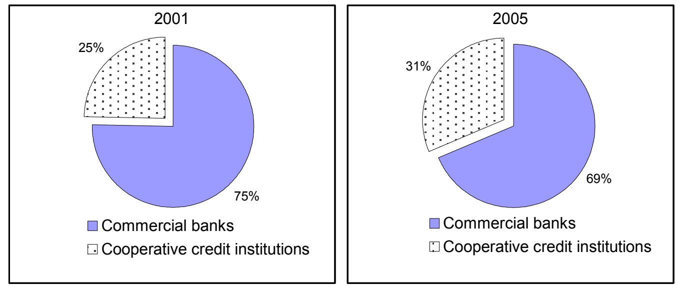
[9] The retirement age was lowered to 63 years of age in 1991.

D. Strengthening the Financial Sector

23. **The financial sector has recovered from the bursting of the stock market bubble at the turn of the century**. Cost-cutting measures and remedial actions to improve the quality of the loan portfolio, together with favorable macroeconomic developments, boosted commercial banks' profitability in 2005–06. In the cooperative bank sector—accounting for roughly 30 percent of private-sector claims—mergers intensified in 2006 in anticipation of the full harmonization of capital requirements with EU directives by end-2007 (text table). The authorities anticipated that about half of the current cooperative credit institutions (CCIs) would merge by joining the cooperative central bank. Also, they expected the recently established common platform between the Cypriot and Athens stock exchanges to increase liquidity and lower transaction costs.

Cooperative banks play an important role in the banking

Cyprus: Claims on the Private Sector 1/



Source: Central Bank of Cyprus.
1/ Up to 2006, international banks had not been allowed to lend domestically.

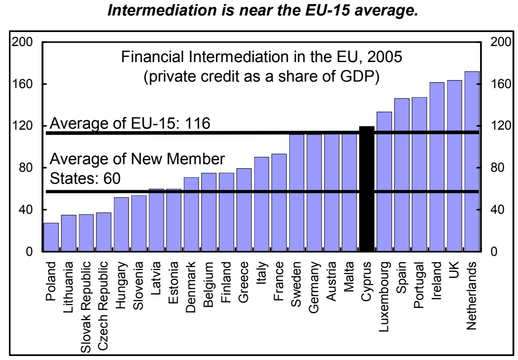
Cyprus: Cooperative Credit Institutions (CCIs), 2002–06

	2002	2003	2004	2005	2006 1/
Number of CCIs	362	361	359	347	305
Number of employees	1,964	2,010	2,101	2,180	...
Number of branches (including central branches)	472	477	477	474	...
Market share of all CCIs (in percent) 2/	24.4	26.8	26.4	24.0	24.2

Source: The Authority for the Supervision and Development of Cooperative Societies.
1/ Data for 2006 as of September.
2/ Defined as deposits of all CCIs to total deposits in local and foreign currency.

24. **However, the economy is experiencing rapid credit expansion and brisk house price increases, which could become sources of risk**. Credit to the private sector accelerated recently (Table 8) from an already high level, driven by mortgage lending. Although house price increases have slowed, they remained high. The authorities have suspended further cuts in the deposit reserve ratio and issued a circular on foreign currency borrowing to emphasize the exchange rate risk of unhedged borrowing. They explained that these measures had clarified the loan-to-value ratio guidelines introduced in 2003 and stressed that they were closely monitoring developments.

Intermediation is near the EU-15 average.



Source: IMF, *International Financial Statistics*.

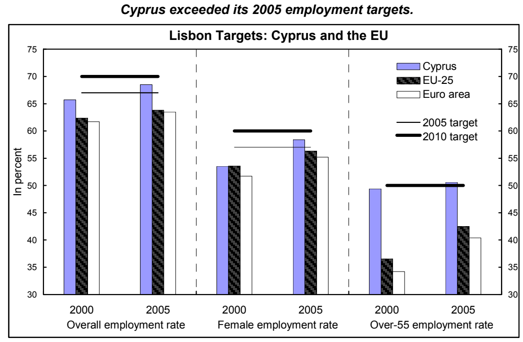
25. **The share of nonperforming loans (NPLs) is declining but remains high by international standards** (Table 9 and Figure 9). The authorities attributed the high stock of bad debt to the drawn-out legal foreclosure process, typically lasting some ten years, and noted that, had there been a more rapid write-off of loans already provisioned for, the ratio of NPLs would have dropped substantially. They agreed that modernizing the foreclosure process, as envisaged in legislation already submitted to parliament, is critical. The mission also argued for more rapid write off by commercial banks, but the authorities noted that, in practice, write offs were uncollectible, despite a formal legal claim.

26. **Financial sector supervision has improved significantly, but challenges remain**. Commercial banks, cooperative credit institutions, stock markets, and insurance companies are supervised by four distinct entities. The authorities noted the progress made in improving the coordination among supervisors, and concurred that there was further scope to take advantage of economies of scale. The Fund's Assessment of Financial Sector Supervision Report (AFSSR) found that, although supervision and regulation in the commercial banking sector were strong and complied with international standards, the supervision of cooperative credit institutions and of the insurance market needed to be strengthened.[10] The authorities explained that the identified shortcomings were being addressed (Table 10), but acknowledged that weaknesses remained in the insurance-market supervision, where severe resource constraints had virtually ruled out on-site inspections. The mission stressed that it was key to ensure that supervisors had clear objectives and responsibilities, operational independence, and adequate resources. The authorities intended to promptly address the resource deficiency in insurance supervision and complete an FSAP in time for the next Article IV consultation.

E. Sustaining Economic Growth Through Structural Reforms

27. **The economy continues to reap the benefits of ongoing reforms**. The National Lisbon Program established a strategy to enhance the growth potential of the economy (Table 11). The introduction of flexible forms of employment, together with strong economic growth, had enabled Cyprus to exceed the 2005 employment targets. The authorities also explained that boosting human capital and enhancing R&D were critical elements of the NLP, and that the reform strategy's implementation would be strengthened by a newly established monitoring unit.

Cyprus exceeded its 2005 employment targets.



Source: Eurostat.

[10] See AFSSR Country Report 06/376, available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=20032.0.

28. **However, several long-standing rigidities remain**. In particular, the mission reiterated its concerns in the following areas:

- Widespread backward-looking COLAs and seniority-based rules governing salary increases in the public sector have introduced real-wage rigidities and increased wages beyond productivity gains. While staff argued that eliminating these would be preferable, removing energy costs and changes in VAT from the COLA adjustment would partially remove this rigidity. The authorities acknowledged the limitations of COLAs, but noted that real wage increases had moderated recently. They also argued that COLAs had helped smooth labor relations.

- Large public incumbents dominate key product markets, notably telecommunications and energy, although some progress has been made in opening these sectors since 2004 (text table). The authorities stressed their commitment to intensify competition, noting legislation before parliament to enhance the investigative powers of the Commission for the Protection of Competition (CPC). However, they were not considering privatizing these state-owned firms.

Cyprus: Private Sector Market Share in the Telecommunications Sector

(based on revenues; in percent)

	2004	2005	2006 Q2
Fixed telecommunications			
Local calls	1.1	6.3	7.0
International calls	...	14.0	22.0
Mobile telecommunications	1.0	7.8	10.2
Internet	16.0	22.2	39.0

Source: IMF staff estimates.

- Public sector efficiency is low and the cost of regulation high. The authorities acknowledged that these issues needed to be addressed to enhance productivity.

- Further improvements are needed to upgrade the tourism sector. The authorities shared this concern, which they had highlighted in the sector's Strategic Development Plan.

IV. Staff Appraisal

29. **Substantial progress in addressing macroeconomic imbalances and reforming the economy has placed Cyprus at the doorstep of EMU**. The economic outlook is strong: economic growth is picking up and continues to outstrip that of the EU; inflation, while bearing watching, is receding with lower oil prices and a strong euro; fiscal consolidation is poised to continue; and the real exchange rate is broadly in line with fundamentals.

30. **Ensuring continued observance of the Maastricht criteria and a smooth adoption of the euro will lay the groundwork for continued growth**. Cyprus is well placed to benefit from euro adoption as planned in 2008. Adopting the euro can augment the benefits of EU membership by lowering transaction costs and stimulating investment through lower long-run interest rates. Macroeconomic policies should continue to be directed to ensure

observance of the Maastricht criteria, especially with regard to inflation, via fiscal and wage restraint. Moreover, there is a need to allay the public's apprehension regarding the potential for abuse in converting prices into euros. The planned dual display of prices should be complemented by policies fostering vigorous domestic competition to curb potential abuses.

31. **Spending limits in the 2007 budget need to be strictly observed, and higher-than-expected revenues should be saved**. Stronger adjustment in 2007 is needed to safeguard against a reemergence of inflation and represent a strong step toward medium-term consolidation. The intention to balance the budget in 2010 is appropriate; adjustment should focus on high-quality fiscal measures, in particular by keeping current expenditures in check. In this connection, the ban on supplementary budgets should be strictly observed.

32. **The planned Medium Term Budget Framework will provide the institutional arrangements needed to rationalize, prioritize, and control public expenditure**. The implementation of the MTBF is welcome, especially as it is a key element of a broader reform to strengthen financial management, including that of public investment. In this regard, the suspension of the ambitious pipeline of public investment is appropriate, until a proper legal framework and institutional setting for PPPs are in place. It is critical that cost-benefit analysis guide project selection, and that value-for-money considerations determine how projects will be procured.

33. **In the long run, fiscal sustainability hinges on implementing reforms to the pension system and relieving aging-related pressures on public expenditure**. Deep reforms are needed to catch up, and keep up, with demographic developments. The authorities' plans to address aging-related pressures are welcome, and the challenge now is to move from diagnosis to action. Measures to increase the effective retirement age back to 65 years and periodic automatic adjustments would ensure that the pension system does not fall behind demographic trends again. Also, switching pension indexation to prices from wages can help to contain costs and, by setting the stage for lower taxes than otherwise possible, protect net-of-tax pension benefits. Phasing in reforms and grandfathering the rights of employees are desirable, but feasible only if reforms are put in place promptly. The National Health Insurance System should also be adjusted, including by establishing user fees, to limit abuse and ensure that expenditures remain manageable.

34. **Although commercial banks are profitable and well capitalized, credit and house price developments need to be closely monitored to contain financial sector risks**. Prompted by EU accession and, more broadly, by worldwide developments, the financial sector has undergone a substantial transformation in recent years. The rationalization of the cooperative banking sector is welcome, as it will serve to strengthen its capital base. Although the authorities' continued monitoring of financial market developments is reassuring, prudential measures to control risks in the banking sector may need to be revisited if the pace of credit expansion does not abate. The recent proposals to change the

legislation and regulations to accelerate the lengthy foreclosure process should be adopted as soon as possible.

35. **Some aspects of financial supervision should be strengthened**. Economies of scale and potential gains from combining the experience of supervisors point to the desirability of unifying the supervision of commercial banks and cooperative credit institutions. Irrespective of the institutional framework, supervisors should have clear responsibilities and objectives, operational independence, professional staff, and adequate resources. The latter holds in particular for the Superintendent for Insurance to be in a position to conduct on site inspections. The decision to complete an FSAP in time for the next Article IV consultation is welcome.

36. **In the end, reaping the opportunities available to Cyprus will depend on its ability to sustain economic growth**. There is little scope for further competitiveness losses, and continuing to implement the National Lisbon Program will be central to Cyprus's success in EMU. Continued real wage increases point to the urgency of complementing reforms with a redesign of the wage-setting system to promote an alignment of real wage growth with productivity developments. Continuing to enhance domestic competition in key markets, either by privatizing state-owned firms or exposing them to vigorous competition, would further boost productivity. In this regard, the Commission for the Protection of Competition should be provided with adequate resources, and legislation to further its investigative capacity adopted promptly.

37. It is recommended that the Article IV consultation remain on a 24-month cycle.

Table 1. Cyprus: Selected Economic and Social Indicators, 2002–08

					Projections		
	2002	2003	2004	2005	2006	2007	2008
	(Annual percentage change)						
Real economy							
Gross domestic product	2.0	1.8	4.2	3.9	3.7	3.9	4.0
Domestic demand	4.3	1.7	6.5	3.1	5.1	4.5	3.8
Net exports (contribution to growth)	-2.2	0.1	-2.4	0.7	-1.5	-0.7	0.1
Employment growth	1.9	3.7	2.9	1.9	1.5	1.5	1.5
Unemployment rate (in percent)	3.2	3.5	3.6	5.2	4.9	4.8	4.7
Harmonized index of consumer prices (period average)	2.8	4.0	1.9	2.0	2.2	2.5	2.4
Gross domestic investment (in percent of GDP)	18.8	17.4	20.2	19.4	19.5	19.5	19.6
Gross domestic saving (in percent of GDP)	15.1	15.2	15.2	13.8	13.2	13.9	13.9
	(In percent of GDP)						
Public finance 1/							
Overall balance	-4.4	-6.3	-4.1	-2.4	-1.9	-1.6	-0.7
Primary balance	-1.3	-2.9	-0.8	1.1	1.4	1.5	2.3
Public debt 2/	64.7	69.1	70.4	69.2	64.8	60.6	52.6
	(Annual rates)						
Money and credit							
Interest rates							
Deposit rates 3/ 5/	4.8	3.8	3.9	4.0	3.6	...	...
Lending rates 4/ 5/	7.2	6.9	7.6	7.1	6.8	...	...
	(In percent of GDP)						
External sector							
Trade balance	-27.3	-23.9	-25.6	-25.0	-27.4	-26.7	-26.4
Current account balance	-3.7	-2.2	-5.0	-5.6	-6.2	-5.6	-5.6
Capital and Financial account	5.3	1.7	5.9	6.6	6.2	5.6	5.6
Of which: Foreign direct investment, net	5.7	3.0	2.9	4.3	4.3	4.3	4.3
Portfolio investment, net	-4.8	1.9	7.5	-0.8	-0.8	-0.8	-0.8
Fund Position (as of November 30, 2006)							
Holdings of Currency (in percent of quota)				90.0			
Holdings of SDR's (in percent of allocation)				14.0			
Quota (in millions of SDR)				139.6			
Exchange rates							
Exchange Rate Regime:				ERM2			
Present rate (December 14, 2006)				CYP 0.578 :€1			
Pounds per U.S. dollar (end-period)	0.55	0.47	0.43	0.48	0.44	...	...
Real effective exchange rate (CPI, 2000=100) 5/	104.1	111.0	113.0	112.9	112.3	...	...

Social indicators

	Year	Cyprus
GDP per capita, in current U.S. dollars	2005	22,372
Population, in thousands	2005	758.0
Population density, inhabitants per square kilometer	2004	89.4
Life expectancy (years at birth): males	2004	76.9
females	2004	81.5
Literacy, percent of persons aged 15 and above	2004	96.8
Automobiles per 1,000 inhabitants	2003	551
CO2 emissions, in metric tons per capita	2002	8.3

Sources: Ministry of Finance; Central Bank of Cyprus; World Bank, *World Development Indicators;* and Fund staff estimates.

1/ General government.
2/ Excludes intragovernmental debt and short-term liabilities of the Central Bank.
3/ For 1-year fixed deposits over CYP 5,000.
4/ For enterprises' secured loans.
5/ Data for 2006 as of October.

Table 2. Cyprus: Monetary Survey, 2002–06

(in millions of £C)

	2002	2003	2004	2005	2006 4/
(End-of-period stocks)					
Foreign assets, net	483.7	835.8	1,153.2	1,814.8	1,802.2
Official (net) 1/	1,726.5	1,600.0	1,742.7	2,139.1	2,298.6
All banks (net)	-1,242.8	-764.1	-589.5	-324.3	-496.4
Claims on domestic economy, net	9,642.4	10,210.2	10,638.3	11,494.5	12,705.6
Claims on public sector	1,738.3	1,908.2	1,794.5	2,103.6	2,453.1
Central government	1,778.4	1,956.9	1,835.5	2,127.6	2,470.5
Advances and loans	1,030.9	1,050.0	1,071.4	1,100.9	1,119.8
Treasury bills and securities	1,413.8	1,730.1	1,693.0	1,925.1	2,220.9
Government deposits	-666.3	-823.1	-928.9	-898.4	-870.2
Government agencies	-3.6	-2.4	-9.8	-8.9	-6.7
Claims on private sector	7,904.1	8,302.0	8,843.7	9,390.8	10,252.5
Unclassified items	-1,960.9	-2,551.9	-2,819.9	-3,424.4	-3,783.0
Broad money (M2)	8,165.2	8,494.1	8,971.5	9,885.0	10,724.8
Money supply (M1)	1,038.8	1,377.1	1,523.5	1,804.9	1,973.5
Currency in circulation	392.8	467.2	513.7	555.9	562.6
Demand deposits	628.2	865.9	921.2	1,139.2	1,265.6
Foreign currency	17.8	44.0	88.6	109.8	145.3
Quasi-money	7,126.4	7,117.0	7,448.0	8,080.1	8,751.3
Savings deposits	239.5	294.6	319.6	361.7	396.4
Time deposits	6,553.5	6,439.2	6,534.8	6,815.4	7,275.6
Foreign currency	333.4	383.2	593.6	903.0	1,079.3
(Percentage change over preceding 12 months)					
Foreign assets, net	-14.0	72.8	38.0	57.4	12.9
Claims on domestic economy, net	9.5	5.9	4.2	8.0	10.5
Of which: claims on private sector	8.0	5.0	6.5	6.2	9.2
Broad money (M2)	10.3	4.0	5.6	10.2	13.3
Money supply (M1)	2.6	32.6	10.5	18.5	22.5
Quasi-money	11.5	-0.1	4.7	8.5	8.3
Memorandum items:					
Income velocity of M2 2/	0.8	0.8	0.8	0.8	...
Income velocity of M1 2/	6.3	5.7	5.1	4.7	...
Deposits with cooperatives 3/	3,513.4	3,985.9	4,136.1	...	...
annual percentage change	13.0	13.4	3.8	...	...
Loans by cooperatives 3/	2,670.3	2,947.0	3,276.4	...	...
annual percentage change	6.0	10.4	11.2	...	...

Source: Central Bank of Cyprus.

1/ Includes reserve position in the IMF.

2/ Nominal GDP/average money stock at beginning and end of year.

3/ In millions of £C; data for 2004 as of June and change during January-June 2004.

4/ Data for 2006 as of August.

Table 3. Cyprus: General Government Accounts, 2002–08 1/

(In percent of GDP)

					Projections		
	2002	2003	2004	2005	2006	2007	2008
Total revenue	35.8	38.8	38.8	41.2	42.1	42.3	42.4
Current revenue	35.8	38.7	38.0	40.2	42.0	42.2	42.3
Tax revenue	31.2	33.0	32.6	34.4	35.6	36.1	36.5
Income and property	11.2	9.6	8.0	9.3	9.7	9.8	9.9
Social security contributions	6.7	7.0	7.7	8.3	8.4	8.5	8.5
Indirect taxes	13.3	16.4	16.9	16.9	17.5	17.7	18.1
Nontax revenue	4.6	5.7	5.5	5.8	6.4	6.1	5.8
Capital revenue	0.0	0.1	0.8	1.0	0.1	0.1	0.1
Total expenditure and net lending	40.3	45.1	42.9	43.6	44.0	43.9	43.1
Current expenditure	36.7	41.1	38.7	40.0	40.5	40.4	39.7
Wages and salaries	13.8	15.6	14.8	14.8	14.6	14.5	14.3
Other goods and services	6.1	5.9	4.7	5.0	5.3	5.2	5.0
Subsidies	1.0	1.2	1.1	0.7	0.6	0.6	0.5
Interest payments	3.1	3.4	3.3	3.4	3.3	3.1	3.0
Social security payments	5.7	5.8	6.3	6.8	6.9	6.9	6.8
Other transfers	6.9	9.2	8.4	9.3	9.9	10.1	10.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	3.6	4.0	4.2	3.6	3.5	3.5	3.4
Investment	3.0	3.4	3.7	3.1	3.1	3.1	3.1
Transfers	0.6	0.7	0.5	0.5	0.4	0.4	0.4
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-4.4	-6.3	-4.1	-2.4	-1.9	-1.6	-0.7
Primary balance	-1.3	-2.9	-0.8	1.1	1.4	1.5	2.3
Cyclically adjusted balance	-3.9	-5.1	-3.2	-1.5	-1.2	-1.0	-0.2
Public debt 2/	64.7	69.1	70.4	69.2	64.8	60.6	52.6
Domestic debt	51.6	53.7	51.2	52.2	49.9	45.9	...
Long-term	42.3	45.9	45.7	47.5	46.1	42.4	...
Short-term	9.3	7.8	5.5	4.7	3.7	3.5	...
Foreign debt	13.2	15.4	19.2	17.0	14.9	14.7	...
Long-term	12.9	13.8	17.6	16.4	14.9	14.7	...
Short-term	0.3	1.6	1.5	0.6	0.0	0.0	...
Memorandum items:							
General government: total revenue excluding income and property tax	24.7	29.2	30.8	31.9	32.5	32.5	32.5
Central government revenue	29.3	32.1	30.1	32.0	37.4	37.5	37.6
Central government expenditure	36.4	40.9	37.2	37.2	39.4	38.9	38.5
Central government balance	-7.1	-8.8	-7.1	-5.2	-2.0	-1.4	-0.8
GDP (in millions of £C)	6,416.5	6,865.9	7,389.8	7,861.6	8,356.8	8,909.3	9,496.0

Sources: Ministry of Finance; and Fund staff estimates.

1/ Consolidates central government budget; public loans fund; social security funds; sinking funds; and defence fund.
2/ Excludes intragovernmental debt and short-term liabilities of the Central Bank.

Table 4. Cyprus: Balance of Payments, 2002–11

					Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
					(In millions of U.S. dollars)					
Current account balance	-393	-297	-788	-950	-1,137	-1,128	-1,206	-1,154	-1,125	-1,091
Trade balance	-2,881	-3,179	-4,044	-4,239	-4,988	-5,350	-5,667	-5,889	-6,127	-6,385
Exports	854	926	1,172	1,551	1,498	1,595	1,675	1,763	1,836	1,919
Imports	3,735	4,105	5,217	5,791	6,487	6,945	7,342	7,652	7,963	8,304
of which : Fuel and lubricants	395	404	647	1,007	1,255	1,306	1,415	1,450	1,481	1,517
Services	2,759	3,115	3,609	3,789	4,101	4,533	4,782	5,034	5,303	5,596
Exports	4,493	5,347	6,250	6,494	7,010	7,751	8,233	8,722	9,246	9,818
of which : Travel (mainly tourism)	1,936	2,094	2,255	2,333	2,448	2,675	2,811	2,954	3,109	3,281
Imports	1,733	2,232	2,640	2,705	2,910	3,218	3,451	3,688	3,943	4,222
Investment income, net	-385	-376	-522	-591	-348	-452	-498	-517	-535	-553
Transfers, net	114	143	169	91	98	142	178	218	234	251
Capital and Financial account balance 1/	560	224	929	1,118	1,137	1,128	1,206	1,154	1,125	1,091
Capital account, net	-5	20	126	87	44	52	60	72	80	71
Direct foreign investment, net	598	402	461	735	789	870	930	955	982	1,011
Portfolio investment, net	-558	263	1,134	-149	-160	-176	-187	-199	-212	-226
Other investment, net	928	-677	-409	1,165	635	570	569	464	395	333
Reserve assets	-403	215	-383	-720	-171	-189	-166	-137	-120	-98
Net errors and omissions	-167	73	-141	-168	0	0	0	0	0	0
Change in official reserves 2/	776	282	661	315	480	297	296	296	301	305
					(Percentage change)					
Memorandum items:										
Goods exports	-12.6	8.4	26.6	32.3	-3.4	6.5	5.0	5.2	4.2	4.5
Goods imports	5.0	9.9	27.1	11.0	12.0	7.1	5.7	4.2	4.1	4.3
Tourism receipts	-3.5	8.1	7.7	3.5	4.9	9.3	5.1	5.1	5.3	5.5
					(In percent of GDP)					
Trade balance	-27.3	-23.9	-25.6	-25.0	-27.4	-26.7	-26.4	-25.8	-25.3	-24.7
Services balance	26.2	23.4	22.9	22.3	22.5	22.6	22.3	22.1	21.9	21.7
Current account	-3.7	-2.2	-5.0	-5.6	-6.2	-5.6	-5.6	-5.1	-4.6	-4.2
Financial account	5.8	1.4	5.4	6.2	6.1	5.4	5.4	4.8	4.4	4.0
Change in official reserves 2/	7.4	2.1	4.2	1.9	2.6	1.5	1.4	1.3	1.2	1.2
					(In millions of US. dollars, end-of-period)					
Gross official reserves	3,173	3,455	4,116	4,431	4,910	5,207	5,503	5,799	6,100	6,405
In months of imports of GS	7.0	6.5	6.3	6.3	6.3	6.1	6.1	6.1	6.1	6.1
Total gross reserves (includes banks)	4,896	5,356	6,157	9,439	9,475	9,603	9,731	9,860	9,987	10,112
In months of imports of GS	17.7	19.6	20.1	28.8	26.4	25.5	24.4	23.5	22.7	22.0
					(In billions of U.S. dollars)					
Gross domestic product	10.5	13.3	15.8	17.0	18.2	20.1	21.4	22.8	24.3	25.8

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

1/ Includes financial derivatives.
2/ Includes valuation effects.

Table 5. Cyprus: External Debt Sustainability Framework, 2001–11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Baseline: External debt	35.7	47.4	51.6	64.2	74.4	**81.5**	**80.9**	**80.4**	**79.9**	**79.5**	**79.2**
Change in external debt	5.8	11.7	4.3	12.6	10.2	7.1	-0.6	-0.5	-0.4	-0.4	-0.4
Identified external debt-creating flows (4+8+9)	5.0	2.9	-3.9	-1.3	2.0	3.7	2.7	2.6	2.0	1.6	1.2
Current account deficit, excluding interest payments	1.3	1.6	0.3	3.4	3.6	3.3	2.0	2.1	1.6	1.1	0.7
Deficit in balance of goods and services	-1.6	1.2	0.5	2.8	2.7	4.9	4.1	4.1	3.7	3.4	3.1
Exports	55.1	50.7	47.2	47.0	47.4	46.7	46.6	46.2	46.0	45.7	45.4
Imports	53.5	51.9	47.7	49.8	50.1	51.6	50.6	50.3	49.7	49.1	48.5
Net non-debt creating capital inflows (negative)	2.8	2.1	3.6	1.9	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	0.8	-0.8	-7.8	-6.6	-2.4	0.4	0.7	0.5	0.5	0.5	0.5
Contribution from nominal interest rate	1.9	2.1	2.0	1.6	2.0	2.9	3.6	3.5	3.5	3.5	3.5
Contribution from real GDP growth	-1.1	-0.6	-0.7	-1.8	-2.3	-2.6	-2.9	-3.0	-3.0	-3.0	-3.0
Contribution from price and exchange rate changes 2/	0.0	-2.3	-9.1	-6.4	-2.1	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	0.8	8.8	8.2	13.8	8.2	3.4	-3.4	-3.1	-2.5	-2.0	-1.6
External debt-to-exports ratio (in percent)	64.8	93.5	109.4	136.6	156.8	174.3	173.6	173.9	173.9	174.1	174.2
Gross external financing need (in millions of US dollars) 4/	729.3	799.0	755.9	1478.0	1776.2	1777.9	1813.6	1962.1	1961.9	1985.0	2005.7
in percent of GDP	7.5	7.6	5.7	9.4	10.5	9.8	9.0	9.2	8.6	8.2	7.8
Scenario with key variables at their historical averages 5/						**81.5**	**84.3**	**84.7**	**85.3**	**86.4**	**87.9**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	4.0	2.0	1.8	4.2	3.9	3.7	3.9	4.0	4.0	4.0	4.0
GDP deflator in US dollars (change in percent)	-0.1	6.8	23.8	14.0	3.4	3.5	6.1	2.7	2.3	2.3	2.3
Nominal external interest rate (in percent)	6.7	6.4	5.3	3.7	3.3	4.2	4.8	4.6	4.6	4.7	4.7
Growth of exports (US dollar terms, in percent)	6.0	0.3	17.3	18.3	8.4	5.8	9.8	6.0	5.8	5.7	5.9
Growth of imports (US dollar terms, in percent)	0.4	5.7	15.9	24.0	8.1	10.6	8.2	6.2	5.1	5.0	5.2
Current account balance, excluding interest payments	-1.3	-1.6	-0.3	-3.4	-3.6	-3.3	-2.0	-2.1	-1.6	-1.1	-0.7
Net non-debt creating capital inflows	-2.8	-2.1	-3.6	-1.9	-0.8	0.0	0.0	0.0	0.0	0.0	0.0

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 6. Cyprus: Proposed Gateway Process for PPPs

		Project Manager or Steering Committee	**PPP Unit and Budget Directorate**
Project Preparation Period	Phase 1: PLANNING	Prepare initial feasibility study and undertake the public sector comparator (PSC) analysis.	• PPP unit: evaluate initial feasibility study and the PSC analysis, assess VfM and global sustainability. • Budget Directorate: evaluate budgetary affordability of project and ensure consistency with overall fiscal goals and priorities. • Both: Report to Finance Minister; advise to turn down project if found to offer insufficient VfM or unaffordable.
		GATEWAY 1: Finance Minister to approve/reject initial project	
	Phase 2: DESIGN AND PREPARATION OF TENDER	Prepare tender documents.	• PPP unit: Review tender documents for consistency with the original project specifications that were agreed in Phase 1. • Report to Finance Minister.
		GATEWAY 2: Finance Minister to approve/reject issuance of tender documents	
	Phase 3: BIDDING AND NEGOTIATION	Receive tender bids and select bidder(s).	• PPP unit: Ascertain VfM of the preferred bid. • Budget Directorate: Ascertain budgetary implications of the preferred bid and ensure consistency with overall fiscal goals and priorities. • Both: Report to Finance Minister; aadvise to reject the preferred bid if found to offer insufficient VfM or unaffordable.
		GATEWAY 3: Finance Minister to approve/reject preferred bid	
		Negotiate PPP contract.	• PPP unit: Review VfM of draft PPP contract. • Budget Directorate: Ascertain budgetary implications of draft PPP contract and ensure consistency with overall fiscal goals and priorities. • Both: Report to Finance Minister; advise to reject draft contract if found to offer insufficient VfM or unaffordable.
		GATEWAY 4: Finance Minister to approve/reject contract	
		PPP contract signed	
Project Implementation Period	Phase 4: CONSTRUCTION AND OPERATION	Supervise and monitor contract on regular basis.	• PPP unit monitors project implementation based on regular reports by the PM. • Budget Directorate monitors budgetary aspects of project implementation on a regular basis.
		If needed, renegotiate the terms of the initial contract.	• PPP unit: Review VfM of renegotiated draft contract. • Budget Directorate: Ascertain budgetary implications of renegotiated draft PPP contract and ensure consistency with overall fiscal goals and priorities. • Both: Report to Finance Minister. Advise to reject draft renegotiated contract if found to offer insufficient VfM or unaffordable.
		GATEWAY: Finance Minister to approve/reject renegotiated contract	

1/ Assumes that SC and PM continue operating after the PPP contract is signed. If not, functions should be exercised by relevant entities/committees replacing them.

Source: Draft PPP framework.

Table 7. Cyprus: Public Sector Debt Sustainability Framework, 2001–11

(In percent of GDP, unless otherwise indicated)

		Actual					Projections					
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
1	**Baseline: Public sector debt 1/**	60.7	64.7	69.1	70.4	69.2	**64.8**	**60.6**	**52.6**	**49.1**	**46.2**	**43.6**
	o/w foreign-currency denominated	37.2	38.8	41.4	39.0	38.8	38.9	38.6	37.9	37.5	37.3	36.9
2	Change in public sector debt	1.9	4.0	4.4	1.3	-1.2	-4.4	-4.2	-8.0	-3.5	-2.9	-2.6
3	Identified debt-creating flows (4+7+12)	-3.3	7.4	5.5	-0.8	-3.5	-2.2	-2.4	-3.0	-2.6	-2.6	-2.5
4	Primary deficit	-1.1	1.3	2.9	0.8	-1.1	-1.4	-1.5	-2.3	-2.2	-2.2	-2.1
5	Revenue and grants	35.9	35.8	38.8	38.8	41.2	42.1	42.3	42.4	42.4	42.4	42.6
6	Primary (noninterest) expenditure	34.8	37.1	41.7	39.6	40.2	40.8	40.8	40.1	40.2	40.2	40.5
7	Automatic debt dynamics 2/	-2.2	6.1	2.6	-1.6	-2.5	-0.8	-0.9	-0.7	-0.4	-0.4	-0.4
8	Contribution from interest rate/growth differential 3/	-0.8	1.3	-0.8	-1.7	-0.9	-0.8	-0.9	-0.7	-0.4	-0.4	-0.4
9	Of which contribution from real interest rate	1.4	2.4	0.3	0.9	1.7	1.6	1.5	1.5	1.6	1.4	1.3
10	Of which contribution from real GDP growth	-2.2	-1.2	-1.1	-2.7	-2.6	-2.4	-2.4	-2.3	-2.0	-1.8	-1.7
11	Contribution from exchange rate depreciation 4/	-1.4	4.8	3.4	0.1	-1.6	...	...	...	...	...	...
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16	Residual, including asset changes (2-3) 5/	5.2	-3.4	-1.1	2.1	2.3	-2.2	-1.8	-5.0	-0.9	-0.3	-0.2
	Public sector debt-to-revenue ratio 1/	169.0	180.6	178.3	181.5	168.0	153.8	143.2	124.2	115.8	109.0	102.3
	Gross financing need 6/	28.9	31.3	20.3	19.2	19.4	18.2	16.9	15.2	13.6	12.5	11.6
	in billions of U.S. dollars	2.8	3.3	2.7	3.0	3.3	3.3	3.4	3.3	3.1	3.1	3.1
	Scenario with key variables at their historical averages 7/						**64.8**	**63.3**	58.6	**58.0**	**58.0**	**58.0**
	Scenario with no policy change (constant primary balance) in 2005-2010						**64.8**	**60.8**	53.7	**51.0**	**49.0**	**47.0**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
	Real GDP growth (in percent)	4.0	2.0	1.8	4.2	3.9	3.7	3.9	4.0	4.0	4.0	4.0
	Average nominal interest rate on public debt (in percent) 8/	6.1	5.3	5.7	4.9	5.1	5.0	5.2	5.3	5.5	5.4	5.1
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.7	4.2	0.6	1.6	2.7	2.5	2.6	2.8	3.3	3.2	3.1
	Nominal appreciation (increase in US dollar value of local currency, in percent)	4.7	-11.3	-8.2	-0.3	4.5	...	...	...	...	...	...
	Inflation rate (GDP deflator, in percent)	3.4	1.2	5.1	3.3	2.4	2.5	2.6	2.5	2.3	2.2	2.0
	Growth of real primary spending (deflated by GDP deflator, in percent)	7.6	8.8	14.0	-0.1	5.9	4.1	4.0	2.6	3.8	4.0	4.9

1/ General government gross debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Table 8. Cyprus: Banking System, 2000–05

	2000	2001	2002	2003	2004	2005
Commercial banks						
			(in millions of £C)			
Total assets	12,776	14,936	15,565	16,621	17,818	22,023
Foreign assets	3,064	3,739	3,161	3,749	4,433	7,318
Advances and loans	6,766	7,652	8,283	8,683	9,332	9,973
of which: Total claims on private sector	6,516	7,320	7,904	8,302	8,844	9,390
Total deposits	9,995	11,474	11,999	12,193	13,102	16,023
of which: Non-resident	3,759	4,396	4,209	4,133	4,610	6,649
Foreign liabilities	298	600	505	672	790	1,436
Return on assets 1/	1.5	0.6	-0.1	-0.1	0.3	0.6
Cooperative credit institutions						
Total deposits	2,822	3,109	3,513	3,986	4,238	4,614
Total loans	2,484	2,519	2,670	2,947	3,276	3,572
Total claims on private sector	...	2,418	2,607	2,876	3,016	4,307
			(in millions of US$)			
International banking units						
Total assets	10,545	10,150	8,139	9,036	12,531	17,081
Advances and loans (to customers)	2,889	3,031	2,611	2,557	4,236	5,501
Claims on banks	4,858	4,346	3,215	4,149	4,395	6,199
Total deposits (from customers)	2,181	2,689	3,013	3,384	3,081	4,871
Liabilities to banks	6,109	5,193	2,611	3,860	4,822	6,210
Memorandum item:						
Exchange rate: £C per US$ (end-of-period)	0.62	0.65	0.55	0.46	0.43	0.48

Sources: Central Bank of Cyprus; IMF, *International Financial Statistics;* and *Cyprus: Assessment of Financial Sector Supervision and Regulation,* IMF Country Report 06/347.

1/ Data are on a cross-border and cross-sector (excluding insurance) consolidated basis. Data for 2005 are for first half only.

Table 9. Cyprus: Financial Soundness Indicators for Banks, 2001–05 1/

(In percent)

Indicator	2001	2002	2003	2004	2005
Core Set					
Regulatory capital to risk-weighted assets	14.0	12.7	11.7	11.4	12.4
Regulatory Tier I capital to risk-weighted assets	11.6	10.1	10.0	9.8	10.0
Nonperforming loans net of provisions to capital 2/	…	…	99.4	72.0	34.8
Nonperforming loans to total gross loans 2/	7.9	9.5	11.3	11.7	7.1
Sectoral distribution of loans to total loans (enterprises and households, domestic and foreign residents)					
Residents					47.9
Loans to non-financial corporations					19.4
Non-residents					52.1
Return on assets	0.6	-0.7	-0.3	0.2	0.8
Return on equity	8.4	-11.1	-4.7	4.3	14.1
Interest margin to gross income	57.5	38.7	32.6	46.1	66.2
Noninterest expenses to gross income	68.2	68.6	66.6	62.7	59.1
Liquid assets to total assets					29.5
Liquid assets to short-term liabilities					34.9
Net open position in foreign exchange to capital	5.8	1.9	2.9	…	2.0
Optional Indicators					
Capital to assets	7.7	6.5	5.9	5.5	5.4
Trading income to total income	-0.8	3.9	4.8	3.9	5.7
Personnel expenses to noninterest expenses	60.6	63.4	63.0	64.0	62.2
Customer deposits to total (non-interbank) loans	137.0	132.0	127.6	140.9	134.7

Source: Central Bank of Cyprus

1/ Data for 2001-04 are for banks compiled on a domestic consolidation basis while the ratio of regulatory capital to risk-weighted assets and the ratio of regulatory Tier 1 capital to risk-weighted assets are compiled on a cross-border and cross sector for all domestically-incorporated banks basis; do not include the cooperative credit institutions and the former International Banking Units. Data for 2005 are for deposit takers compiled on a domestically-controlled, cross-border consolidation basis; do not include the cooperative credit institutions and foreign controlled banks. In 2005, on a cross-border and cross-sector consolidation basis for all domestically-incorporated deposit takers, which exclude the cooperative credit institutions but include the former International Banking Units, the ratio of regulatory capital to risk-weighted assets was 13,4 percent, and the ratio of regulatory capital to risk–weighted assets was 13,4 percent, and the ratio of regulatory Tier 1 capital to risk-weighted assets was 10,2 percent.

2/ The numbers are not fully comparable over time, because the threshold for classifying loans as non-performing was changed from 9 months in arrears to 6 months in 2005. The threshold was further reduced to 3 months in 2006. In addition, only data for 2005 are compiled according to the methodology and specifications provided in the IMF “Compilation Guide on Financial Soundness Indicators.” The recent decline in nonperforming loan (NPL) ratios reflects repayments and write-offs of NPLs as well as denominator effects (growth in capital/loans).

Table 10. Cyprus: Cooperative Supervision Measures Identified in the 2006 Offshore Financial Center Assessment

Recommended Actions	The Authorities' Response
CP 1.1 Objectives: Manage changes during the transitional period through a global change committee.	The ASDCS, the Cooperative Central Bank (CCB), the Cooperative Computer Society, the Pancyprian Cooperative Confederation, and the Audit Office of Cooperative Societies closely coordinate their activities. Several committees and work groups have been set up for particular subjects. The work of the different groups and committees is coordinated and monitored by a Committee consisting of the heads, or their representatives, of each of the above instituions.
CP 1.2 Independence: Full government support of supervisory strengthening capacity	A Staff Restructuring Plan was prepared by the Public Administration and Personnel Service in cooperation with the ASDCS and was approved by the House of Representatives in July 2005. The Plan provides for a new organisational structure, recruitment of additional staff, upgrading of entry requirements through differentiation of schemes of service, upgrading of posts, etc. The implementation of this plan will increase the total number of the permanent staff employed today from 36 to 57. In October 2006, two promotions and one recruitment took place at top management posts (Assistants to the Commissioner). Moreover, there are now four vacancies for high level posts (directly under the posts of Commissioner's Assistants) in progress for recruitment. Finally, the vacancies for 20 officers are published in the official gazette of the Republic. Applications have been sent to the ASDCS for appropriate evaluation and selection. The incoming staff will mainly reinforce and strengthen the supervisory capacity of the ASDCS.
CP 2 Permissible Activities Finalize regulatory decision defining permissible services and activities. Make provision that the term "Cooperative Credit Institution" or any derivative of this term cannot be used without the approval of the CSSDA	(a) A draft regulative decision regarding the permissible activities has been prepared and is now pending for approval by the Committee of the ASDCS. (b) The prohibition for the use of the term 'Cooperative Credit Institution' has been included in an amending bill which is being prepared by the ASDCS.
CP 5 - Investment Criteria - Finalize regulatory decision regarding participation in other enterprises.	A draft regulative decision has been prepared and will soon be forwarded to the Committee of the ASDCS for approval.

Recommended Actions	The Authorities' Response
CP 6 Capital Adequacy. Mandatory semi-annual reporting on each CCI's compliance with capital requirements regime.	The Commissioner's directive regarding the mandatory semi-annual reporting of CCI's compliance with CAD II is going to be finalized prior to the issue of any license to an authorized cooperative credit institution, i.e. by 31/12/2007, at the latest. The implementation of this directive is directly related with the time of implementation of the provisions of Basel II.
CP 7 Credit Policies. Strengthen supervisory capacity. Enhance the supervisors' capacity to evaluate loan policies.	The on going procedure of recruiting of additional qualified staff (see CP 1.2 above) and the ASDCS's continuous effort in organizing training/educational programs for its staff are enhancing the ASDCS's supervisory capacity. An EU Twinning Light Program (under the transitional fund of 2005), entitled «Technical Assistance for the Effective Supervision of Cooperative Credit Institutions», is being implementeed.
CP 8 Loan Evaluation. Strengthen supervisory capacity. Provide for additional prudential reporting	A project is underway for the full computerization of the ASDCS in direct connection with the Cooperative Computer Society's central server which provides computer services to most CCIs. A part of it concerning the issues of administrative and statistical data as well as issues and some reports necessary during on site and off site supervision has been provisionally completed and is currently under testing. Most of the CCIs are connected (and those that are not will soon be connected) through the central server of the Cooperative Computer Society, thus providing up-to-date, comprehensive reporting to the ASDCS. The construction of monitoring and early warning systems is one of the goals of the above computerization project and of the twinning light program (see CP 7 above).
CP 9 Large Exposure Limits. Strengthen supervisory capacity.	A draft regulatory decision has been prepared and will soon be forwarded to the Committee of the ASDCS for approval.
CP 10 Connected Lending. Strengthen supervisory capacity. Facilities to connected persons should not be granted on terms more favorable than those used in the normal course of business.	An article regarding the connected lending has been included in an amending bill which is being prepared by the ASDCS.
CP 12 market Risks. Adjust and develop expertise to supervise new risks.	Training programs and seminars both in Cyprus and abroad have been attended by ASDCS's staff members.

Recommended Actions	The Authorities' Response
CP 13 Other Risks. Strengthen supervisory capacity. Organize accelerated access to centralized reporting system regarding interest rate risk.	This information (regarding mainly interest rate risks) is currently available to the management of the CCIs and is shared with the ASDCS when required, through its on site supervision and off site monitoring. Direct access will be granted to ASDCS when the project of prudential reporting is completed (see CP8 above)
CP 14 Internal Controls. Strengthen supervisory capacity. Undertake efforts to encourage mergers favoring critical mass and organizational capabilities of CCIs	Promising results are reached from the on going efforts to encourage mergers of the CCIs that favor critical mass, economies of scale and their organizational capabilities (including internal controls). The total number of CCIs was reduced from 361 at end-2004 to 347 at end-2005 and to 305 in September 2006. It is expected that the number will be reduced to approximately 275 by the end of 2006 and to approximately 150 by the end of 2007.
CP 15 Money Laundering. Update guidance note.	All CCIs have already appointed a Compliance Officer. A Guidance note was issued by ASDCS on 16/5/2005 which is in line with the CBC's Guidance note to the commercial banks. After the recent publication of the MONEYVAL Report, an amending guidance note will be issued in accordance with the recommendations of the report and in cooperation with the CBC.
CP 16 On-site and Off-site Supervision. Strengthen supervisory capacity.	The recruitment of additional staff (see CP 1.2), the continuous training of the current and new staff, and the completion of the computerization project (see CP8) will greatly assist in strengthening of the ASDCS's supervisory capacity.
CP 17 Bank Management Contact. Impose mandatory and timely communication of material changes in activities and adverse developments.	A draft regulatory decision has been prepared and will soon be forwarded to the Committee of the ASDCS for approval.
CP 18 Off-site Supervision. Strengthen supervisory capacity. Accelerate direct connection to central data server.	The ASDCS has accelerated direct connection to the central server and the use of information provided by those CCIs that are and will be connected through the central server of the Cooperative Computer Society (see CP 8 above).
CP 19 Validation of Supervisory Information. Strengthen supervisory capacity.	Recruitment of addition staff is in progress (see CP 1.2 above).

Table 11. The National Lisbon Program

	Key challenges	Actions/Measures
1	Sustainability of public finances.	• Achieve a close to balanced fiscal position, mainly by (i) imposing ceilings on public expenditure; (ii) improving tax effectiveness; and (iii) introducing a medium-term budgetary framework.
		• Achieve long-term sustainability, through (i) reducing the government debt well below 60 percent of GDP, via the implementation of the fiscal consolidation program; (ii) increasing female and old-aged labor market participation; (iii) promoting reforms in the Social Insurance Scheme via parametric changes; and (iv) reforming the health sector, including providing more autonomy to hospitals and introducing a national insurance scheme.
		• Including by improving of the quality of public finances via a redirection of public expenditure. Specially, by redirect public expenditure in favor of growth enhancing expenditure categories (on infrastructure, R&D; innovation; ICT; education, and health).
2	Enhancing competition and improving the overall business climate.	• Enhance flexibility of semi-government organizations to enable them to compete in the new liberalized environment.
		• Increase the efficiency of the public sector by (i) introducing a new performance appraisal system; (ii) developing one-stop shops; and (iii) extension of the web-enabled services.
		• Further enhance the competition in the utilities sector.
		• Reduce regulatory and administrative burden.
		• Rationalize state aid by (i) carrying out of an interim evaluation of all existing state aid schemes with regard to the achievement of the set objectives; and (ii) carrying out of an ex-ante evaluation of all proposed state aid measures to identify if there is a market failure in the proposed area of intervention.
3	Diversification of the economy towards higher value-added activities, mainly through an increased utilization of the comparative advantages of the country.	• Strengthen the competitive advantages by (i) strengthening the institutional framework - setting up of an agency for the promotion of Cyprus as an entrepreneurial base and the attraction of FDI; (ii) maintaining the taxation burden at low levels; and (iii) extending the network of treaties for the avoidance of double taxation.
		• Upgrade and enrich the tourist product (construction of marinas and golf courses; promotion of sports tourism; study for the creation of casinos; promotion of agrotourism; and incentives for upgrading hotel establishments).
		• Enhance the competitiveness of the manufacturing sector by (i) continuation of the Government Guarantee Scheme for loans to SMEs; (ii) continuation of the scheme for the technological upgrading of small and medium enterprises; (iii) providing grants for the creation of viable business units in rural areas; and (iv) operation of a Council of Industrial Development.

	Key challenges	Actions/Measures
4	Promotion of Research and Development (R&D) and innovation.	• Increase public spending on R&D, with emphasis on applied research; target: increase total spending on R&D to 1 percent of GDP by 2010; • Implement an upgraded Program for Research and Technological Development, with substantially increased funds. • Utilize more of EU research programs. • Enhance R&D infrastructure (establishment of a research and training centre on public health and environmental issues in cooperation with Harvard University). • Facilitate innovation and greater utilization of information and communication technologies (ICT) by (i) further promoting and utilizing the business incubators institution; (ii) creating a technology park; (iii) providing more on-line services to the public; (iv) promotion of e-commerce and e-learning; (v) licensing digital terrestrial television broadcasting, fixed wireless networks and TETRA networks.
5	Upgrading basic infrastructure	• Expand and upgrade infrastructure in the areas of transport, energy, and communications. • Diversify the energy supply sources.
6	Further human capital development.	• Enhance old-aged and female participation rates by (i) promoting training and employability of inactive women, (ii) expanding and improving care services for the children, elderly, disabled, and other dependents, (iii) reducing the gender pay gap; and (iv) increasing the retirement age in the public sector. • Increase the flexibility of the labor market by (i) enhancing and modernizing the Public Employment Services, (ii) promoting flexible forms of employment; and (iii) ongoing assessment of the economy's labor market needs. • Develop a comprehensive strategy on the employment of foreign labor. • Continuously improve the quality of education at all levels. • Increase opportunities for university studies. • Extend and upgrade the programs for technical and vocational training. • Develop a comprehensive strategy for life-long learning.
7	Further enhancements of the conditions of social cohesion.	• Safeguard affordable access to government services, including education and health to all. Introduce a National Health Insurance System. • Adopt a more needs targeted approach in the provision of social benefits. • Develop one-stop shops for government services. • Elaborate and implement a 10-year action plan for the development of health care services for the elderly, setting short, medium, and long-term targets. • Implement an Action Plan for Drug Demand Reduction. • Provide training and incentives for the employment of people with disabilities and other public assistance recipients.
8	Ensuring environmental sustainability.	• Create/expand the environmental infrastructure for sustainable management of resources and waste. • Promote energy saving and renewable energy sources.

Source: The National Lisbon Program for the Republic of Cyprus, 2005

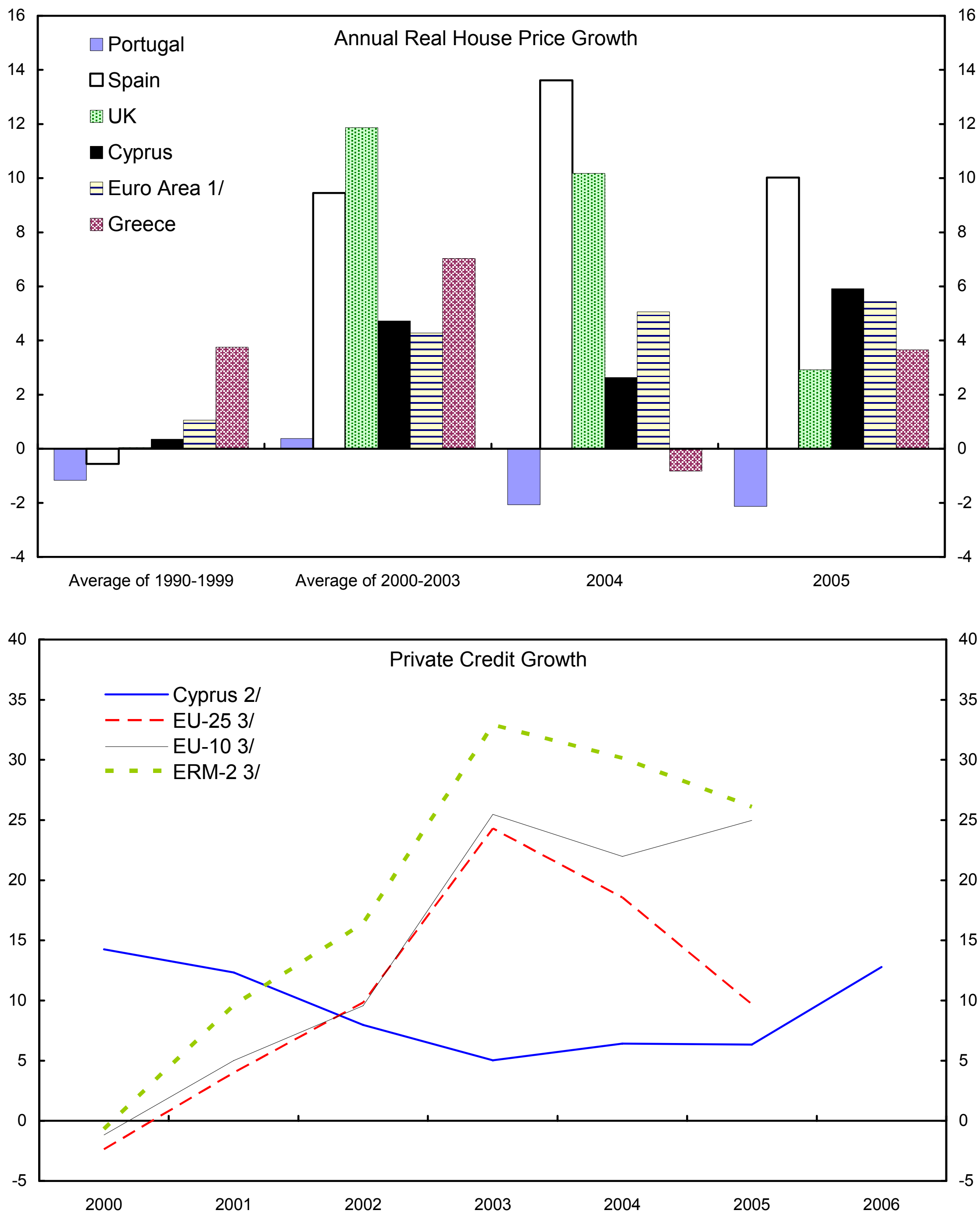
Table 12. Cyprus: Vulnerability Indicators, 2002–08

	2002	2003	2004	2005	2006	2007	2008
					Projections		
Financial indicators							
Public debt, net of intergovernmental debt	64.7	69.1	70.4	69.2	64.8	60.6	52.6
Broad money (percent change, 12-month basis)	10.3	4.0	5.6	10.2	8.1	8.5	8.5
Private sector credit, real (percent change, 12-month basis)	5.0	0.9	4.0	3.7	5.4	5.7	5.8
Domestic credit	150.3	148.7	143.8	146.3	147.9	149.5	151.2
Share of foreign exchange deposits in total bank deposits (in percent)	4.3	5.0	8.3	10.3	12.1	...	...
External indicators							
Exports G&NFS (percent change, in U.S. dollars)	0.3	17.3	18.3	8.4	5.8	9.8	6.0
Imports G&NFS (percent change, in U.S. dollars)	5.7	15.9	24.0	8.1	10.6	8.2	6.2
Current account balance	-3.7	-2.2	-5.0	-5.6	-6.2	-5.6	-5.6
Financial account balance	5.8	1.4	5.4	6.2	6.1	5.4	5.4
Of which: Direct foreign investment, net	5.7	3.0	2.9	4.3	4.3	4.3	4.3
Portfolio investment, net	-4.8	1.9	7.5	-0.8	-0.8	-0.8	-0.8
Other investment, net	8.8	-5.1	-2.6	6.9	3.5	2.8	2.7
Reserve assets	-3.8	1.6	-2.4	-4.2	-0.9	-0.9	-0.8
Net errors and omissions	-1.6	0.6	-0.9	-1.0	0.0	0.0	0.0
Change in official reserves	7.4	2.1	4.2	1.9	2.6	1.5	1.4
Net foreign assets of commercial banks (US$ billions) 1/	-2.3	-1.6	-1.3	-0.7	-0.9	...	...
Official foreign exchange reserves (US$ billions)	3.2	3.5	4.1	4.4	4.9	5.2	5.5
Official reserves in months of imports G&NFS	7.0	6.5	6.3	6.3	6.3	6.1	6.1
Reserve money/reserves (end-period, percent)	86.4	97.8	97.0	84.6	88.8	89.9	91.3
Broad money to gross official reserves (end-period, ratio)	4.7	5.3	5.2	4.6	4.9	5.0	5.2
Short-term external debt to gross official reserves (percentage)	14.5	20.0	20.1	14.5	14.0	14.5	14.7
Total external debt	47.4	51.6	64.2	74.4	81.5	80.9	80.4
Of which: Public sector debt	13.3	15.8	19.2	17.1	15.0	14.6	14.3
Total external debt to exports G&NFS	93.5	109.4	136.6	156.8	174.3	173.6	173.9
Total external debt service payments to exports G&NFS	8.2	8.0	14.3	16.7	20.2	21.6	21.5
Exchange rate (per US$, period average)	0.61	0.52	0.47	0.46	0.46	...	...
Real effective exchange rate (CPI, 2000=100) 1/	104.1	111.0	113.0	112.9	112.3	...	...
Financial market indicators (end-of-period)							
Stock market general index (percent change)	-27	-15	-10	63	134	...	...
Long-term foreign currency debt rating (S&P) 2/	A	A	A	A	A	...	...

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

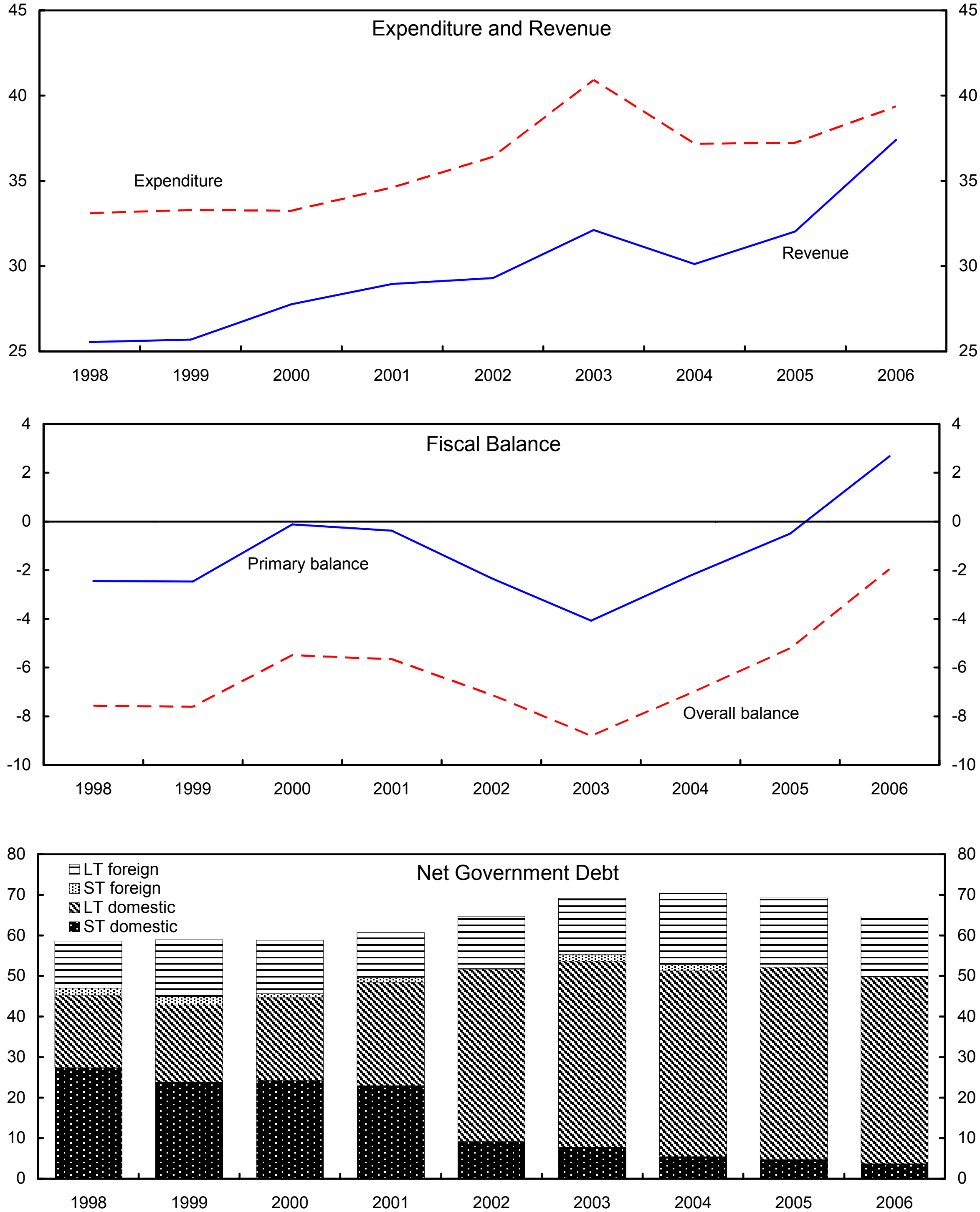
1/ Data for 2006 as of October.
2/ Data for 2006 as of November.

Figure 1. Cyprus: House Prices and Private Credit, 1990–2006



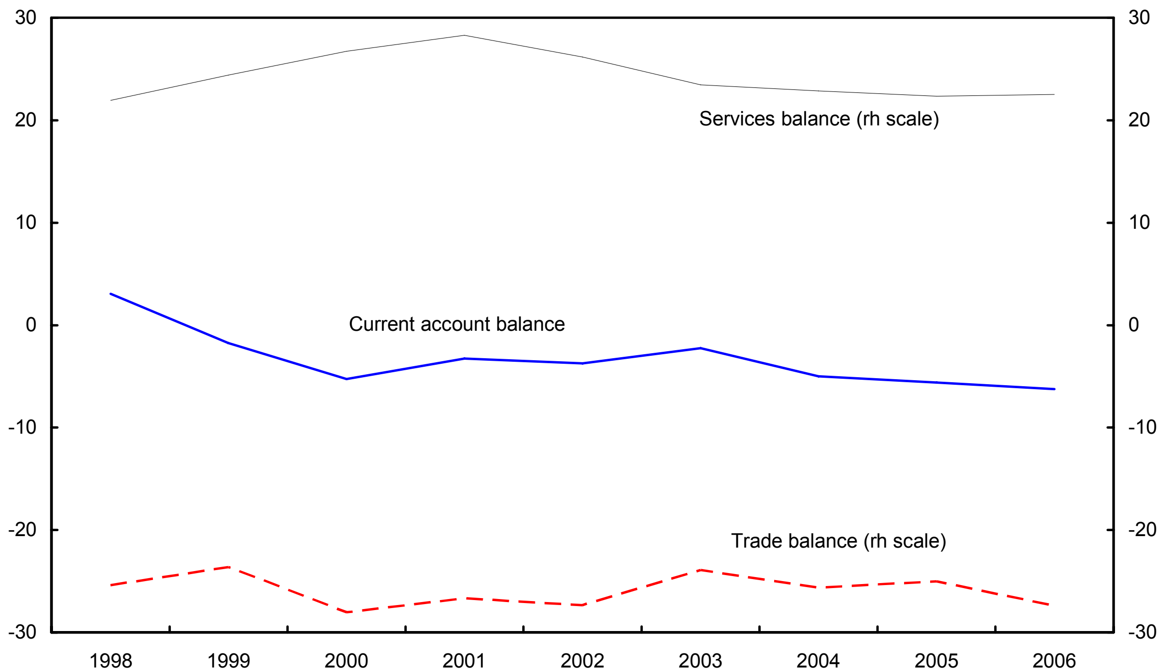
Source: IMF, *International Financial Statistics*; IMF, *World Economic Outlook*; Staff Estimates.
1/ Unweighted average.
2/ Yearly growth as of July.
3/ Growth rates of the respective aggregates.

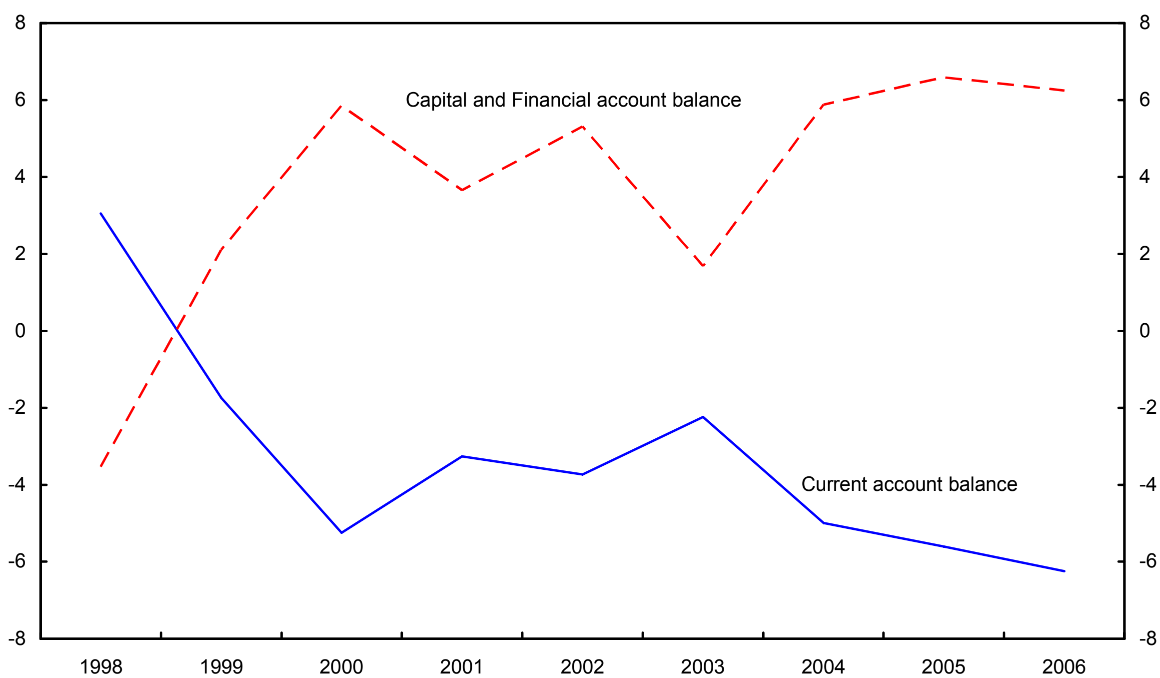
Figure 2. Cyprus: Central Government Finances, 1998–2006 1/



Source: Ministry of Finance.
1/ Consolidated central government budget, public loans fund, social security funds, sinking funds, and defence fund. Data for 2006 are projections.

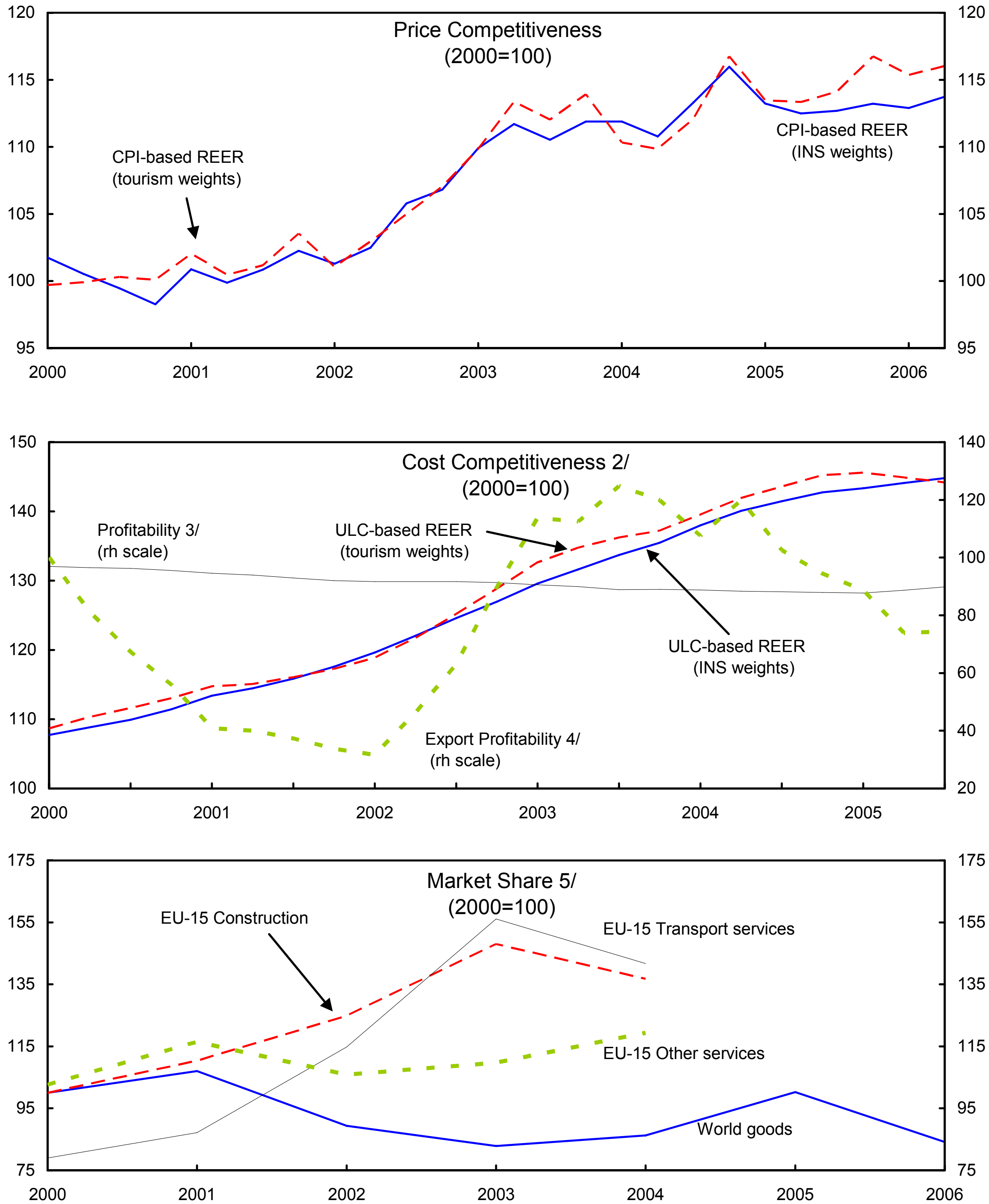
Figure 3. Cyprus: Balance of Payments, 1998-2006 1/
(in percent of GDP)





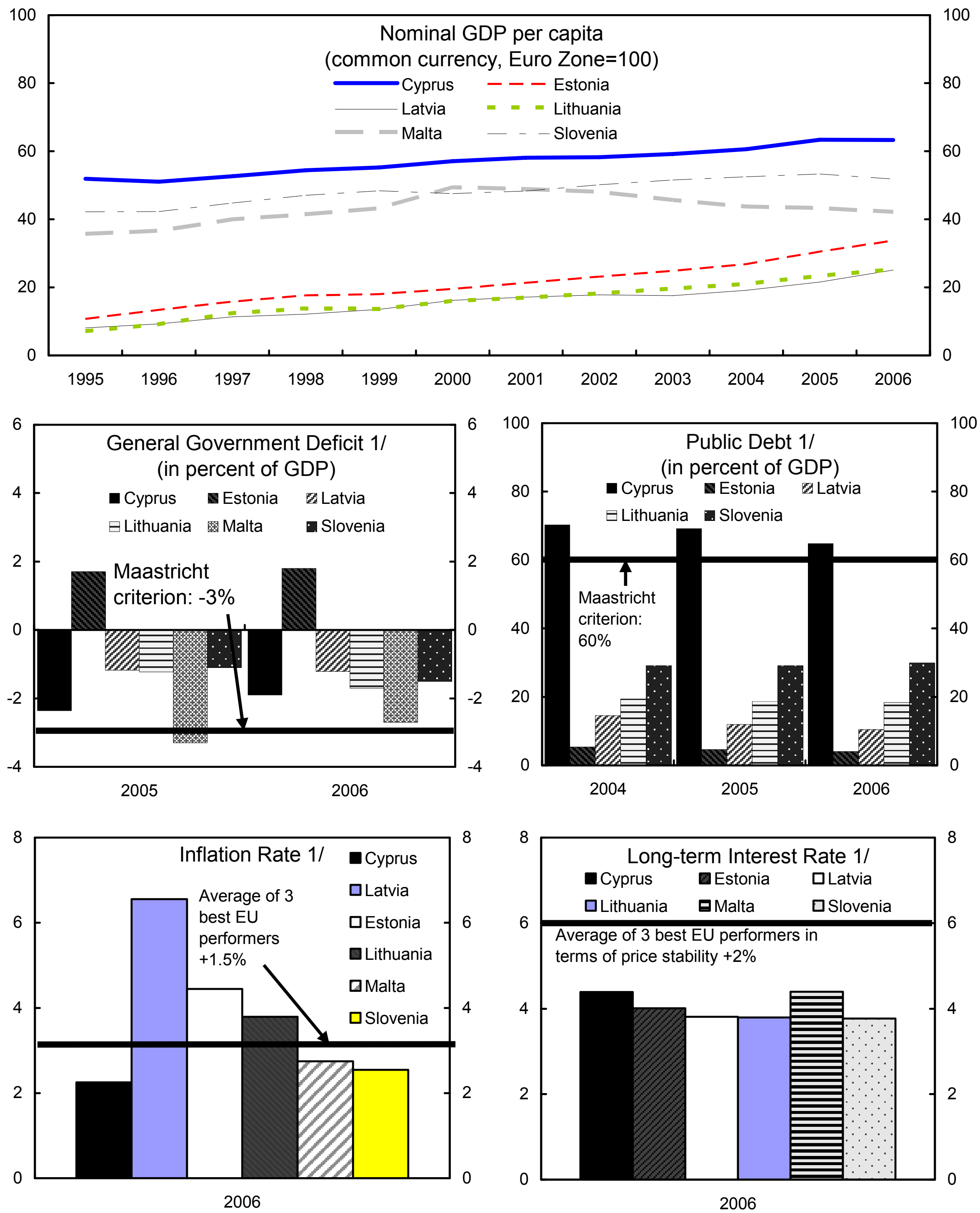
Source: Central Bank of Cyprus.
1/ Data for 2006 are projections.

Figure 4. Cyprus: Competitiveness Indicators, 1998–2006 1/



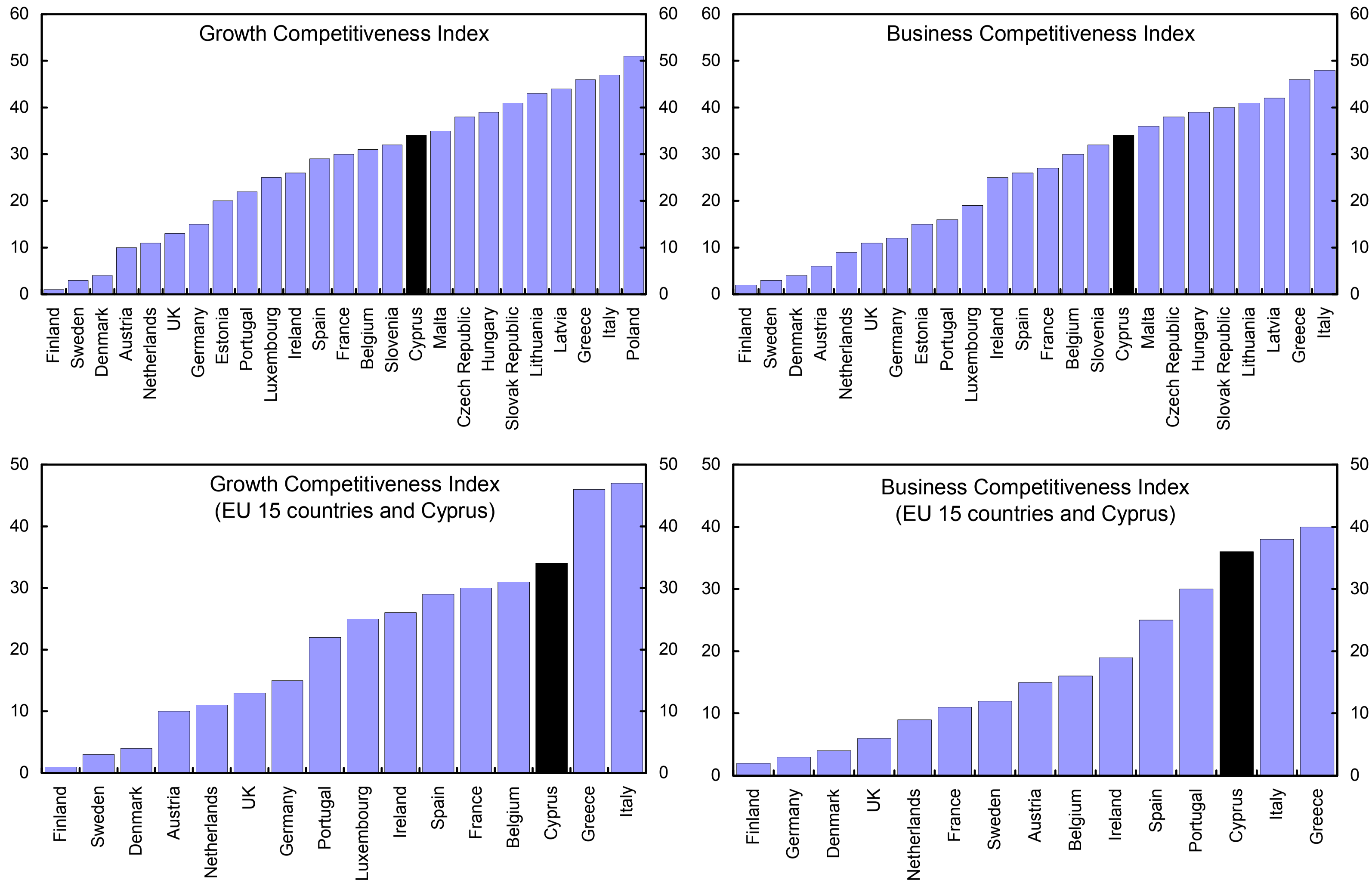
Sources: IMF, *International Financial Statistics;* IMF, *World Economic Outlook;* staff estimates; and OECD.
1/ Data for 2006 are projections.
2/ Four-quarter moving average.
3/ Defined as the ratio of the GDP deflator to unit labor cost.
4/ Defined as the ratio of the export price index to unit labor cost.
5/ Index of the share of Cyprus's exports over those of the EU-15 and the world respectively.

Figure 5. Cyprus and Other ERM2 Countries: Real and Nominal Convergence with the Euro Area, 1995–2006



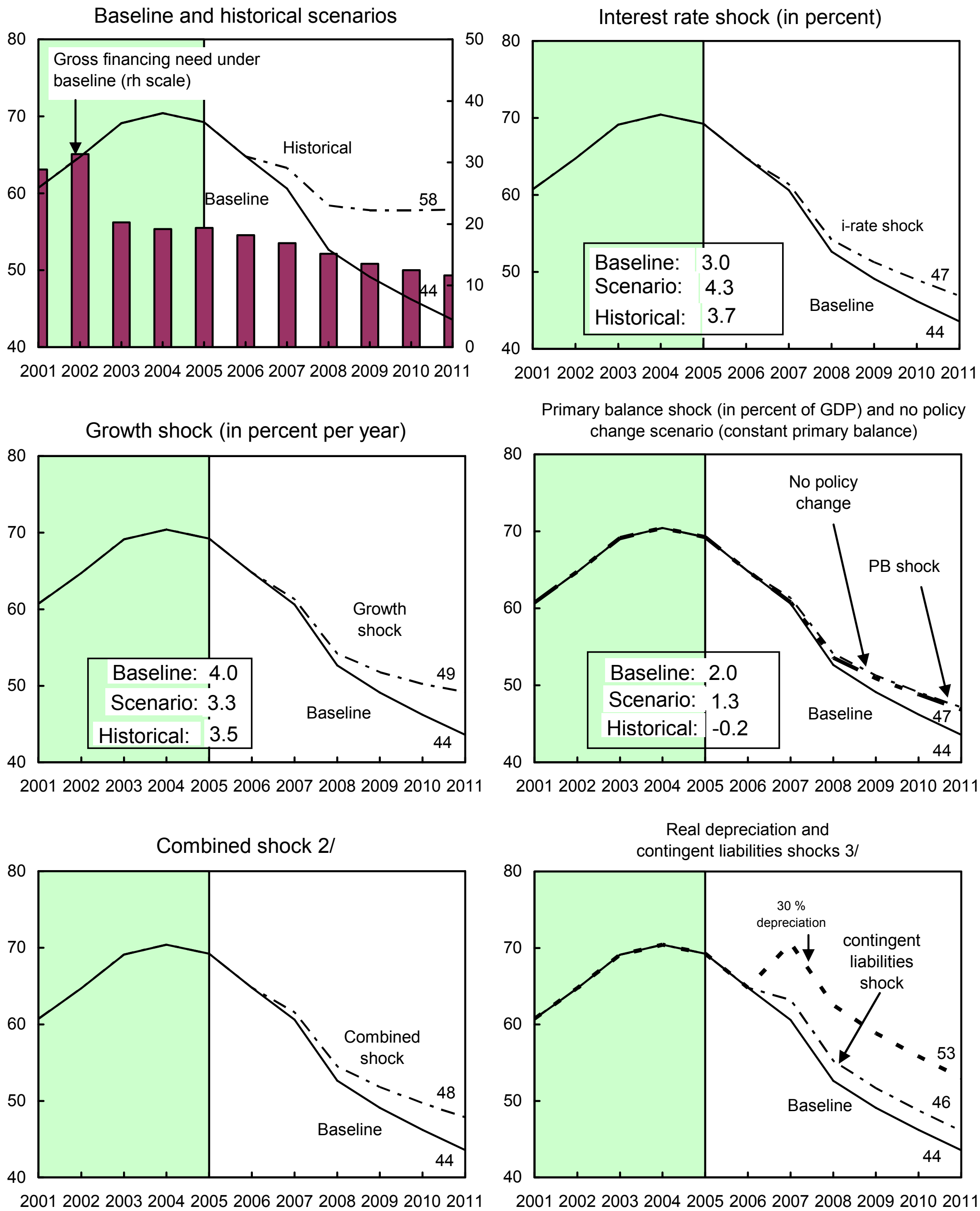
Sources: IMF, *World Economic Outlook;* and Eurostat.
1/ Projections for 2006.

Figure 6. World Economic Forum Competitiveness Ranking



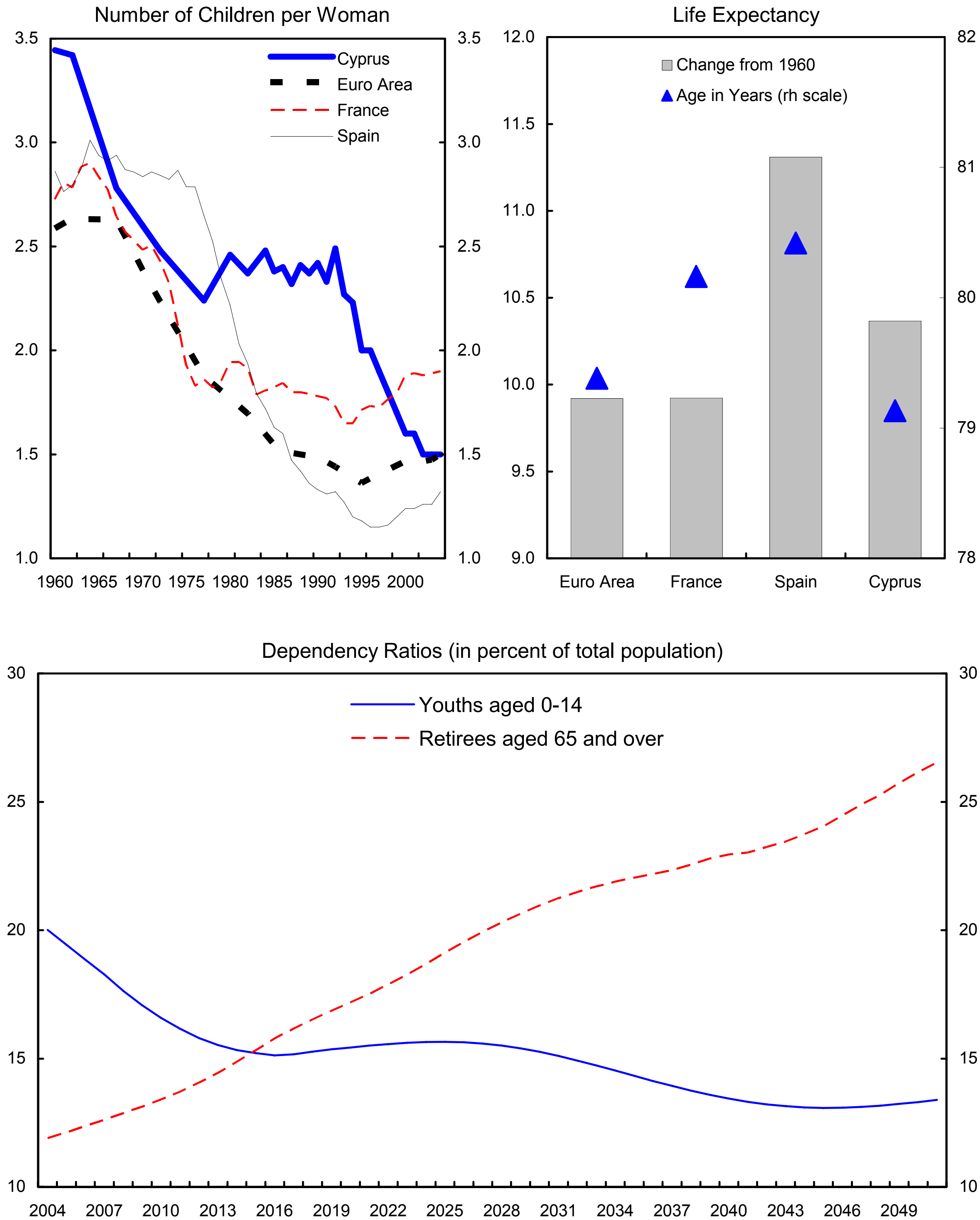
Source: World Economic Forum, Global Competitiveness Report 2005–06.

Figure 7. Cyprus: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



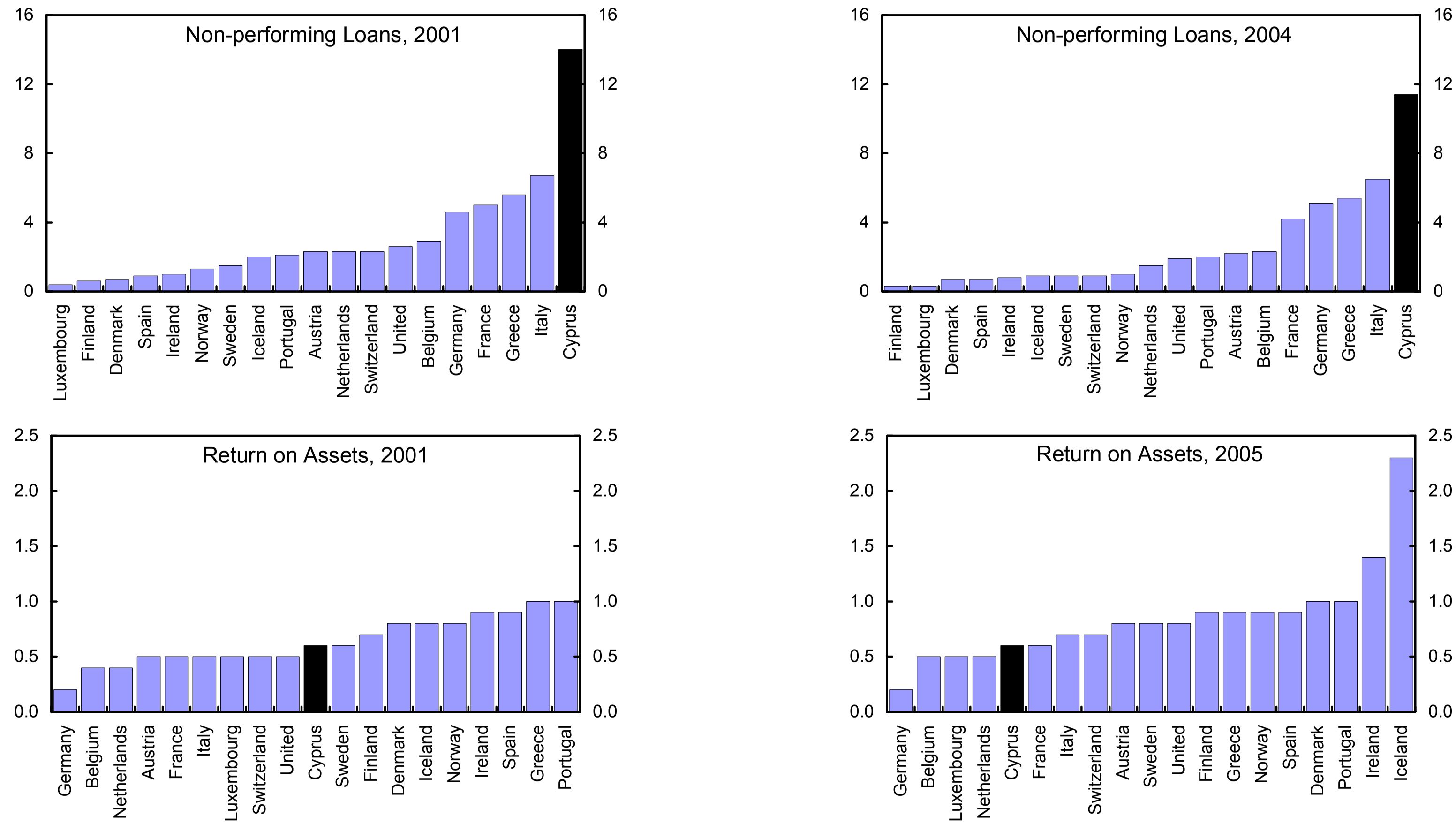
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. 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.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 8. Cyprus and EU Demographic Indicators



Sources: World Bank, *Development Indicators*; and Eurostat.

Figure 9. Cyprus and Western Europe: Banking Sector, 2001–05



Source: IMF, *Global Financial Stability Report*.

CYPRUS—ANNEXES TO THE 2006 ARTICLE IV CONSULTATION STAFF REPORT

Contents | Page

ANNEX I. CYPRUS: FUND RELATIONS

As of November 30, 2006

Mission: Nicosia, October 25-November 6, 2006. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2006/110606.htm.

Staff team: Mr. Hoffmaister (head), Mr. Jafarov, and Ms. Hassine (all EUR).[1]

Country interlocutors: Minister of Finance Sarris, Central Bank Governor Christodoulou, and other senior officials; Mr. Christofides (OED) attended the meetings.

Fund relations: Cyprus is on a 24-month cycle, and the previous Article IV consultation was concluded in October 2004; there was a staff visit in December 2005 to discuss economic developments and euro adoption. 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.

Outreach: The mission met with members of parliament, business, labor, as well as the academic community. A press conference was held at the end of the mission, and an unofficial transcript of the question and answers session is available at http://www.centralbank.gov.cy/media/pdf/NPANG_ANSWERS081106.pdf.

Statistical issues: The data in this report refer only to the government-controlled areas, except where otherwise noted. These statistics are generally of good quality and are adequate for surveillance, though some improvements are needed (Annex II): www.mof.gov.cy/mof/CyStat, www.centralbank.gov.cy. The authorities intend to subscribe to the Special Data Dissemination Standard by 2008. Statistics for the areas not under the effective control of the government of the Republic of Cyprus are thought to be weak: www.devplan.org.

Publication: The authorities have agreed to publish the staff report.

[1] Mr. Hoffmaister stopped in Brussels for discussions with EC representatives before the mission.

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

II. **General Resources Account**:	SDR Million	Percent of Quota
Quota	139.60	100.0
Fund holdings of currency	125.57	89.95
Reserve position in Fund	14.07	10.08

III. **SDR Department**:	SDR Million	Percent of Allocation
Net cumulative allocation	19.44	100.0
Holdings	2.72	14.01

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

V. **Latest Financial Arrangements**: None

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/interest		0.68	0.68	0.68	0.68
Total		0.68	0.68	0.68	0.68

VII. **Exchange Rate Arrangements**: In June 1992, the peg of the Cyprus pound changed from a broad basket of currencies to the ECU. The central rate was set at ECU 1.7086 per £C with a margin of ±2.25 percent. On January 1, 1999, the euro replaced the ECU as the basis of the peg. In August 2001, the fluctuation margins increased to ±15 percent, but the central rate remained unchanged. Subject to certain limitations, including a limit on spreads between buying and selling rates, authorized dealers (banks) are free to determine and quote their own buying and selling rates. Effective from May 2, 2005, Cyprus has participated in ERM2.

VIII. **Article IV Consultation**: The last Article IV consultation mission took place during October 18–29, 2004, and the staff report (CR/05/107, 3/22/05) was discussed by the Executive Board on February 18, 2005.

IX. **Assessment of the Offshore Financial Sector**: In March-April 2005, the IMF undertook a Module 2 assessment under the policy described in *Offshore—Financial Centers-The Assessment Program—A Progress Report and the Future of the Program*, including assessments of compliance with the Basel Core Principles for Effective Banking Supervision, of the observance of the Insurance Core Principles, and on the implementation of IOSCO Objectives and Principles of Security Regulations. The Cypriot authorities have agreed to publishing the assessments.

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

XI. Resident Representative: None.

XII. Exchange Restrictions: Cyprus is an Article VIII member and maintains an exchange system free of restrictions subject to Fund jurisdiction. It maintains measures adopted for security reasons, which the authorities are in the process of notifying the Fund for approval in accordance with Decision 144.

XIII. Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT):

The legal provisions and supervisory arrangements for AML/CFT were found to be satisfactory by the Council of Europe's MONEYVAL Committee in February 2006. The authorities intend to implement the recommendations of this evaluation in the first six months of 2007. Furthermore, the authorities plan to change the existing laws and regulations in line with the requirements of European Union's Third Money Laundering Directive, which is due for implementation by Member States by 15 December, 2007, and of the (new) Council of Europe's Convention on money laundering and terrorist financing.

ANNEX II. CYPRUS: STATISTICAL ISSUES

Cyprus has an open publication policy and its statistical data are generally of a high quality and adequate frequency. A large amount of information is available through the internet, including press statements as well as data from the Statistical Service and the Central Bank of Cyprus.

Although Cyprus has not yet subscribed to the Special Data Dissemination Standard (SDDS), format and requirements for most data broadly observe the general provisions of the standard. However, some data series are only available with long time lags, and advance-release calendars are not disseminated to users.

National accounts data are disseminated on the internet site of the Ministry of Finance with consistent series from 1995 onwards. Data in volume for national accounts were revised to reflect changes in recording the production of Financial intermediation services indirectly measured (FISIM). Also, a chain-link methodology was introduced with 2000 as a new base year. Quarterly real GDP growth rates are published with a few months delay; annual national accounts are published with up to five months delay. The Ministry of Finance also disseminates monthly economic indicators, notably on trade flows, tourism arrivals, and industrial production with a lag of a couple of months for most indicators. Since January 1999, the consumer price index has been compiled according to the EU definition (Harmonized Index of Consumer Prices - HICP) used to assess compliance with Maastricht treaty requirements.

Balance of payments statistics are presented in the format specified by Eurostat in Balance of Payments Vade Mecum, which is based on the *IMF Balance of Payments Manual*, fifth edition (BPM5). From 2002 onwards, the BOP statistics have been compiled using the *BPM5* definition of residency. Trade statistics are available on a monthly basis with a lag of about three months; current account statistics are available on a quarterly basis, with a lag of about four months. While the data are generally of good quality, some concerns remain regarding coverage of data (including the International Investment Position) and timeliness and transparency of revisions.

Fiscal data for the central government are of good quality and coverage. Monthly fiscal data are generally of high quality, but not published on a timely basis. Consolidated general government accounts exist from 1998 and are published on the internet on an annual and quarterly basis, with a lag of several months.

Monetary and financial statistics are disseminated on a timely basis. Tables with monetary authority and commercial bank balance sheets, together with interest rate and other relevant information, are available with a lag of about one month.

CYPRUS: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of January 8, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	01/08/07	...	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	November 06	...	M	M	M
Reserve/Base Money	November 06	...	M	M	M
Broad Money	November 06	...	M	M	M
Central Bank Balance Sheet	November 06	...	M	M	M
Consolidated Balance Sheet of the Banking System	November 06	...	M	M	M
Interest Rates[2]	01/08/07	...	D	D	D
Consumer Price Index	December 06	...	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	...	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2006 Q2	...	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2006 Q2	...	Q	Q	Q
External Current Account Balance	2006 Q2	...	Q	Q	Q
Exports and Imports of Goods and Services	2006 Q3	...	Q	Q	Q
GDP/GNP	2006 Q3	...	Q	Q	Q
Gross External Debt	2006 Q2	...	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by Yuri G. Yakusha, Alternate Executive Director for Cyprus and Charalambos Christofides, Advisor to Executive Director January 26, 2007

General remarks

The Cypriot authorities welcome the staff's positive assessment of the economy and helpful recommendations, which they broadly share. The authorities also wish to thank the staff for their continuing engagement, including the provision of significant technical assistance, which has been both well targeted and extremely productive.

Indeed, Cyprus continues to converge toward euro-area incomes, and the authorities are confident that Cyprus will join EMU and adopt the euro as its currency on January 1, 2008 as planned. Macroeconomic policies, traditionally sound and generally characterized by fiscal and monetary rectitude, have more recently been strongly geared toward not only ensuring a smooth EMU accession, but also to making participation in the broader European project a success. In terms of the Maastricht criteria, the aim is not merely to meet them, but whenever possible to out-perform them in a sustainable manner. And, finally, while ensuring that Cyprus itself is a contributor to the European economy as well as a beneficiary, that visible benefits should be available to the average Cypriot citizen, who has been willing to accept a faster pace of change and the need to adapt to an ever more competitive environment.

The real economy—performance, outlook, productivity, and structural reforms

The economy has continued to recover, with a near 4 percent GDP growth rate approaching what is currently estimated to be a sustainable level. The economy has adapted well considering that it had to weather a number of negative, and fairly persistent, shocks. These included not only the oil price shock, which has affected Cyprus significantly given its dependence on imported energy, but also a series of regional shocks spanning several years that affected tourism. The most recent of these shocks, although short-lived, occurred during the busiest tourist months only last summer. Cyprus received well-deserved accolades for its provision of humanitarian support to the expatriates fleeing Lebanon, support which Cyprus itself mainly financed, yet potential foreign visitors saw news items of clogged ports, crowded airports, and filled hotel units.

Despite the rise in the growth rate, inflation has remained muted, ending the year at only 1.5 percent, with some intra-year volatility attributed not only to oil price developments but also to changes in indirect tax rates mandated by Cyprus' EU responsibilities, and the need to address tax distortions between used cars (whose taxes were already reduced) and new cars (whose taxes had remained high, until they were lowered last November). In terms of the Maastricht inflation criterion, which is of course only a projection at this point, the authorities expect that the Cypriot inflation rate will remain comfortably below the projected threshold. Of course, an assessment of inflation performance should also focus on its longer-term sustainability. On this score, it is clear that Cyprus has followed strong anti-inflation policies for many years now. It has been able to maintain the peg of the Cyprus pound within a narrow (informal) band since June, 1992, while competitiveness is assessed by all available studies as being adequate. Given also that there is continuing strong productivity growth, moderate wage growth, and prudent policies, there should thus be little question that Cyprus will (barring some unforeseen developments) meet the inflation criterion.

The external current account deficit has widened to around 6 percent of GDP, to a significant extent reflecting oil price developments. Over the medium term, however, it is expected to ebb to 4 percent of GDP, as a number of transitory developments abate, most notably oil prices and a recent increase in the income outflows from foreign firms. FDI inflows, on the other hand, have increased substantially, easing the economy's external financing needs. Thankfully, the tourist sector has started to recover, expanding moderately in terms of revenue, despite a small decline in arrivals. Another encouraging development has been the rise in the exports of services, as Cyprus continues to make progress in becoming a regional business hub. The shipping services sector has been especially strong, as staff data show, with Cyprus developing valuable expertise in this area, serving a large Cypriot-flagged commercial fleet. In this regard, the continuing Turkish refusal to allow such ships to use Turkish ports, despite Turkey's EU obligations in this matter, is having a negative economic impact on Cyprus, by holding back a very dynamic export sector.

The economy has continued to generate not only growth, but jobs. Cyprus' labor market is very open and reasonably flexible, especially in the private and SME sectors (there is a part that includes semi-governmental and financial sector organizations where workers have strong job security and enjoy a number of privileges). Indeed, over the years the labor market has been so strong as to require a significant importation of foreign labor, currently comprising about 16 percent of the total labor force, while ensuring a very low unemployment rate (between 3.5-5 percent depending on the definition). The opening up of the "green-line" has allowed Turkish Cypriots who wish to do so to work and to take advantage of health, social insurance, and other amenities in the government-controlled areas, and in fact they have done so in large numbers: Turkish Cypriots constitute almost 1 percent of the labor force in the areas under the effective control of the Republic of Cyprus. Another testament to the strength and flexibility of the labor market has been Cyprus' welcoming of the recent accession of Bulgaria and Romania into the EU. Cyprus did not place any restrictions on the working opportunities of their citizens in Cyprus.

The disadvantages of the COLA mechanism, which a series of Fund missions have singled out for criticism, have so far remained mainly hypothetical. On the other hand, its contribution to maintaining labor peace has been quite real. Other mechanisms (including sectoral wage differentiation in collective agreements) have acted to help maintain the flexibility of the labor market to adapt to shocks. Overall wage growth has consequently been moderate, running at a nominal rate of 4-6 percent on an economy-wide basis, i.e., including both domestic and foreign workers.

Finally, turning to the economic outlook for 2007 and beyond, prospects remain favorable. GDP growth should remain close to potential growth, sustained by employment growth in the 1.5-2 percent range, a capital investment contribution between 1-1.5 percent, and TFP of 1.5 percent. Since there still remains considerable room before actual output reaches potential output (estimates are for a closing of the gap by 2010) there should be no immediate impediment or inflationary pressure that by itself could choke off the continuing recovery.

A number of structural measures and other developments should help underpin this forecast, especially in support of productivity growth. Ongoing infrastructural investments have opened up communication between cities, significantly reducing commuting time. To address a recurring water shortage, the government is reconsidering investments in two new desalination plants. Cyprus, in the context also of the Lisbon strategy, which has received considerable attention and support by governmental and civil society circles, is planning a significant increase in the share of GDP devoted to R&D. On public services and utilities, although no privatization is currently being contemplated, action has been ongoing to improve competition. Legislation is pending to enhance the powers of the Commission for the Protection of Competition. In telecommunications, the private sector already enjoys a significant and rising share in mobile telephony. On tourism, there are plans being developed to help upgrade the offerings, through such efforts as building marinas and golf courses, and attracting more traffic from professional conventions. For Cyprus Airways, actions have already been taken to reduce staffing and other costs so as to help make the company more competitive. Although Cyprus had until recently been lagging in terms of internet adoption rates, there has been a very rapid increase in the share of households with internet access. If the experience of other countries is any guide, a more widespread adoption has the potential to eventually further boost productivity.

Monetary policy and the financial sector

The Central Bank of Cyprus (CBoC) will remain focused on containing inflation and keeping the economy on track for EMU accession and the locking of the parity between the Cyprus pound and the euro at around mid-2007. The CBoC has already proved its readiness to be ahead of the curve if necessary, including by changing the policy interest rates by a full 100 basis in one step (once in the upwards, and once in the downwards, direction) since 2004. Most recently, on September 1 the CBoC raised interest rates by 25 basis points to counteract inflationary pressures and strong credit expansion, while on another occasion it left rates unchanged despite a reduction of 25 basis points by the ECB, thereby further increasing the interest rate differential. Finally, a harmonization took place between the operational framework of the CBoC and euro area practices on September 1, 2006. The bid rate is now being used on the main financing operations as the basis for the pricing of credit institutions instead of the Lombard rate that was previously used, which had the effect of increasing the bid rate on the main refinancing operations by 125 basis points. The net effect is that there is now a 100 basis point interest rate differential between the Cyprus pound and the euro at the short end. All in all, there should be strong confidence in the ability of the CBoC to continue to successfully manage monetary conditions.

The authorities are fully committed to their plans to adopt the euro on January 1, 2008, decided collectively by the Council of Ministers. The adoption of the euro as the currency of the country is a much broader issue, and the authorities have been actively preparing at various levels, together with civil society. The authorities have been working on the large range of laws that will have to be adapted, and have been participating actively on a public relations campaign. The authorities have made a number of statements in support of euro adoption and to assuage public fears that euro adoption will lead to an inflationary blip as (it is claimed) merchants take advantage and "round prices up." During the mission, the Staff was also helpful in presenting data showing that in other countries that adopted the euro inflation was not significantly higher, although selected items of frequent use did see some upward pressures, which may have contributed to the inaccurate perception that euro adoption is linked with higher inflation. Interest rates and spreads have naturally benefited, with Cyprus able to borrow abroad at favorable rates. Most of the remaining very small premium is attributed to a liquidity rather than a credit risk premium, and is expected to decline as the market of primary dealers for government paper starts to operate.

The financial sector is generally healthy, and has been restructuring fairly strongly as competition has increased and EU accession has changed the playing field. Higher profitability has allowed for improved provisioning against NPLs—which it should be noted appear higher than they would under international recording practices. Banks are reluctant to write off loans which have already been provided for before all lengthy legal measures against the borrowers concerned are exhausted and, specifically, due to the long time required under the present legal and judicial arrangements, to foreclose property mortgaged in favor of banks. Already a controlling interest has been acquired in the second largest commercial bank by a foreign (Greek) concern, with the two subsequently merging; meanwhile, interest in the largest commercial bank has been expressed by two foreign (again, Greek) concerns. The cooperative sector has been under both competitive pressure on housing loans from commercial banks and regulatory pressure to improve capitalization, so merger activity has been increasing there as well (though within the cooperative sector at present). The staff have made sensible recommendations in this area, which are shared by the authorities, drawing also upon a recently concluded Detailed Assessment of Standards and Codes for Banking Supervision, Insurance Supervision, and Securities Regulation. The authorities have been working to implement the specific recommendations of that assessment, including to increase the staff available to the Insurance Supervisor to enable her to perform on-site inspections.

Fiscal policy

The pace of fiscal consolidation has been very fast, with a more than halving of the deficit between 2003 and 2005, resulting in Cyprus being the first country to have its excessive deficit procedure abrogated by the EU. A well thought-out set of measures, including expenditure restraint as counseled by the staff, has contributed to this result. The public sector employment growth has been kept low, the real wage growth component was set at zero for two consecutive years, and public procurement and investment were kept under tight control. Some of these measures did have a one-off character (at least partially), such as the tax amnesty during 2004-05. However, they were at least successful in raising revenue and, by broadening the tax base, may be having a more lasting beneficial impact. In any case, they were a necessary step towards bringing more of the economy into the tax net.

There is also a consistent plan of supportive measures for 2007. Public sector real (basic) wages are planned to rise by only 1 percent (following zero percent growth during 2004-05 and 2 percent during 2006). Public sector employment growth is to be limited to 1 percent per year (below economy-wide employment growth), and current expenditure growth will be contained to below nominal GDP growth. On the revenue side, continued efforts to improve tax administration are planned. Overall, most of the expected adjustment between 2007 and 2010 will come from the expenditure side. The cyclically adjusted structural balance will, in fact, even during 2007, be fairly restrictive, with the decline between 2006 and 2007 in the pace of fiscal consolidation relative to earlier mostly explained (other than by cyclical effects) by the abatement of one-off measures. One should also note that the provision of compensating grants through the EU budget will be terminated in 2006, where it accounted for 0.4 percent of GDP, which also affects the degree of fiscal adjustment effected between 2006 and 2007.

According to data just received, the authorities are now in a position to announce that the fiscal year 2006 has ended with a general government deficit of around 1.5% of GDP, compared to the Convergence Program target of 1.9% of GDP. This of course could have implications for the target for 2007. For now, the target will remain unchanged, however, if the favorable revenue performance can be sustained, the authorities, also in view of the requirements of the Stability and Growth Pact, stand ready to revise the target appropriately. For the medium-term, the challenge remains to maintain the good performance and to reach the Medium-Term Objective, of close to balance, by 2009-10, so as to put the debt-to-GDP ratio on a distinct downward path.

The longer-term fiscal and demographic challenge

Everyone agrees that there do remain important fiscal challenges over the medium- and longer-term. There are 4 pillars to the authorities' strategy for meeting these challenges: (1) utilize the medium term budget framework (MTBF) to institutionalize expenditure rules, while increasing both accountability and independence for line ministries vs. quantified targets; (2) align social welfare spending better with need; (3) strengthen the modernization of the public sector; and (4) further improve tax collection by tackling tax evasion and improving tax administration.

The Fund has been instrumental in this process. With very targeted and helpful technical assistance from the Fund, the authorities have worked to implement a medium term budget framework, to be fully operational from 2008. Some elements have already started being implemented. Further TA by the Fund on the implementation of the MTBF will be very useful in helping achieve these aims, ensuring that the resulting framework is solid and transparent. By helping to avoid the need for supplementary budgets, the MTBF will further help reduce wasteful year-end spending.

Also, the risk that public-private partnerships (PPPs) could act to weaken expenditure control and possibly add unquantified contingent risks to the public finances should be averted permanently. Again, with Fund technical assistance, a draft legal framework was developed, and institutional mechanisms are being devised to act as gatekeepers, to ensure that the risks are quantified and manageable, and to stop low economic return projects from going ahead.

The biggest long-term challenge is the demographic shock and its possible impact on the social security system. Staff's work on this topic was appreciated by the authorities and other interested parts of the public, and helped raise awareness of the scale of the problem. On a technical level, while of course being consistent with recent work in the economic literature, the main driver of the results is that a drop in the fertility rate to 1.5 (a relatively recent development in Cyprus, and in fact a situation that is among the better ones within Europe) is maintained into the indefinite future, implying an ultimate dire impact on population. Clearly, measures to address this situation need to be taken. The authorities have prepared a set of measures intended to be taken in two stages to address the problem. In terms of the staff's suggestions, there are reservations mainly on the political sensitivity regarding how fast the retirement age can indeed be raised, and on the proposal to link pension benefits to inflation only. As experience in other countries has shown, the danger in the latter is that social security benefits over time become mere welfare benefits, covering less and less of retirement need, and significantly raising the poverty rate among the elderly. Hence more thought needs to be given to this problem, including perhaps on measures to help address the fertility problem more directly taking account of Cyprus' circumstances (rather than accepting it parametrically—France, for instance, has been successful in introducing measures to reverse the decline in its fertility rate). With public debt expected to continue to decline rapidly (eventually falling below 50 percent of GDP before beginning to rise under the demographic pressures) there fortunately is some room to further refine and implement policies to address this problem.

Issues relating to the reunification of Cyprus

The Government of Cyprus has been actively looking for ways to aid the Turkish Cypriot community. Over the years, a significant amount of aid has been directed toward them by the Government. Looking forward, this is likely to continue and under the right conditions to include EU Funds. Of course, these activities must take place in ways that promote the ultimate reunification of Cyprus, and must not be in a form that could provide international cover or recognition (even by implication) to the occupation regime in the areas of the Republic of Cyprus not under the effective control of the Government of the Republic of Cyprus.

Regarding the role of the IMF, the authorities have been cooperative with Fund staff in their efforts to contact Turkish Cypriot technocrats with a view to find ways to provide non-financial assistance, under the conditions mentioned in the previous paragraph, through such activities as collecting information on economic developments in the areas of the Republic of Cyprus not under the effective control of the Government of the Republic of Cyprus, and receiving training from the Fund. Even though no such assistance has been agreed upon so far, the authorities will continue to support the staff in their efforts to find a solution that satisfies both the needs of the Turkish Cypriot community and the sensitivities of the Cypriot authorities.

Public Information Notice (PIN) No. 07/21
FOR IMMEDIATE RELEASE
February 21, 2007

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

IMF Executive Board Concludes 2006 Article IV Consultation with Cyprus

On January 26, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cyprus.[1]

Background

Economic activity has recovered from a relatively weak performance in 2002–03. Declines in interest rates and strong capital inflows associated with Cyprus's accession to the European Union in May 2004 spurred growth in private consumption and investment, while recovering tourist receipts reduced the external drag on the economy. These developments were reflected in tight labor market conditions and continued progress toward real convergence with the euro area.

Inflation has slowed, reflecting changes in tax rates, increased competition in the wake of EU accession-related reforms, and global developments. Most recently, inflation went up somewhat in the first half of 2006, but then declined rapidly to a year-on-year rate of 1.5 percent in December. These developments were largely driven by variation in oil prices and movements of the euro—and the Cypriot pound that is fixed to it— against other currencies.

Before the latest deceleration in inflation, the Central Bank of Cyprus increased interest rates by 25 bps on September 1. This rate hike followed three consecutive cuts (totaling 125 bps) in 2005, which had been made in response to strong capital inflows related to Cyprus's participation in ERM2 in May, 2005. Although interest rate differentials against the euro have fallen significantly, the exchange rate continues to trade close to the (unofficial) upper band.

---

[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.

The fiscal deficit was cut in half to under 2½ percent of GDP in 2003–05. As a result, in July 2006, Cyprus became the first new member of the EU to have its excessive deficit procedure abrogated. Further fiscal adjustment is in store in 2006, with the deficit projected to fall below 2 percent of GDP. Initially, fiscal consolidation relied on one-off measures, but the adjustment has also benefited from tight expenditure control, combining moderation in public sector wage increases and expenditure ceilings on public consumption and investment. In the long run, aging challenges fiscal sustainability.

Rising energy costs and robust domestic demand have led to a widening of the external current account deficit in 2004–06. Non-energy imports surged in 2004—prompted by a sharp increase in investment and a reduction in excise duties—and recorded robust growth in 2005–06. Pressure on export margins continued but less so than earlier in the decade. Recent declines in competitiveness—as the real exchange rate has appreciated—have contributed to the fall in the export share of goods, but services exports have held their ground.

The economy is experiencing rapid credit growth and brisk house price increases. Total credit to the private sector accelerated recently, with mortgage lending leading the expansion.

Executive Board Assessment

Executive Directors welcomed the Cypriot authorities' substantial progress in addressing macroeconomic imbalances and reforming the economy. Inflation has receded, the fiscal deficit was cut sharply, and the economy has continued to recover, raising living standards in Cyprus closer to those in the rest of the EU and placing the economy at the doorstep of the EMU. Directors noted that continued observance of the Maastricht criteria, in particular the inflation criterion, and a smooth adoption of the euro will lay the groundwork for sustained growth going forward. This will require both fiscal and wage restraint, along with policies fostering domestic competition and continued vigilance of monetary policy.

Directors welcomed the favorable fiscal outturn in 2006 and the focus on durable fiscal measures in the 2007 budget. They encouraged the authorities to remain ambitious in their fiscal adjustment efforts to safeguard against inflation risks by observing spending limits, avoiding supplementary budgets and saving any higher-than-envisaged revenues.

Directors supported the authorities' intention to balance the budget by 2010 and stressed that high-quality fiscal adjustment should be ensured by keeping current expenditure in check. They welcomed the planned full implementation of a medium-term budget framework in 2008, as it would provide a strong institutional framework to rationalize, prioritize, and control public expenditure. Directors considered the suspension of the ambitious public investment program to be appropriate to allow the authorities to put in place a proper legal framework and institutional setting for private-public-partnerships. These actions will help bring economic considerations to bear on the selection and procurement of public investment projects.

Directors stressed that long-run fiscal sustainability hinges on mitigating the aging-related pressures on public expenditure. They called on the authorities to implement pension reforms that would allow the social security system to deal with adverse demographic trends, noting that prompt action would allow a more gradual phasing in of reforms and grandfathering of the rights of employees. Directors noted the need to avert rising health care costs when the National Health Insurance System is introduced in 2008 and encouraged the authorities to consider adequate incentives to this end, such as user fees.

Turning to the financial sector, Directors noted that commercial banks are profitable and well capitalized. Nonetheless, non-performing loans, while declining, remain high. Rapid credit growth and brisk house price increases could become sources of risk, and the authorities should stand ready to take appropriate measures if the pace of credit growth does not abate and risks increase. Directors welcomed improvements in financial sector supervision, while encouraging steps to consolidate the supervision of commercial banks and cooperative credit institutions. Irrespective of the institutional framework, supervisors should have clear responsibilities and objectives, operational independence, professional staff, and adequate resources. Directors encouraged the early adoption of legislation and regulations to accelerate the lengthy foreclosure process and welcomed the authorities' intention of completing an Financial Sector Assessment Program in time for the next Article IV consultation.

Directors stressed the importance of safeguarding external competitiveness to sustain economic growth. While recognizing that the current wage-setting process has helped smoothen labor relations, Directors concurred that continued high real wage increases point to the need to move towards a mechanism that would better align real wage increases with productivity developments. Directors welcomed progress in opening the telecommunications and energy sectors, and saw scope for further progress to enhance competition in these markets.

Directors encouraged continued efforts towards reaching an agreement on a framework under which Fund technical assistance could be provided to the Turkish Cypriot community in the non-government-controlled areas of the Republic of Cyprus. In this respect, several Directors welcomed the pragmatic approach adopted by the Cypriot authorities.

Directors welcomed the authorities' intention to subscribe to the Special Data Dissemination Standard by 2008.

Cyprus: Selected Economic Indicators

	2001	2002	2003	2004	2005	Estimate 2006
Real economy						
Gross domestic product (change in percent)	4.0	2.0	1.8	4.2	3.9	3.7
Domestic demand (contribution to annual growth)	3.4	4.2	1.7	6.6	3.2	5.2
CPI inflation (period average)	2.0	2.8	4.1	2.3	2.6	2.5
Unemployment rate (in percent)	3.0	3.2	3.5	3.6	5.2	4.8
Gross domestic saving (in percent of GDP)	13.2	15.1	15.2	15.2	13.8	13.2
Gross domestic investment (in percent of GDP)	16.4	18.8	17.4	20.2	19.4	19.5
Public finances (general government, in percent of GDP)						
Overall balance	-2.2	-4.4	-6.3	-4.1	-2.4	-1.9
Primary balance	1.1	-1.3	-2.9	-0.8	1.1	1.4
Gross public debt 1/	61.5	64.8	69.4	70.3	69.2	64.8
Money and credit (percent change)						
Reserve money	7.5	22.7	4.8	8.0	2.6	6.8
Broad money	13.3	10.3	4.0	5.6	10.2	13.3
Domestic credit	14.9	9.5	5.9	4.2	8.0	7.5
Interest rates (in percent)						
Deposit rates 2/	6.0	4.8	3.8	3.9	4.0	3.6
Lending rates 3/	7.5	7.2	6.9	7.6	7.1	6.8
Balance of payments (in percent of GDP)						
Trade balance	-26.7	-27.3	-23.9	-25.6	-25.0	-27.4
Current account balance	-3.3	-3.7	-2.2	-5.0	-5.6	-6.2
Fund Position (as of November 30, 2006)						
Holdings of Currency (in percent of quota)					90.0	
Holdings of SDR's (in percent of allocation)					14.0	
Quota (in millions of SDR)					139.6	
Exchange rates						
Exchange Rate Regime:					ERM2	
Present rate (January 31, 2006)					C£0.579 :€1	
Real effective exchange rate 4/	101.0	104.1	111.0	113.0	112.9	112.3

Sources: Ministry of Finance; Central Bank; World Bank, *World Development Indicators;* and IMF staff estimates.
1/ Excludes intragovernmental debt and short-term liabilities of the Central Bank.
2/ For 1-year fixed deposits over £C 5,000. Data for 2006 as of October.
3/ For enterprises' secured loans. Data for 2006 as of October.
4/ CPI-based, 2000=100. Data for 2006 as of October.