CYPRUS

Highlights

- **Economic growth returned in the first quarter of 2015.** A quarterly growth rate (seasonally adjusted) of 1.2 per cent represented the first positive quarterly outcome after 14 quarters of negative growth. However, deep-seated problems, including lack of credit to the real economy, remain from the 2013 crisis and short-term growth prospects continue to be modest.
- **Important legislation on insolvency and foreclosure has been introduced.** This has paved the way for resumption of the Troika programme and should help in tackling the exceptionally high level of non-performing loans (NPLs) in the banking system.
- **Key privatisations are moving forward.** Steps have been taken to bring the telecommunications company Cyta to sale, including through the appointment of a privatisation adviser, while progress has also been made towards the long-term goal of increasing private sector involvement in the ports and unbundling the energy sector before commercialisation and eventual privatisation.

Key priorities for 2016

- **Implementation of the Action Plan for Growth should be stepped up.** Short-term growth prospects remain low and unemployment is high. Key priorities include measures to attract investment, as Cyprus's level of capital formation has lagged behind its EU competitors in recent years.
- **Further efforts are needed to restore the soundness of the banking sector and rebuild depositor and market confidence.** This will require further strengthening of supervision and work-outs of NPLs in the banking system, including further legislative changes to encourage the sale of NPL portfolios to specialist work-out firms.
- **Privatisation momentum should be maintained.** It will be important to build on the progress already made and achieve concrete results on the flagship telecommunications sale, as well as making further progress towards port concessions and eventual privatisation in the energy sector.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	0.3	-2.4	-5.4	-2.5	1.0
Inflation (average)	3.5	3.1	0.4	-0.3	-1.5
Government balance/GDP	-5.8	-5.8	-4.9	-3.0	-1.3
Current account balance/GDP	-3.4	-6.9	-1.9	-1.2	-4.2
Net FDI/GDP [neg. sign = inflows]	-0.7	-6.2	-0.9	-1.8	-0.7
External debt/GDP	429.6	409.4	317.0	436.3	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	249.7	253.9	256.8	260.2	n.a.

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Macroeconomic performance

The economy is slowly moving towards economic recovery. After contracting 10 per cent over the past three years, the Cypriot economy grew by 1.2 per cent quarter-on-quarter in the first quarter of 2015, expanding for the first time after 14 consecutive quarters of negative growth. The economy grew further in the second quarter by 0.5 per cent quarter-on-quarter. This followed a contraction in 2014 of 2.5 per cent – less severe than many had predicted. The service sectors, such as trade, tourism (hotels and restaurants), legal and accounting services, and the maritime sector have consistently proved to be much more resilient than had been expected given the condition of the banking sector and the anticipated impact of capital controls on the banking and business services sector. Nonetheless, the crisis has resulted in unemployment climbing by over 10 percentage points to 16.2 per cent in 2014, compared with just 6.3 per cent in 2010, with youth unemployment at around 37 per cent. However, wages have also adjusted, cushioning some of the impact on jobs, with compensation per employee declining in 2014. The subdued economy and low inflationary pressures in the eurozone led to deflation in 2014 of 0.3 per cent.

Fiscal performance has been strong. The general government deficit was reduced from -5.8 per cent of GDP in 2012 to -4.9 per cent of GDP in 2013 and further to -0.3 per cent in 2014 (not including the one-off capital injections to the cooperative sector). The significant consolidation reflects a combination of higher tax revenues and lower-than-expected expenditure across most items. Measures addressing the wage bill including restrictive employment policies; wage and pension cuts (a progressive rate cut in addition to a flat rate cut of 3 per cent) in the public sector; abolition of allowances; and a comprehensive pension reform have helped to contain spending while revenues have been boosted by increases in corporate income tax rates (from 10.0 to 12.5 per cent) and value-added tax (standard rate from 17 to 19 per cent, and reduced rate from 8 to 9 per cent) as well as higher excise. Public finance management has been strengthened through the enactment of a Fiscal Responsibilities and Budget Systems Law providing *inter alia* the establishment of an independent fiscal council. Nevertheless, general government debt was 107 per cent of GDP in 2014 (up by 50 percentage points since 2010) and the fiscal scope is thus severely limited to absorb any additional domestic or external shocks.

The Troika programme is back on track. In June 2015, the International Monetary Fund (IMF) completed the combined fifth, sixth and seventh reviews of Cyprus's economic adjustment programme and approved a €278.4 million disbursement. The reviews had been prolonged by delays in establishing a private sector debt restructuring framework, but the new insolvency and foreclosure frameworks (see below) are now in place. Following the successful review, Cyprus became eligible for participation in the European Central Bank's (ECB's) quantitative easing (QE) programme. On 3 July 2015 the Central Bank of Cyprus (CBC) began purchases of Cypriot government bonds, leading to a reduction of approximately 16 basis points on Cypriot five-year government bond yields. Cyprus sold €1 billion in seven-year bonds in April 2015, with a yield of just 3 per cent.

The slow economic recovery is expected to continue. Following the turnaround in the first half of the year, the economy is expected to grow by 1.0 per cent in 2015, rising to 1.7 per cent in 2016. Nonetheless, the financial sector remains a significant obstacle for economic recovery, as it remains overburdened with NPLs, which account for nearly half of total loans. The economy is also vulnerable to negative spillovers from Greece, a possible eurozone downturn, and regional instability in the Middle East, as well as a potential reduction in tourist numbers from Russia (which account for 25 per cent of total tourist arrivals) because of the economic contraction in that country. The necessary internal restructuring and reform agenda is also subject to implementation risks.

Major structural reform developments

Efforts are being made to improve the business environment and remove barriers to growth. In February 2015, the Council of Ministers adopted an Action Plan for Growth. The plan was developed in response to Cyprus's economic crisis and the burgeoning recognition that a new growth model would be needed if the country were to return to a sustainable growth path. The plan has a strong focus on horizontal measures to improve the business environment, encourage

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investment and promote e-governance. The first review of the plan, in June 2015, noted that implementation was overall on track. The plan aims to improve Cyprus's ranking on international competitiveness indicators, including the World Bank's *Doing Business* indicators. In the latest report Cyprus was ranked 47th out of 189 economies, a jump of 13 places since the previous year. Major improvements were with regards to insolvency resolution, getting electricity and getting credit.

New insolvency legislation has enabled activation of the foreclosure law. This legislation, passed in April 2015, is a key step both for putting the economic adjustment programme with international creditors back on track and for helping the country tackle the overhang of bankruptcies and NPLs. The foreclosure law had been passed by parliament in September 2014, but its implementation was delayed until the parliament could approve other bills that are designed to offer protection to some vulnerable categories of debtors. The new law is designed to speed up the process of foreclosure significantly and establish procedures for valuing properties and auctioning them.

Key privatisations are advancing. Following the establishment of a Privatisation Unit within the Ministry of Finance in 2014, progress has been made on some of the flagship privatisations identified in the government's plan. Advisers have been selected for the privatisation of the telecommunications company (Cyta) and the commercial activities of the ports authority (CPA) at the Limassol port. Legislation has been prepared to convert Cyta into a limited liability company, and the regulatory framework will be amended as necessary for the private concession of the Limassol port. A large number of companies have expressed interest in concessions of Limassol's port activities and the next step in the tender process is expected to be taken by the end of 2015.

Energy sector reforms are under way, with an emphasis on green energy. The legal unbundling of the Energy Authority of Cyprus (EAC), the semi-governmental electricity utility, is due to be implemented by the end of March 2016. Meanwhile the government has commissioned an expert study on the development of renewable energy sources (RES), and is preparing an action plan for their promotion.

Capital controls imposed during the crisis have been eliminated. The removal of the last remaining controls took place in early April 2015, two years after a range of strict controls were introduced in the immediate aftermath of the temporary bank holiday and imposition of a haircut on uninsured depositors in the banking system. The move followed a positive review of the banking system by the ECB in its comprehensive assessment of the system's asset quality. Deposits in the banking system have been stable over the past year, indicating that confidence in the system is being restored.

NPLs in the banking sector remain exceptionally high by international standards. According to provisional data published by the CBC, the level of NPLs in the banking sector was 46.1 per cent as of June 2015, only marginally below the end of 2014 level (47.5 per cent). NPLs in the non-financial corporate sector and among households remain above 50 per cent. The adoption of new insolvency and foreclosure frameworks is an important step towards addressing the problem. The main banks have established work-out units but progress to date has been slow and further legislative changes on sales of NPL portfolios are to be put in place.