CYPRUS

Highlights

- **Robust growth is continuing.** A broad-based recovery is under way in 2017, underpinned by high growth in tourism, recovering investments, and rising confidence; while unemployment continues on a downward path.
- **Privatisation has come to a standstill.** Work on several flagship sales has ground to a halt, with an uncertain future, and the privatisation unit within the Ministry of Finance has been disbanded.
- **Non-performing loans (NPLs) are being reduced gradually.** The large overhang of NPLs from the crisis is being addressed by the banking sector, and one bank has partnered with a debt servicing company, but banks are missing their targets and the speed of resolution is below expectations, mostly due to limited progress in corporate reform and weak contract enforcement.

Key priorities for 2018

- **The authorities should kick-start the privatisation process.** A revitalisation could help attract fresh capital and improve the performance and governance of state-owned companies, namely in the telecommunications and energy sectors. Energy reform, including a substantial increase in renewable power production and energy efficiency improvements, depends on removing the dominance of the power monopoly company.
- **The resolution of NPLs should be speeded up.** NPLs are a major drag on the economy and the pace of dealing with them has lagged recently. A concerted effort is needed to streamline judicial procedures and facilitate the increased use of debt-service providers and loan workout packages.
- **The government should focus on further development of renewable energy sources.** Cyprus has significant potential in this area, but the current share of renewables in total consumption is below the country's 2020 target. Implementation of a long-term strategy for investments in renewables, including a well-defined regulatory framework supporting bankable investments, would help the country to reach its large and unmet potential.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-5.9	-1.4	2.0	3.0	3.5
Inflation (average)	0.4	-0.3	-1.5	-1.2	0.8
Government balance/GDP	-5.1	-8.8	-1.2	0.5	0.9
Current account balance/GDP	-4.9	-4.3	-2.9	-5.3	-3.8
Net FDI/GDP [neg. sign = inflows]	-1.7	-8.0	48.4	5.8	-1.0
External debt/GDP	569.8	555.6	550.4	597.2	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	299.8	288.0	283.7	252.7	n.a.

*Cyprus is a member of the Euro area.

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Macroeconomic performance

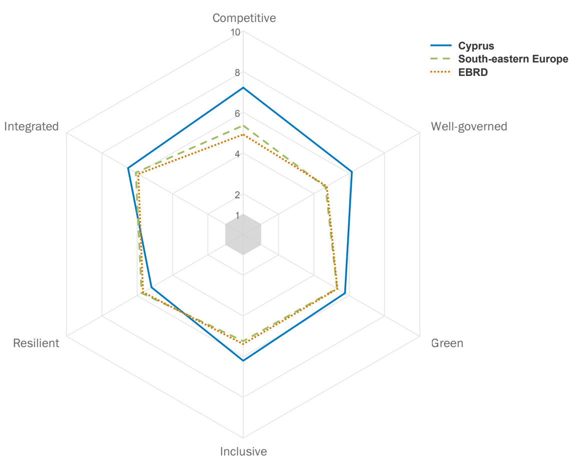
The economic recovery is continuing into 2017. After the return to growth in 2015 (2.0 per cent), following three years of contraction, the economy performed well in 2016, with GDP growth reaching 3.0 per cent, above expectations. Tourism was one of the main drivers of the economy, with arrivals last year up by around 20 per cent (almost 3.2 million tourists visited Cyprus in 2016) and virtually all hotels at full occupancy, while other sectors such as construction and professional services also contributed to the ongoing recovery. Economic growth has continued at a robust rate in the first half of 2017. The second quarter of 2017 GDP growth was 3.5 per cent year-on-year, following 3.7 per cent year-on-year in the first quarter, driven by strong performances in retail and wholesale trade, construction and manufacturing. Tourism is also having another exceptional year, continuing to benefit from instability elsewhere. In the first nine months of 2017, the number of tourist arrivals was nearly 15 per cent higher than in the same period in 2016. Unemployment remains at double-digit levels but has fallen to 10.7 per cent as of August 2017, more than two percentage points lower than a year previously.

Fiscal performance remains strong. The government is maintaining a prudent fiscal stance and delivered an overall budget surplus for 2016, at 0.5 per cent of GDP (the first one after 2008), following a fiscal deficit of just 1.2 per cent of GDP in 2015. In the first half of 2017, the general government budget remained in surplus at 0.3 per cent of GDP, with the expectation of an overall small budget surplus for 2017 as a whole. The government is able to access capital markets at favourable terms; in June 2017, the government issued a seven-year euro medium-term note (EMTN) of €850 million. Meanwhile, in July 2017 the government made a partial early payment of €0.3 billion to the IMF, thus reducing the outstanding balance to €0.7 billion.

Cyprus's credit ratings continue to improve. The country has benefited from a series of upgrades over the past year and a half, following the successful early exit from the adjustment programme with the IMF, European Commission and European Central Bank in March 2016. As of October 2017, Cyprus was rated BB+ by Standard & Poor's (after a one-notch upgrade in September 2016 and another in March 2017); BB by Fitch (also upgraded one notch in October 2017) and Ba3 by Moody's; and all three ratings agencies have a positive outlook for their ratings.

The economic recovery is expected to continue. The economy is projected to grow by 3.5 per cent in 2017, and further growth is expected in 2018 but at a more moderate rate (2.5 per cent). Banks continue to be burdened by high NPLs, which account for nearly half of total loans, notwithstanding the major reforms to the system that are under way, and the elevated levels of private and public debt are constraining private and fiscal spending. The necessary internal restructuring and reform agenda to increase potential growth rates is subject to significant implementation risks, as shown by the stalled privatisation programme which has encountered internal resistance (see below). Risks stem particularly from the ongoing drag of high NPLs, and possible negative external developments in major trading partners.

Assessment of transition qualities (1-10)



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Major structural reform developments

The action plan for growth has been revised. The plan was first adopted in February 2015 and has served as a framework for a broad range of reforms across the economy. In December 2016, the Council of Ministers adopted a revised plan, and a fourth progress report on the plan was issued in January 2017. The report noted the introduction of a number of measures to improve competitiveness, including a new investment framework for 2017 that will encourage fast-track investments. At the same time, Cyprus's ranking on the World Bank's *Doing Business 2018* report remains low by EU standards. The country ranked 53rd out of 190 economies in the aforementioned report, with particular problems persisting in the areas of contract enforcement and dealing with construction permits.

Privatisation has ground to a halt. Little progress has occurred in the past year in key privatisations envisaged under the former adjustment programme (which ended in March 2016) with the IMF, European Commission and European Central Bank. The lack of progress includes the telecommunications company Cyta, which remains in majority state-owned hands, and the Electricity Authority of Cyprus, for which progress towards ownership unbundling has been minimal. In July 2017, parliament passed a bill scrapping the privatisation unit within the Ministry of Finance, illustrating the significant opposition to privatisation within parts of the political system.

Bank lending is increasing amid rising confidence and stability. In its latest bank lending survey, published in July 2017, the Central Bank of Cyprus noted that net loan demand by households and businesses increased in the second quarter of 2017, and that a further rise was expected in the third quarter on the back of the positive developments and outlook for the economy, low interest rates and rising confidence. The largest bank, Bank of Cyprus, was listed on the London Stock Exchange in January 2017.

Non-performing loans are being resolved slowly. The overhang of NPLs in the banking system remains exceptionally high by international standards. Overall non-performing exposures were still 48 per cent of gross loans as of March 2017. A new framework for insolvencies and foreclosures is in place but implementation has been slow and a number of impediments and inefficiencies remain within the insolvency service. The banking system as a whole was underperforming on several quantitative targets related to NPL resolution as of March 2017. A step forward occurred in July 2017 when the second-largest private bank, Hellenic Bank, sold its NPL and real estate management business to APS Debt Servicing Cyprus Ltd. This is the first debt servicing platform in the Cypriot market and is expected to accelerate the resolution of NPLs in the bank.

A new renewable energy agency is being created. The government announced plans in February 2017 to establish the new agency, and the relevant legislation is being prepared. Currently, the share of renewables in total energy consumption is 9.8 per cent, versus a 2020 target of 13.0 per cent. From January 2017, the so-called "green tax" on electricity bills was doubled from 0.5 to 1.0 cent per kWh, with some vulnerable groups being exempted.