CYPRUS

Highlights

- **A major economic recovery is continuing.** GDP growth in 2017 was 4.2 per cent, and the level of economic output has almost reached the pre-crisis level. Fiscal performance remains strong and the government reached an overall fiscal surplus for the second year in a row.
- **Privatisation remains largely on hold, while liberalisation of the energy sector has been delayed.** There appears to be little appetite for selling a majority stake of the state-owned telecommunications company, although this had been one of the government's priorities during the crisis.
- **The Cyprus Cooperative Bank (CCB) has been liquidated.** The healthy part was bought by the Hellenic Bank, while the state will absorb the remaining parts of the bank.

Key priorities for 2019

- **A new push for renewable energy is needed.** The government is developing a new renewable energy strategy to help meet long-term renewable targets, but a firmer commitment to implementing a competitive tariff regime and support for auctions of renewable energy is necessary for the long-term viability of the sector.
- **Heightened efforts are needed to tackle non-performing loans (NPLs).** The level of NPLs remains exceptionally high by international standards. Recent progress in restructuring of companies and banks and in sales of NPL portfolios are encouraging and should be further developed.
- **Targeted business environment reforms are needed.** The authorities should focus on areas such as contract enforcement and permitting, where Cyprus continues to lag behind best practice in other EU countries.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-1.3	2.0	4.8	4.2	3.9
Inflation (average)	-0.3	-1.5	-1.2	0.7	0.8
Government balance/GDP	-9.0	-1.3	0.3	1.8	2.1
Current account balance/GDP	-4.3	-1.5	-4.9	-6.7	-3.1
Net FDI/GDP [neg. sign = inflows]	-7.9	47.4	-7.8	-23.1	-5.5
External debt/GDP	554.4	572.7	588.9	557.3	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	287.4	282.1	250.5	224.6	n.a.

*Cyprus is a member of the Euro area.

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Macroeconomic performance

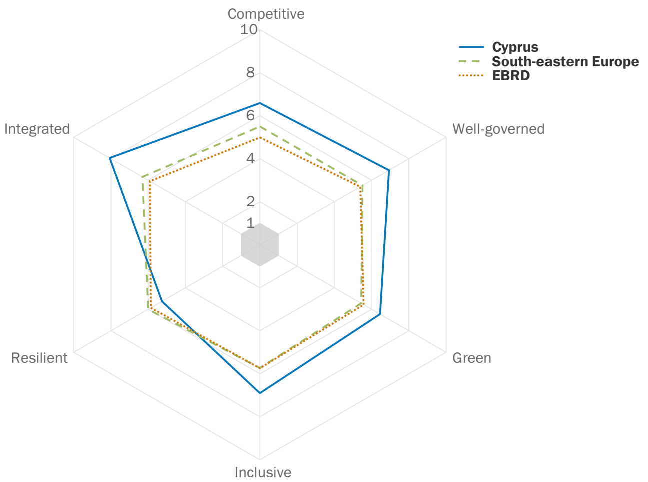
Robust growth is continuing. Economic activity in Cyprus continued at a strong rate in 2017 with GDP growth of 4.2 per cent. Growth in 2017 was mainly driven by investment and private consumption. Gross fixed capital formation accounted for more than 20 per cent of GDP for the first time after 2010, driven by the construction and real estate sectors. After many years of negative contribution to growth, government spending also provided a small growth boost. Net exports were the only drag on growth as imports, supported by rising private consumption and investments, grew by a higher rate than exports. Tourist arrivals in 2017 increased by almost 15 per cent and the leading indicators in the first half of 2018 point to another strong year for tourism in Cyprus, which is continuing to benefit from instability elsewhere. Meanwhile, unemployment has dropped to single-digit levels, reaching 7.4 per cent in September 2018, more than three percentage points lower than a year previously, and more than seven percentage points lower than its peak in 2014. After a few years of declining prices, inflation returned to the economy, averaging 0.7 per cent in 2017 and 0.4 per cent in the first eight months of 2018. The positive GDP trends have continued into 2018 with growth in the first quarter of 4.0 per cent year-on-year and 3.9 per cent year-on-year in the second quarter.

Fiscal performance remains strong. For the second year in a row, the government reached an overall surplus in 2017 of 1.8 per cent of GDP. This was due to a strong recovery in revenue collection owing to the stronger-than-expected GDP growth. These positive trends have helped drive down general public debt to below 100 per cent of GDP by the end of 2017, although the ratio has risen again in 2018 because of the one-off restructuring of the cooperative banks (see below). This is expected to cost the government more than 15 per cent of GDP, putting back the government's debt reduction efforts. However, the move is expected to reduce systemic risks in the banking sector significantly.

Cyprus's credit ratings have further improved in the past year. The latest upgrades by major ratings agencies were by Standard & Poor's in September 2018 and by Fitch in October 2018, both from BB+ to BBB-, lifting the country back to investment grade for the first time since the crisis. The Standard & Poor's upgrade was followed by a 10-year €1.5 billion bond issuance at a yield of just 2.4 per cent, significantly below previous issues.

Strong growth is likely to continue in the short term. GDP growth for 2018 is projected at 3.9 per cent and 3.5 per cent in 2019.These growth rates are likely to be accompanied by further fiscal surpluses, contributing to another reduction in the public debt-to-GDP ratio. However, significant downside risks remain to this forecast, given the relatively undiversified nature of the economy and reliance on a few sectors, and given the difficulties in reducing the burden of exceptionally high levels of NPLs on the financial sector, which are still around 40 per cent of total loans.

Assessment of transition qualities (1-10)



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Major structural reform developments

Overall reform momentum has been limited in the past year. The election cycle in early 2018 contributed to the slow-down in reforms. Privatisation remains largely on hold; the law abolishing the privatisation unit in the Ministry of Finance, passed in 2017, was upheld by the Supreme Court in February 2018. Regarding the telecommunications company CyTA, the plan now is to corporatise the company, with the government retaining a majority stake. The business environment still has serious deficiencies in several respects, notably in the areas of contract enforcement and dealing with construction permits, as illustrated by the country's poor overall ranking (57th out of 190 countries) in the World Bank's *Doing Business 2019* report.

Energy sector liberalisation has been delayed. The authorities are committed to liberalising electricity and gas markets by July 2019, but progress to date has been slow, and the target may be missed. A step forward occurred in 2018 when a licence was given to F. E. First Electric Supply, the first independent power producer in Cyprus. This supplier would interact with producers and consumers of electricity based on bilateral contracts. Further licences are expected to be granted in the coming months. However, plans for full unbundling of the sector have been delayed.

The Cyprus Cooperative Bank (CCB) is being restructured and sold. The bank is still the second biggest in the country but has struggled to recover from the negative effects of the crisis five years ago, with more than half of its loans non-performing. In March 2018 the government offered the bank for sale and in April 2018 it carried out a balance sheet operation, injecting €2.5 billion into the bank. In June 2018 it was announced that Hellenic Bank, the third largest in the country, would take over management of the healthy part of the bank, consisting of the majority of assets and customer deposits, while the state would absorb the remainder, including the portfolio of NPLs. Hellenic Bank officially took over the operations of CCB in September 2018.

NPLs are being tackled slowly. Despite the economic recovery in recent years, NPLs in Cyprus remain exceptionally high, at 44 per cent of total exposures as of January 2018, only marginally below the level of a year earlier. Some legislative changes have been enacted recently, or are in progress, in order to speed up the process. In particular, in July 2018 the parliament amended the legal framework around insolvencies and foreclosures in order to speed up the process of NPL resolution. Sales of NPLs have advanced during 2018. In January 2018 Hellenic Bank sold €145 million of NPLs to Norway's B2Holdings ASA. In addition, the Bank of Cyprus, the country's biggest bank, is in the process of selling a portion of its NPLs to an asset management company. The deal was agreed in August 2018 but is pending regulatory approval. This would represent the first major such deal in Cyprus since the crisis.