# CYPRUS

## Highlights

- **The strong post-crisis economic recovery continues.** Gross domestic product (GDP) growth remained solid in 2018 at 3.9 per cent, driven by rising investment and private consumption, and unemployment rates continue to fall.
- **Non-performing exposures (NPEs) have dropped significantly.** Current levels (as of the middle of 2019) of NPEs are still elevated by European standards at 20 per cent of all loans, but this constitutes a major reduction relative to the 43 per cent recorded at the end of 2017. Legislative changes and sales of bad loans have both contributed to this major reduction in NPEs.
- **Energy sector liberalisation has been delayed.** Progress is being made towards full opening up of the energy market but plans are behind schedule and are meeting some resistance.

## Key priorities for 2020

- **Further efforts are needed to reduce non-performing exposures.** The major reduction in NPEs in the past year is welcome, but the share of NPEs in total remains high and should be cut to single digits. This means the government should avoid any steps that would unnecessarily impede the resolution of NPEs.
- **Business environment reforms should be accelerated**. The authorities should focus on areas such as public administration and the judiciary, as well as anti-money laundering, where Cyprus continues to lag behind best practice in other EU countries.
- **Energy sector reform should advance.** Increasing the efficiency and competitiveness of the state-owned power company is crucial for the strength and development of the economy.

Main macroeconomic indicators %

| | 2015 | 2016 | 2017 | 2018 | 2019 proj. |
|---|---|---|---|---|---|
| GDP growth | 2.0 | 4.8 | 4.2 | 3.9 | 3.2 |
| Inflation (average) | -1.5 | -1.2 | 0.7 | 0.8 | 0.5 |
| Government balance/GDP | -0.3 | 0.3 | 1.8 | -4.8 | 3.3 |
| Current account balance/GDP | -1.5 | -5.1 | -8.4 | -7.0 | -7.3 |
| Net FDI/GDP [neg. sign = inflows] | 47.4 | -9.8 | -23.1 | -22.6 | -8.9 |
| External debt/GDP | 572.6 | 576.5 | 552.3 | 494.6 | n.a. |
| Gross reserves/GDP | n.a. | n.a. | n.a. | n.a. | n.a. |
| Credit to private sector/GDP | 246 | 222.8 | 198.2 | 142.3 | n.a. |

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## Macroeconomic performance

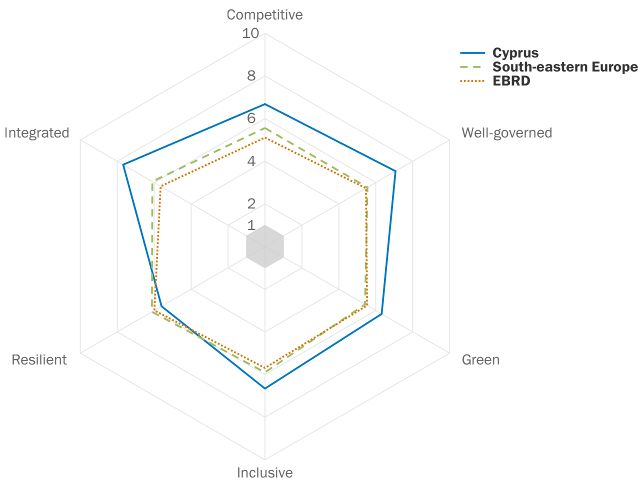
**Robust growth is continuing.** Economic activity continued at a strong rate in 2018 with GDP growth of 3.9 per cent. Investment was one of the main drivers, as the construction sector continued to grow strongly. The increase in private consumption was another significant factor and is expected to remain resilient, thanks to improving labour market conditions, wage increases and buoyant economic sentiment. Unemployment has continued on a downward trend, reaching 6.6 per cent (seasonally adjusted) in September 2019, its lowest level in eight years and more than eight percentage points below the peak in 2014. In the first quarter of 2019, GDP growth moderated slightly to 3.4 per cent year-on-year, followed by 3.2 per cent year-on-year in the second quarter. On the demand side, private consumption has remained robust, while gross fixed capital formation grew strongly, especially in residential investment. Cyprus enjoyed a particularly good tourism season in 2018, but the sector has levelled off so far in 2019, with tourist arrivals down by 1.1 per cent over the first five months of 2019 compared with the same period in 2018.

**Fiscal performance remains strong.** Due to the sale and winding down of the Cyprus Cooperative Bank (CCB), the second-largest bank in the country, the public debt burden remains large at around 102.5 per cent of GDP and the primary fiscal balance was negative at -2.3 per cent of GDP in 2018. However, strong GDP growth and primary surpluses (expected to be at 5.7 per cent of GDP in 2019) should allow the debt-to-GDP ratio to resume its downward path from this year onwards. Moreover, the resolution of CCB has reduced systemic risks in the banking sector significantly.

**Cyprus is rated investment grade by some credit rating agencies.** Both Standard & Poor's (S&P) and Fitch rate Cyprus at investment grade BBB-, with S&P raising the sovereign rating to that level in September 2018 and Fitch in October 2018. In October 2019, Fitch also revised the outlook on its BBB- rating for Cyprus from stable to positive. The other major rating agency, Moody's, still has Cyprus below investment grade at Ba2, but in September 2019, it raised the outlook from stable to positive. Yield spreads over German sovereign bonds have dropped to historically low levels, helping the government to issue a €1 billion 15-year Eurobond and a €750 million 30-year Eurobond in 2019, the longest maturity Eurobonds to date, at an average yield of 2.75 and 2.88 per cent, respectively. Moreover, given the current low market rates of Republic of Cyprus bonds, the government announced in October 2019 that it intends to repay early the remaining amount of the debt to the International Monetary Fund, which stands at 570 million Special Drawing Rights (approximately €700 million).

**Robust growth is likely to continue in the short term.** Taking into account all the relevant factors, we expect growth to slow down moderately in 2019 and 2020 to 3.2 per cent and 2.8 per cent, respectively. Key downside risks include the slowing European economy and internal risks associated with high levels of personal and corporate debt, as well as an economy that remains dependent on a few key sectors.

Assessment of transition qualities (1-10)

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## Major structural reform developments

**The banking sector continues to strengthen.** In 2018, the sector reported the first net profit in eight years. NPEs had been exceptionally high, accounting at one point for more than half of all loans, but the rate has come down dramatically in the past two years, from 43.0 per cent as of the end of 2017 to 30.5 per cent at the end of 2018. The process was helped by two one-off transactions in 2018: the transfer of the non-performing Cyprus Cooperative Bank (CCB) assets to the state-owned management company KEDIPES, and the sale of a large NPE portfolio by the Bank of Cyprus. These two operations strengthened the balance sheets of these two banks, which are the largest in the country. Legal changes in recent years to encourage the sale of NPEs are also having an important effect.

**Anti-money laundering (AML) legislation and supervision of insurance and pension funds are being improved.** According to the fifth AML Law, the transposition of the fifth EU AML Directive into Cyprus law should take place in 2019. Full functionality of the Ultimate Beneficial Owner registries is expected to be in place from March 2020. Meanwhile, in order to integrate and strengthen the supervision of insurance companies and occupational pension funds, a draft bill on the creation of a single independent supervisory authority for the supervision of insurance companies and occupational pension funds has been prepared, based on an independent report commissioned with the support of the European Insurance and Occupational Pensions Authority. It aims at a more efficient and effective supervision of the two sectors, thus better managing risks and guarding the interests of stakeholders. The future organisational structure of the new supervisory entity is currently under consultation, following which the final draft Bill will undergo legal vetting, with the aim of adopting the bill by December 2019.

**Energy-sector liberalisation has been delayed.** The authorities originally committed to liberalising electricity and gas markets by 2019, but progress to date has been slow. The Cyprus Energy Regulatory Authority (CERA) is now working towards the full opening up of the energy market and granting consumers the right to choose their own supplier – with expectations of full liberalisation in 2020-21. CERA's proposition is a "net pool" model, where the operations of the state power company, EAC, are unbundled and the production and supply operations separated. EAC production would then enter into bilateral agreements with suppliers for the sale of energy at regulated prices. However, these plans have experienced some resistance from unions, as they are seen as moves that could increase pressure to privatise EAC.

**The business environment still has serious deficiencies in several areas.** Cyprus continues to receive a poor overall ranking (54th out of 190 countries) in the World Bank's *Doing Business 2020* report, although it has risen by three places relative to the previous year. The reform of the judicial system and, in particular, the ongoing reforms to increase the efficiency of the courts and accelerate enforcement of commercial claims remain key challenges for achieving a better business environment. Other issues to be tackled include the reform of public administration and the establishment of an e-justice system.