CYPRUS

Highlights

- **The economic recovery is well under way.** Economic growth returned in 2015 and the positive trend has continued so far in 2016. The recovery has been driven by robust performance in sectors such as tourism, trade, and legal and accounting services.
- **Cyprus has exited its economic adjustment programme.** The exit came in March 2016, two months ahead of schedule, and reflects an impressive fiscal consolidation and a return to stability in the banking sector. Capital controls have also been removed.
- **Privatisation results have been disappointing.** Several flagship sales envisaged under the economic adjustment programme have been put on hold, although private concessions for Limassol port were awarded in April 2016.

Key priorities for 2017

- **Non-performing loans need to be tackled more vigorously.** The level of non-performing loans (NPLs) remains exceptionally high by international standards and is holding back much-needed credit to the economy. An accelerated approach to insolvencies and foreclosures is needed to bring down NPL levels substantially.
- **Commercialisation and privatisation in the telecommunications and energy sectors should be resumed.** The blocking of progress in these key sectors is holding back new investment. A more commercial approach to service delivery, with private sector involvement, would bring long-term benefits to consumers.
- **Further business environment improvements are needed.** The authorities should step up efforts to improve permitting procedures and contract enforcement.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-3.2	-6.0	-1.5	1.7	2.7
Inflation (average)	3.1	0.4	-0.3	-1.5	-1.0
Government balance/GDP	-5.8	-4.4	-0.2	-1.4	-0.5
Current account balance/GDP	-5.6	-4.5	-4.6	-3.6	-0.9
Net FDI/GDP [neg. sign = inflows]	14.1	6.7	4.1	26.8	-4.2
External debt/GDP	595.7	531.1	559.6	584.4	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	308.9	300.7	290.9	287.3	n.a.

*Cyprus is a member of the Euro area.

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Macroeconomic performance

The economic recovery is well under way. Economic growth returned in 2015, at 1.7 per cent, after three years of contraction. The country's service sectors, such as trade, tourism, and legal and accounting services, have proved to be much more resilient than expected given the poor condition of the banking sector in the wake of the 2013 crisis and the expected impact of capital controls. Revenues from tourism, which directly or indirectly accounts for roughly one quarter of the economy, were €2.2 billion in 2015, close to record levels, with more than 2.5 million international tourist arrivals. Growth accelerated in the first half of 2016 to 2.7 per cent year-on-year, and consumer confidence has risen sharply, exceeding the EU average in recent months and supporting strong private consumption growth. The more dynamic economy had positive spillovers on the labour market, as the unemployment rate has begun to fall, reaching 12.0 per cent in mid-2016 compared with the 2014 peak of 16.3 per cent. Fiscal performance has also been strong, with the fiscal deficit falling to just 1 per cent of GDP in 2015. Nevertheless, general government debt is still high, exceeding 100 per cent of GDP at the end of 2015.

Cyprus exited its economic adjustment programme in March 2016, two months ahead of schedule. The international community was supporting Cyprus with a €10 billion programme: €9 billion from the European Stability Mechanism (ESM) and €1 billion from the International Monetary Fund (IMF), following the country's 2013 financial crisis. The programme had two main goals: to put the banking sector on a sound footing and to return public finances to a sustainable path. Both of these objectives were substantially achieved, making the Cypriot economy more resilient in the future. Strict adherence to fiscal targets has meant that Cyprus has been able to refrain from using almost €2 billion of the €9 billion available from the ESM, as the country has drawn only €7.3 billion of the €10.0 billion available.

Cyprus has regained access to international capital markets. Following the successful June 2015 review of the programme, Cyprus became eligible for participation in the European Central Bank's (ECB's) quantitative easing programme. In 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. However, in March 2016, following the country's exit from the programme, the ECB decided to lift its waiver for Cypriot bonds that has allowed the country's banks to use non-investment grade Cypriot sovereign bonds as collateral to draw liquidity from the ECB. Now Cypriot bonds are treated according to the same terms as those of the rest of the eurozone, which means that, until the country's rating returns to investment grade, they cannot be used for the provision of cheap liquidity to Cypriot banks. As of October 2016, Cyprus is rated BB by Standard & Poor's (after a one-notch upgrade in September 2016), BB- by Fitch (also upgraded one notch in October 2016) and B1 by Moody's. In July 2016 the government successfully issued long-term government bonds on international markets, raising €1 billion with seven-year maturity and 3.75 per cent yield. The proceeds of the issuance were partially used to adjust the country's debt repayment profile, reducing the maturity concentration over the next three years.

The economic recovery is expected to continue. Further growth is expected in 2016 and 2017 but is likely to remain moderate (2.7 and 2.2 per cent, respectively) as banks remain 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 level of public debt is constraining 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 significant internal resistance.

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Major structural reform developments

Implementation of the action plan for growth has advanced. The action plan, adopted in February 2015, envisaged a number of horizontal measures to improve the business environment, encourage investment and promote e-governance. The second progress report on the plan, published in December 2015, noted that the plan was on track, with a number of measures introduced or at an advanced stage to attract investment and simplify the business environment. However, Cyprus continues to score poorly on certain aspects of the World Bank's *Doing Business* analysis, including dealing with construction permits and enforcing contracts. The country's overall ease of doing business ranking has dropped four places from 41st to 45th (out of 190 countries) in the latest report.

Privatisation results have been disappointing. The economic adjustment programme, which was successfully completed in March 2016, had envisaged a number of flagship privatisations, whose sales were foreseen to generate a total of up to €1.4 billion in revenue for the government by 2018. However, progress has stalled on several fronts. In December 2015, the government approved a privatisation plan for the national telecommunications company, Cyta, but the plan was subsequently blocked in parliament in April 2016 and the sale has been postponed until the end of 2017 at the earliest. At the same time, parliament also blocked further moves towards privatising the Electricity Authority of Cyprus (EAC). Prices for the provision of telecommunications and electricity services to consumers remain high by EU standards, highlighting the absence of strong competitive pressures in these sectors.

Significant progress has been achieved in commercialisation of ports. In February 2016, the government awarded three long-term concessions to international consortia. In April 2016, the government signed contracts with the new operators of Limassol port's container terminal, multi-purpose terminal and port marine services. A consortium of Eurogate International, Interorient Navigation Company and East Med Holdings was awarded a 25-year concession for the exclusive rights to operate the container terminal. DP World Limassol has been awarded a 25-year concession for the exclusive right to operate the multi-purpose terminal, while P&O Maritime Cyprus, a wholly owned subsidiary of DP World Limited, has been awarded a 15-year concession to provide a full range of port marine services.

Insolvencies and foreclosures are taking place slowly. Following the introduction of new legislation in the first half of 2015, the first auctions under the new framework took place in June 2016, when the Bank of Cyprus (the largest bank in the country) foreclosed on 10 properties. However, the process is moving slowly and the European Commission has called on the authorities to improve staffing levels and IT infrastructure at the Insolvency Service, and ensure the adoption of all necessary rules and regulations.

A National Investment Fund has been set up to manage future gas revenues. In June 2016, the government approved a bill to establish the National Investment Fund to administer future revenue from the sales of hydrocarbons and help reduce public debt. The framework provides for the management of future natural gas proceeds to be targeted either at reducing public debt or towards investment opportunities abroad. Production at the Aphrodite field, Cyprus's first gas discovery, which contains 4.5 trillion cubic feet of natural gas, is not expected to begin before 2020.

The share of renewable energy sources in power generation has risen. In 2015, the share rose to 8.5 per cent from 7.0 per cent in 2014, mainly on increased output from solar systems. In 2015, total power generation rose 4.6 per cent to 4,512,404 MW/h compared with 2014, with the share of thermal power generators, operated by three power plants belonging to the state-owned power producer Electricity Authority of Cyprus, shrinking to 91.5 per cent. The rise in output from photovoltaics was partly a result of the increased capacity installed, which rose last year 25.0 per cent to 76.5 megawatts, after almost doubling in 2014. Overall windpower generation capacity rose 7.4 per cent to 157.5 megawatts.

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The Cooperative Central Bank was recapitalised at the end of 2015. The recapitalisation was done through the newly created Recapitalisation Fund – financed by levies from the banking sector – which provided the necessary recapitalisation in exchange for ordinary shares in the Cooperative Central Bank (CCB). The move was subsequently approved by the European Commission, as part of the necessary state-aid programme. It is the second time since the banking crisis of 2013 that the CCB was recapitalised, and follows the identification in 2015 of a €175 million capital shortfall after a stress-test conducted by the ECB's Single Supervisory Mechanism (SSM). However, the European Commission ruled that additional state aid needs to be accompanied by supplementary restructuring measures, in order to ensure that the bank becomes viable without continued state support in the future and that the distortions of competition created by the state aid are mitigated. Cyprus has committed to either list the Cooperative group's shares on the stock exchange or sell a significant part of the capital to solid investors by 2018.