

Staff statement following the seventh post-programme surveillance (PPS) mission to Cyprus

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European Commission staff, in liaison with staff from the European Central Bank (ECB)*, visited Cyprus from 16 to 20 September to conduct the seventh post-programme surveillance (PPS) mission. The mission was coordinated with an International Monetary Fund (IMF) Article IV mission. Staff from the European Stability Mechanism (ESM) participated in the mission on aspects related to the ESM's Early Warning System.

While remaining strong, economic growth is gradually decelerating. After real GDP growth of 3.9% in 2018, the pace of economic expansion moderated in the first half of 2019, largely reflecting external headwinds. Private consumption held up well on the back of a tightening labour market with still rising employment and disposable income, while investment benefitted from a number of large-scale foreign-financed tourism and infrastructure projects. Following record high growth rates in 2016-2018, tourism revenues showed some weakness in the first half of 2019. Inflation is expected to remain subdued amid the deteriorating external environment. Robust, albeit weaker growth is forecast to continue over the medium term on the back of resilient domestic demand. Risks are tilted to the downside, as the sizable current account deficit and the declining, but still elevated private sector indebtedness render Cyprus vulnerable, including to potentially tightening financial conditions.

Fiscal performance is expected to remain strong. The general government balance in 2019 is projected to show a sizable surplus of above 3.5% of GDP on account of buoyant tax revenues and some one-off factors. Surpluses are expected to decline somewhat in 2020 and 2021, partially reflecting increases in public health expenditure and in the public sector wage bill due to the stepwise reversal of wage measures implemented during the crisis. The still high public debt-to-GDP ratio is set to decline over the coming years. To firmly anchor its downward path, containing public expenditure remains essential, in accordance with the requirements of the preventive arm of the Stability and Growth Pact. This is particularly important in view of fiscal risks associated with the health insurance reform (especially in relation to the public hospitals' budget execution), upcoming court judgements on the constitutionality of wage and pension cuts during the crisis, and remaining contingent liabilities in the financial sector.

Good progress was made in consolidating the banking sector and reducing non-performing loans but important challenges remain. Despite the recent sizable reduction, the Cypriot banking sector still has the second highest NPL ratios in the euro area. Therefore, efforts to further reduce NPLs remain a priority, including plans for further loan sales and securitisations. In this context, the amendments to the foreclosure framework approved by Parliament on 2 August 2019 backtrack on key elements of the reform adopted in July 2018, which was an important step towards improving financial stability and payment discipline through a more effective enforcement of claims and NPL workout. The ESTIA scheme, which aims to address the NPLs collateralised with primary residences, has been officially launched. Rigorously enforcing compliance with the eligibility criteria and swiftly triggering foreclosure procedures in the case of re-defaults are crucial for the ultimate performance of the scheme. Swiftly finalising the establishment of KEDIPES, the largest asset management company in the EU relative to the size of the economy, is essential, including adherence to the state aid commitments and maximisation of recoveries of the assets to repay the state. Additional concerns regarding the financial sector include persistently high operating costs and low profitability.

The structural reform momentum needs to be renewed to support growth and economic resilience going forward. Addressing inefficiencies in the justice system is key for improving the business environment and the enforcement of claims. It is also essential for the effective implementation of the insolvency and

foreclosure frameworks as well as NPL resolution. Furthermore, setting up a reliable and transparent system to issue and transfer title deeds and resolving backlogs in the title deeds issuance are long overdue. Other reforms to improve the business environment and attract investment need to be accelerated, such as privatisation, the simplification of procedures to obtain building permits and introduction of fast track approval for strategic investments. Public administration reform and the reform of local governments remain a high priority, in view of the expected significant increase in administrative efficiency. Furthermore, the implementation of the national health system continues to require close monitoring given the potential sizeable fiscal implications, particularly in the initial set-up years.

The mission would like to thank the Cypriot authorities for the constructive and open discussions and IMF staff for their cooperation. The next PPS mission will take place in the spring of 2020.

** ECB staff participated in this mission and the drafting of this statement, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.*

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