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November 29, 1984

To: *Members of the Executive Board*

From: *The Secretary*

Subject: Cyprus - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Cyprus. A draft decision appears on page 13.

This subject has been tentatively scheduled for discussion on Wednesday, December 19, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mrs. Ter-Minassian (ext. (5)8844).

Att: (1)

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INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives
for the 1984 Article IV Consultation with Cyprus

Approved by Hans Schmitt and S. Kanesa-Thasan

November 28, 1984

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Mr. E. Spitaeller, Ms. M. Xafa (all EUR), Mr. A. Mansoor (FAD) and, as secretary, Ms. A. Munante (EUR) visited Nicosia on October 11 to October 22, 1984 to conduct Article IV consultation discussions. The mission met with the Minister of Finance, Mr. S. Vassiliou, the Governor of the Central Bank of Cyprus, Mr. A. Afxentiou, and with officials of the Ministries of Finance, Trade and Labor, of the Central Planning Bureau and of the Central Bank. Mrs. Ter-Minassian also met with the Acting President of the Republic, Mr. Ladas, to appraise him of the mission's findings.

The political situation in Cyprus remains somewhat unsettled. U.N.-sponsored "proximity" talks with the self-proclaimed Turkish-Cypriot Government have not produced significant results so far. The Government of President Kyprianou has to rely on the outside support of the communist (AKEL) party to obtain a majority in Parliament.

Cyprus continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement.

II. Report on the Discussions

1. Recent economic developments

Following a successful stabilization effort in 1981, which was supported by a first credit tranche stand-by arrangement with the Fund, the stance of financial policies was eased markedly in 1982. Overall ceilings on domestic bank credit to the private sector were eliminated, and the rate of growth of credit accelerated significantly. Liquidity was also boosted by a sharp increase in foreign borrowing by the Government. The easing of financial policies was reflected in a rebound of domestic demand, which rose by 7.5 percent, while GDP growth remained below 5 percent as the foreign balance deteriorated markedly (Table 1). A strong performance of services contributed, however, to maintaining the current

account deficit of the balance of payments near 7 percent of GDP (Table 2). The rate of inflation in consumer prices decelerated to 6.4 percent, mainly reflecting the moderation of import prices.

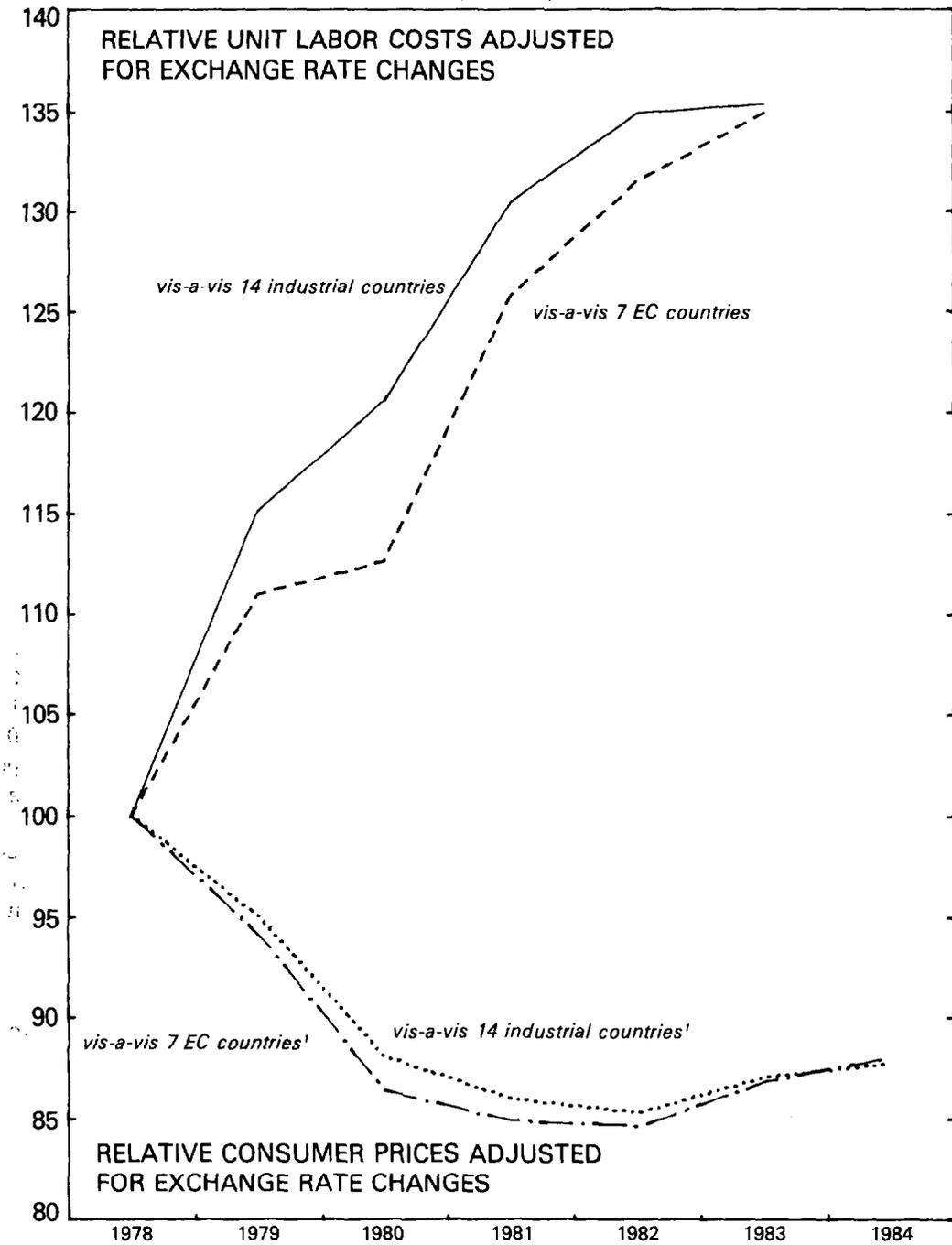
Financial policies remained accommodating in 1983. The deficit of the Central Government widened to £C 77 million (7.1 percent of GDP) from £C 59 million (5.9 percent of GDP) in 1982 (Table 3), and the rates of growth of the monetary and credit aggregates continued to exceed significantly that of nominal GDP (Table 4). The rate of growth of nominal and real wages decelerated, however, significantly from the very high levels of 1982 and, in conjunction with continued moderation in import prices, facilitated a further slight deceleration in the rate of inflation in the CPI, to around 5 percent. The rate of growth of domestic demand in real terms, albeit moderating in comparison with the previous year, remained--at 4.7 percent--relatively high, and contributed to a further marked increase in imports (Tables 1 and 2). Domestic merchandise exports recorded a significant decline, in reflection of a continued deterioration in cost competitiveness (Chart 1), as well as of the recession in foreign demand, especially in Arab countries, which account for over 40 percent of Cyprus's exports.

The marked deterioration in the trade account was only partly offset by a 26 percent increase in receipts from tourism, which account for nearly 30 percent of foreign exchange earnings. Thus, the current account deficit of the balance of payments widened to £C 94 million (8.6 percent of GDP) (Table 2). This deficit was fully financed by capital inflows, mainly in the form of public sector borrowing so that the overall balance of payments continued to show a surplus, albeit much smaller than in the preceding two years. External debt outstanding rose to over £C 450 million (41.5 percent of GDP) from £C 366 million (under 37 percent of GDP) in 1982, and the debt service ratio increased from 10.5 percent of exports of goods and nonfactor services in 1982 to 13.3 percent in 1983 (Table 5).

Concern over the continuing rapid growth in domestic demand and the deterioration in the external accounts prompted the authorities to introduce at the end of 1983 a package of tax measures--mainly increases in excises and in customs duties--designed to yield about £C 16 million additional revenue (equivalent to 1.5 percent of private disposable income). These measures contributed to a significant moderation in private consumption and imports (excluding the purchase of two airbuses by Cyprus Airways) in the first half of 1984. Available indicators point, however, to a significant rebound in domestic demand and imports in the second half of the year, in reflection of an acceleration in government spending and in the rate of monetary expansion.

The deficit of the Central Government is officially projected to decline from the equivalent of 7.1 percent of GDP in 1983 to 6.2 percent in 1984, mainly as a result of the increased fiscal burden as public expenditure is expected to remain virtually unchanged in relation to GDP (Table 3). Developments in revenues and expenditures in the first half of the year appear to be broadly in line with the official projection,

CHART 1
CYPRUS
REAL EFFECTIVE EXCHANGE RATE INDICES
(1978=100)



Sources: IMF, *International Financial Statistics*; data provided by the Cypriot authorities; and staff estimates.
1The 1984 value is the average for January through September.

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but there is a danger that spending especially on subsidies and on interest payments may be stepped up in the second half of the year, leading to some excess of the budget deficit over the official estimate. The composition of the financing of the deficit is expected to shift toward domestic bank credit, as the authorities attempt to moderate the growth in the external debt. The expansion of domestic credit to the public sector is projected to contribute over 5 1/2 percentage points to the growth of broad money in 1984. The total financing of the budget (excluding issues of bonds to the nonbank public) is likely to contribute nearly 9 percentage points to monetary expansion. The growth of domestic bank credit to the private sector is projected to decelerate to a rate (just over 11 percent) more closely in line with the growth of nominal GDP than in previous years. However, also in reflection of the expected increase in net international reserves, monetary growth will continue to exceed significantly the increase in nominal GDP, leading to a further decline in income velocity (Table 4).

The progress recorded in 1982 and 1983 on the inflation front is expected to be partly reversed in 1984, as a small deceleration in unit labor costs is likely to be more than offset by an acceleration in the growth of import prices (Tables 1 and 2). The 12-month rate of inflation in consumer prices picked up from 4.5 percent at the end of 1983 to over 7 percent during the summer, partly reflecting a spurt in food prices on account of temporary shortages of some produce items. The increase in retail prices has, however, moderated in recent months, and for the year as a whole is expected to remain around 5 1/2 percent.

The deficit in the current account of the balance of payments is expected to widen substantially, to around £C 135 million (11 percent of GDP). This deterioration is, however, mainly due to the purchase by Cyprus Airways of two airbus planes valued at £C 59 million (4.8 percent of GDP). Net of this exceptional factor, the current account deficit should show a significant improvement in 1984--to a level equivalent to 6 1/4 percent of GDP--on account of the moderation of imports in the first half of the year, of a strong recovery of exports and of a projected 40 percent increase in receipts from tourism (Table 2). The rebound in exports reflects mainly a good harvest and unusually high potato prices, which boosted agricultural export earnings, and a recovery in sales to Arab countries, especially Lybia. Nonagricultural exports to industrial countries (especially the EC) remain relatively depressed, a fact probably not unrelated to the appreciation of the Cyprus pound vis-à-vis the main European currencies over the last two years.

The overall balance of payments is expected to record a sizable (£C 17 million) surplus in 1984, on account of continued substantial foreign borrowing by the Government and by semipublic institutions. Total external debt is likely to exceed £C 525 million (43 percent of GDP) by the end of 1984. However, due to the timing of scheduled amortizations and the recovery in foreign exchange earnings, the debt service ratio is expected to decline slightly in 1984. Gross international reserves stood at the equivalent of US\$594 million (US\$577 million in

foreign exchange, or over six months of imports) at the end of August 1984. About 45 percent of gross international reserves is, however, accounted for by foreign liabilities of the banking system, mainly in the form of foreign currency deposits by nonresidents.

2. Economic policies and prospects

The staff report on the 1983 Article IV consultation with Cyprus (SM/83/166, 7/29/83) discussed some unsatisfactory aspects of the economic performance of Cyprus in recent years and their causes. In particular the report pointed to the persistence of relatively high current account deficits in the balance of payments, with attendant rapid increase in external indebtedness, despite a virtual stagnation of productive investments especially in the manufacturing sector. The main factors behind these worrisome trends were identified in the rise of government spending in relation to GDP, with consequent maintenance of the budget deficit at over 6.0 percent of GDP, in an accommodating stance of monetary and credit policies through most of the recent years, and in the rapid growth of real wages in excess of productivity gains--although the corresponding effect on income shares has probably been partly offset by a lower tax burden on nonwage incomes on account of generous tax incentives and higher tax evasion.

The Cypriot authorities noted that some of the deteriorating trends in the economy had been arrested in 1984. Growth is estimated to approach 5 percent compared with 3 percent in 1983, with a significant positive contribution stemming from the foreign balance (excluding the purchase of aircraft). A clear deceleration is projected in the growth of disposable income and consumption, while some recovery is expected in productive investment. While recognizing that an important role in the improved economic performance in 1984 was played by external factors probably of a nonrecurring nature, the authorities also felt that a contribution had been made by the relative moderation in wage demands and by some tightening of fiscal policy, particularly in the first part of the year.

The authorities are, however, conscious that many of the underlying weaknesses in the economy, including rigidities which hamper the effectiveness of existing policy instruments, remain very much untackled and that, in the absence of firm corrective action, the economic performance would in all probability deteriorate again in 1985 and beyond. The authorities also recognize that, while the still relatively low level of the external debt service and the availability of foreign financing could disguise the external constraint for some time to come, adequate corrective measures are needed soon if a sharp and costly adjustment effort is to be avoided over the medium term. The discussions focussed on the prospects for the economy in 1985 on present trends and on the scope for corrective policies.

a. Prospects

The record of the economic performance of Cyprus in the last several years has highlighted the sensitivity of this small, open economy to often unforeseeable external developments. This fact, as well as the

scarcity of reliable statistical information ^{1/} make it difficult to forecast with any precision the likely behaviour of economic aggregates in the year ahead. The staff projections presented in Tables 1-4 are based on the assumptions of the maintenance of a relatively favorable external environment--with the growth of foreign demand remaining around 5 percent and no significant loss in the terms of trade--as well as of a rather accommodating stance of financial policies. The consolidated deficit of the Central Government is projected to rise to around 7.5 percent of GDP, in reflection of a deceleration in the growth of tax receipts and of a pickup in both current and capital spending. The financing of such a deficit could be expected to contribute over 9 percentage points to monetary growth in 1985. Assuming the maintenance of the rate of growth of credit to the private sector at the same level as in 1984, the growth of total domestic credit would remain, at over 14 percent, relatively high. In the circumstances, and given available evidence of a substantial buildup of excess liquidity in the economy over the last couple of years, the overall balance of payments could be expected to shift into deficit even under the assumption of an increased recourse of the public sector to external borrowing.

The projections are further based on the assumption of no modifications to the existing wage indexation mechanism and of the maintenance of nominal wage increases--including contractual increases and wage drift--below 10 percent. Within this framework the rate of growth of domestic demand--after adjustment for the differential impact of the purchases of airbuses in the two years ^{2/}--is likely to accelerate significantly between 1984 and 1985, reflecting a pickup in both consumption and investment. The real trade balance is expected to show a substantial deterioration, in reflection of a marked decline in the growth of merchandise exports from the abnormally high level of 1984 and of the maintenance of a rapid rate of growth of imports, excluding the aircraft. The rate of inflation is projected to continue edging up although, on the working assumption of a stabilization of the U.S. dollar/Cyprus pound rate at around its current level, its acceleration is likely to remain modest.

The impact of the deterioration in the trade balance on the current account of the balance of payments is likely to be cushioned once again by a strong performance of tourism, with the growth in tourism receipts remaining, at 15 percent, relatively high albeit decelerating. The current account deficit is expected to decline slightly in relation to GDP from its record level of 1984; this, however, mainly reflects the

^{1/} Information on the national accounts, wage and cost developments and on industrial production is only available on an annual basis. Data on developments in volume and prices of foreign trade are available on a monthly basis but econometric analysis is further hampered by the structural break that occurred in most time series as a result of the partition of the island after 1974.

^{2/} One further aircraft is expected to be imported in 1985, at a cost of EC 25 million (1.9 percent of GDP).

reduced aircraft purchases. After adjustment for this factor, the current deficit would increase by nearly 2 1/2 percentage points in relation to GDP.

The Cypriot authorities did not find substantial difficulties with the staff projections but noted that these projections were especially sensitive to the assumptions about the export performance on the one hand, and about such parameters as the savings ratio and the elasticity of imports to aggregate demand, on the other. They were hopeful that a more sustained growth of exports could be maintained and that the rates of growth of both consumption and imports could be contained to more moderate levels, leading to a somewhat better balance of payments outcome than that projected by the staff. Nevertheless, they recognized that, even if the current account deficit could be limited to around £C 100 million, it would remain relatively high and would indicate no underlying improvement with respect to 1984. Therefore, they saw a clear need to secure a significant improvement in the economic policy stance for 1985 as well as for the medium term.

b. The scope for corrective action

The Cypriot authorities recognize that the current position and trends in the public finances constitute a major area of weakness in economic policy. The maintenance of relatively high deficits in the central government budget, particularly in the presence of a legal ceiling on interest rates which limits the scope for recourse to nonbank financing, severely constrains monetary policy on the one hand, and leads to a rapid accumulation of external debt, on the other. In a medium-term perspective, the objective of ensuring the stabilization of the external debt service at a sustainable level, while limiting the growth of domestic credit to rates consistent with a moderate growth of activity and a stable inflation performance, will inevitably require a corresponding moderation of the public sector deficit.

In the absence of corrective actions, the public sector deficit is certain to rise significantly in relation to GDP in 1985 on account of several factors: (a) an adjustment recently granted by the Government in the brackets of the personal income tax, expected to reduce revenue by about £C 3 million; (b) a moderation in the rate of growth of indirect taxation, which was boosted in 1984 by the tax package of end-1983; (c) a continued rapid growth of interest payments on the public debt; and (d) the start-up of some major investment projects, such as the southern conveyor project for water resource development in the southern section of the country.

The Cypriot authorities noted that, although the tax burden remains relatively low in comparison to countries with similar levels of development, the scope for raising it through increases in the rates of existing taxes is limited. Rates of taxation--both direct and indirect--are relatively high but the tax burden is unevenly distributed due to differential

rates of tax evasion, on the one hand, and to widespread loopholes and exemptions on the other. The authorities see as more promising means of securing a steady but moderate increase in the tax ratio over time the widening of the tax base, through the early introduction of VAT and through a reduction of existing loopholes, and a substantial strengthening of tax administration and enforcement. A draft bill for the introduction of VAT has been prepared and is expected to be presented to Parliament in the very near future, after review by a technical assistance team of the Fiscal Affairs Department of the Fund. A number of recommendations to improve tax administration and to reduce the erosion of the tax base were made both by the IBRD ^{1/} and by government-appointed commission, and the Cypriot representatives were confident that they could begin to be implemented in 1985.

A possible area of action to contain the prospective budget deficit was identified in subsidies which currently absorb nearly 10 percent of current expenditure and which have been growing rapidly in recent years, as prices for subsidized grain products have not been adjusted since 1974 and currently stand over 50 percent, on average, below world market prices. Despite foreseeable political resistance, the authorities expressed their intention to enact a sizable increase in these prices for 1985. Recent studies suggest that the direct impact of such price increases on the retail price index would be small, although there could be significant second-round effects from the likely increase in meat prices which would follow unless existing restrictions on imports of meat products were liberalized.

9. A significant reduction of the budget deficit below its currently projected level would greatly facilitate the deceleration in the growth of the monetary and credit aggregates which would be required to ensure a gradual absorption of the existing excess liquidity in the economy. The authorities recognized that, in this respect, it would also be appropriate to seek a decline in the rate of growth of credit to the private sector. In their view, the preferred way of achieving this objective would be greater flexibility in interest rate policy. They were, however, not very hopeful that long-standing political resistance in Parliament to a raising of the legal ceiling on interest rates could be overcome. The authorities were also becoming increasingly conscious of the distortions fostered by existing selective credit ceilings on trade and personal loans, as well as of their ineffectiveness as instruments of overall credit control, and were, therefore, considering their abolition in 1985. Thus, they saw changes in reserve requirements and in the banks' liquidity ratio as the main instruments of monetary control for the near future. They also indicated their intention to step up their efforts to bring cooperative credit societies (which account for about 25 percent of consumer credit) under supervision by the Central Bank.

^{1/} IBRD, Cyprus--Trends and Issues in Public Finance--Country Program Department II, EMENA, July 1984.

The authorities recognize that, while the deceleration in prices and wages in the last two years has made the problem of labor costs less acute, the existing full wage indexation mechanism continues to represent an important rigidity in the system which greatly weakens the effectiveness of other policy instruments (such as the exchange rate, indirect taxes and administered price increases) and, in conjunction with inevitable wage drift and unions' pressures for contractual increases, leads to sizable increases in real wages, often above productivity gains. In principle, indexation could be modified through a government decree, without resort to legislative action. The Government has, however, so far refrained from such action in the face of strong opposition by the relatively powerful trade unions. Instead, the authorities have concentrated their efforts on containing contractual increases, especially in the public sector. At the time of the consultation discussions, important negotiations had begun in some semipublic organizations--such as the Telecommunications Authority--which were expected to set the pattern for subsequent wage contracts in other public institutions and in the private sector as well. The Cypriot representatives were hopeful that, despite initial union demands for increases on the order of 7 percent over two years, contractual increases could be avoided or limited to around 1-1.5 percent a year, which would be consistent with the maintenance of nominal wage increases below 10 percent in 1985, on the assumption of no significant acceleration of inflation.

In the authorities' view such an outcome would be consistent, given the foreseeable growth of productivity, with the broad maintenance of the current level of cost competitiveness, on the assumption of no further appreciation of the exchange rate in effective terms. The authorities recognize that competitiveness as measured by relative unit labor costs has suffered a substantial deterioration over the last several years, although its effects on the export performance have apparently been offset by not easily quantifiable factors, especially the low effective burden of taxation on profits, and by relatively low other costs of production, including the cost of capital. The deterioration appears to have been especially pronounced vis-à-vis European currencies in 1983 and 1984. The authorities reiterated, in this respect, their view that adjustments in the exchange rate, given the full indexation of wages, only secure a temporary improvement in competitiveness, while their costs in terms of the inflation performance are likely to be high. They felt that the maintenance of a satisfactory export performance should be sought through continued efforts to secure wage moderation and to improve the quality of Cypriot products as well as their marketing.

The importance of a relatively rapid growth of export earnings over the medium term is highlighted by some illustrative scenarios of developments in the external debt and its service through 1991 prepared by the staff. These scenarios, which are summarized in Table 6 and discussed in Appendix III, clearly illustrate three basic conclusions: (a) A sustained growth of exports (especially of goods, in the light of the natural

limits on the growth of tourism) is essential in the medium-term if a reasonable rate of GDP growth is to be maintained without running into severe external constraints. The growth of exports is to be accompanied by the containment of domestic demand so as to be consistent with a moderate growth of imports (Scenario A). (b) Any attempt at compensating a slow growth of exports through a boost to domestic demand is bound to lead over time to an unsustainable level of the external debt and its service (Scenario B). (c) If adjustment is postponed and then forced upon the economy by a drastic reduction in available external financing, it would lead to a sharp cutback in the growth of demand and output, with likely severe political and social costs (Scenario C). The average growth rate over the whole period would remain below that which could be achieved with one early and sustained adjustment (Scenario D).

Cyprus maintains a restriction on current payments subject to Fund approval under Article VIII, in the form of a maximum £C 350 allowance per person per year for tourist travel. The current limit was set in January 1982, when the allowance was raised by £C 50. The Central Bank has informed the staff that the allowance will be raised to £C 450 effective January 1, 1985. Residents purchasing a tour package in Cyprus are allowed to deduct the normal air fare from the cost of the package for purposes of computing the travel allowance. The allowance for business travel is not fixed, but depends on the length of stay abroad, the country or countries to be visited, and the purpose; for medical treatment abroad, the amount is unlimited but based on actual expenses. The allowance for Cypriots studying abroad include the full amount of tuition plus living expenses (for details see Appendix II of the recent economic developments paper). The authorities regard the maintenance of such a restriction as necessary in the current conditions of political uncertainty and balance of payments weakness.

III. Staff Appraisal

The economic performance of Cyprus in the final months of 1983 and in the first half of 1984 appears to have interrupted the deteriorating trends evident in recent years, particularly in the external accounts. The current account deficit of the balance of payments, excluding the purchase of aircraft, narrowed significantly while growth, spurred by a strong performance of exports and tourism and by a recovery of investment, accelerated and inflation remained on a moderate course. The factors behind this improvement appear to be to a considerable extent of an external nature or at any rate beyond the control of the authorities, such as the good harvest, although a role was also played by the enactment of a package of tax measures and by some deceleration in the growth of labor costs.

There are, however, signs that these favorable trends have already begun to be reversed. The growth of imports, in particular, is accelerating markedly, reflecting a pickup in domestic demand, linked to the maintenance of a relatively loose overall stance of financial policies, in particular a budget deficit which through its domestic and external financing is expected to contribute nearly 9 percentage points to the growth of broad money in 1984. If the trends evident in the economy in recent months are confirmed in the last quarter of the year, the current account deficit of the balance of payments could reach a very high level in relation to GDP, also in reflection of the exceptional imports of aircraft, and the external debt/GDP ratio could exceed 43 percent, a level which is high by international standards and nearly double that prevailing five years ago.

What is more worrisome is the fact that, in the absence of early and determined corrective actions, and barring exceptional favorable developments, which should not be counted upon, the economic performance can be expected to deteriorate further in 1985. The growth of consumption is likely to accelerate in 1985, boosted by continued relatively rapid growth of real disposable income and by the existence of excess liquidity in the economy. At the same time, the starting of large public investment projects will boost fixed capital formation. This will be reflected in a further spurt in imports while the growth of exports of goods and services will inevitably decelerate substantially from the abnormally high rate recorded in 1984. In these circumstances the current account deficit could rise in nominal terms from the high level of 1983, despite the reduction in imports of aircraft. This would lead to either a further significant rise in the ratio of the external debt to GDP or to a substantial loss of net international reserves. The rate of inflation may also begin to rise, especially if the exchange rate were to come under some pressure.

In the view of the staff, a minimal objective for economic policy in 1985 would be the maintenance of the current account deficit of the balance of payments at the same level as in 1984 (excluding in both years the purchase of aircraft). Indeed, it would be desirable to aim at a lower target, and gear financial policies accordingly, so as to leave room for some easing of policies in 1986. Staff calculations suggest that, in the light of the current prospects for exports of goods and services, the attainment of even this minimal target would require a marked cutback in the projected growth of domestic demand. In order to safeguard productive investment, the brunt of this cutback should be borne by consumption through measures aimed at containing the growth of real disposable income and at raising the savings ratio.

The central role in the corrective effort should be played by fiscal policy, through a substantial reduction of the deficit of the Central Government from its currently projected level for 1985. It is important that the deficit not be allowed to increase from the 1984 level, which

IV. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Cyprus's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Cyprus, in the light of the 1984 Article IV consultation with Cyprus conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Cyprus maintains a restriction on the amount of foreign exchange made available for foreign travel. The Fund notes that the authorities have decided to raise the amount of the allowance effective January 1, 1985 and, in the light of the current political and economic circumstances of the country, it grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Fund Relations with Cyprus

(As of October 31, 1984; in millions of SDRs)

I. Membership status

Cyprus became a member of the Fund on December 21, 1961. Cyprus continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement.

A. Financial Relations

II. General department

- (a) Quota: SDR 69.7 million.
- (b) Total Fund holdings of Cyprus pounds: SDR 69.27 million (99.38 percent of quota).
- (c) Fund credit: SDR 4.24 million (6.1 percent of quota) arising from the stand-by. No resources used under enlarged access and no compensatory financing.
- (d) Reserve tranche position: SDR 4.675 million.
- (e) Current operational budget: no use of the Cyprus pound is planned in the current budget.
- (f) Lending to the Fund: Cyprus is not a participant.

III. Stand-by or Extended Arrangements and Special Facilities

A one-year stand-by program (first credit tranche) equivalent to SDR 8.5 million covered the period June 1980-June 1981 with one purchase of SDR 8.5 million in August 1980.

IV. SDR Department

- (a) Net cumulative allocation: SDR 19.4 million.
- (b) Holdings: SDR 0.592 million or 3.04 percent of net cumulative allocation.
- (c) Current designation plan: Cyprus is not included in the current plan.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

is already relatively high. Within this constraint it would be desirable to make room for the targeted increase in public investment through an adequate reduction in the public sector dissaving. Such a reduction could be achieved through a combination of measures including the introduction of VAT by mid-year, selective increases in existing indirect taxes (e.g. on oil products), the closing of some tax loopholes and strengthened efforts on tax enforcement and collection. On the expenditure side, it would be desirable to ensure a significant cut in grain subsidies, a reduction in public employment through attrition and strict adherence to the policy of no contractual increases for civil servants, as well as a tight control over purchases of goods and services. To the extent that these measures cannot effect the necessary cutback in the deficit, the postponement of some proposed public investment projects should be considered, along with increases in user charges to allow a greater cost recovery.

Budgetary restraint should be accompanied by a clear deceleration in the growth of credit to the private sector, to at most a rate in line with GDP growth, in order to ensure a needed moderation in the growth of broad money and to allow a gradual reabsorption of existing excess liquidity. A moderate tightening of financial policies, without resorting to quantitative credit controls which have well-known costs over the longer run in terms of the efficiency of the banking system and the allocation of resources, would be greatly facilitated by a lifting of the existing ceiling on interest rates and by bringing the cooperative credit societies under supervision by the Central Bank. The staff would urge the authorities to intensify efforts in both of these areas.

The tightening of fiscal and financial policies is, in the view of the staff, an essential condition for a moderation in the growth of nominal incomes, particularly in an economy close to full employment, such as that of Cyprus. Financial restraint could, however, usefully be complemented by specific actions in the area of wage determination, particularly by a firm refusal to grant contractual increases to public and semipublic employees and by renewed efforts to secure the political consensus for a modification of the indexation mechanism, in conjunction with a credible effort to reduce tax evasion by nonwage income earners. A significant further moderation in the growth of labor costs is necessary for a lasting recovery of productive investment and continued growth of employment over the medium term. It is also an essential condition for a sustained growth of domestic exports, especially of the manufacturing sector and toward industrial countries, while maintaining a policy of broad stabilization of the effective exchange rate. The staff appreciates the merits of such a policy in a context of full wage indexation and consequent downward rigidity of real wages such as the one currently existing in the Cypriot economy. These limitations of the exchange rate as an instrument of adjustment make correspondingly greater the need for alternative means to safeguard the competitiveness of the economy, including moderation in contractual wage increases, efforts to increase productivity, and improvements in nonprice determinants of competitiveness. As indicated by the external debt scenarios prepared by the staff, a strong export

performance is crucial to allow a sustained growth of the economy over the medium term without excessive resort to external indebtedness. Moreover, a rapid export growth would facilitate the reduction of protection which remains relatively high in the Cypriot economy, with clear costs in terms of efficiency and allocation of resources.

B. Nonfinancial Relations

VII. Exchange rate arrangements

Since July 1973, the market rate for the Cyprus pound has been adjusted daily to maintain its effective relationship with the currencies of the main trading partners. The effective rate appreciated by 3.2 percent in 1982 and a further 4.6 percent in 1983. On June 30, 1984 the rate of the Cyprus pound was £C 1 = SDR 1.6742.

VIII. The last Article IV consultation was concluded in May 1983 and the staff report (SM/83/166, 7/29/83) was discussed by the Executive Board on September 2, 1983. At that time the following decision was adopted:

1. The Fund takes this decision relating to Cyprus's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Cyprus, in the light of the 1983 Article IV consultation with Cyprus conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Cyprus maintains a restriction on the amount of foreign exchange made available for tourist travel. The Fund notes that the authorities intend to relax it as soon as circumstances permit, and in these circumstances grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Cyprus is on a 12-month consultation cycle.

IX. Technical assistance

A Fund mission from Fiscal Affairs Department is currently visiting Cyprus advising the authorities on the introduction of VAT at the earliest date possible.

Basic DataArea and population

Area (whole island)	9,251 square kilometers
Population	532,000
GNP per capita (1983)	£C 2,058

<u>Income and expenditure in 1983</u> (at current prices)	<u>In millions of</u> <u>Cyprus pounds</u>	<u>In per</u> <u>cent</u>
Private consumption	701.3	64.1
Public consumption	188.4	17.2
Gross capital formation	348.0	31.8
Gross domestic expenditure	1,237.7	113.1
Exports of goods and services	572.7	52.3
Imports of goods and services	728.4	66.5
GDP at market prices	1,094.8	100.0

<u>Selected economic indicators</u> (annual percentage change)	<u>1981</u>	<u>1982</u>	<u>1983</u>
GDP (at constant market prices)	3.0	4.8	4.9
Private consumption (at constant prices)	3.4	9.5	5.5
Gross fixed investment (at constant market prices)	-7.7	1.0	2.1
Manufacturing output	6.8	4.0	2.6
Unit labor costs in manufacturing	19.8	10.4	5.4
Consumer prices	10.8	6.4	5.1

<u>Public sector accounts (as per cent of GDP)</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
<u>Consolidated Central Government</u>			
Tax revenue	18.5	19.0	20.4
Current expenditure	25.2	25.1	27.5
Current balance	-2.9	-1.7	-2.3
Overall balance	-6.9	-5.9	-7.1

<u>Balance of payments (in millions of SDRs)</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
Exports, f.o.b.	432	454	410
Imports, f.o.b.	888	989	1,024
Trade balance	-456	-535	-614
Net invisibles	329	397	447
Current account balance	-127	-138	-167
Medium- and long-term capital	176	200	134
Short-term capital	13	23	38
Overall balance	62	85	5
Foreign exchange reserves, year-end	382	490	564
External debt outstanding, year-end	536	680	777
Effective exchange rate (percentage change)	0.4	1.9	2.3

Sources: Data provided by the Cypriot authorities; and staff estimates.

Medium-Term External Debt Scenarios for Cyprus

The rapid growth of the external debt of Cyprus over the last few years and the prospect of the persistence of deficits in the current account of the balance of payments during the rest of this decade make it desirable to attempt a projection of the development of the external debt and its service burden over the medium term (specifically, through 1991) under alternative assumptions about the path of external adjustment of the economy during that period.

After extensive experimentation, the staff has selected four illustrative scenarios. The first (Scenario A) is designed to highlight the importance of a strong export growth for an open economy like that of Cyprus. In this scenario the path of the current account balance, external debt and its service are simulated under the assumption of a 6 percent a year real growth in foreign exchange earnings and a 4 percent growth in GDP, leading, on the assumption of an average elasticity of import to aggregate demand of 1.2 in volume terms, to a real growth of imports of 5.6 percent a year between 1985 and 1991.

Scenario B illustrates the consequences of attempting to maintain the same rate of GDP growth, in the face of a significantly reduced growth of foreign exchange earnings (4 percent a year in volume terms), through a faster growth of domestic demand. In this scenario it is assumed that there will be no constraints on the supply of external financing throughout the simulation period, despite the rapid deterioration in the indicators of creditworthiness. On the contrary, in Scenario C it is assumed that the country would be forced into adjustment by 1988 by a marked reduction in external financing. This scenario shows the compression of imports and consequently of GDP growth that would follow the decline in external financing. In this scenario, as in B, it is assumed that, in reflection of reduced creditworthiness, the cost of borrowing is higher than under Scenario A. Finally, Scenario D illustrates the results of early adjustment. In this scenario, where foreign exchange receipts are also assumed to grow by 4 percent a year in real terms, the current account deficit is nevertheless reduced significantly in 1985 and broadly maintained in relation to GDP thereafter. In the last two scenarios, the current account deficit is taken as a target and the rate of growth of imports consistent with such a target and with the assumed rate of growth of foreign exchange earnings is derived as a residual.

Assumptions common to all scenarios include no changes in the terms of trade, with exports and import prices growing both at 5 percent a year, a moderate growth in line with past trends of both nondebt capital inflows and interest receipts, equilibrium in the overall balance of payments and three years average grace period, with repayments equally spread over five years thereafter, for new loans.

The main results of the scenarios have been presented in Table 6 and commented upon in Section II-2 above. Sensitivity analysis on the assumptions underlying the three scenarios suggest that the results are likely

to be especially affected by changes in the assumptions regarding the elasticity of imports with respect to aggregate demand and the terms of borrowing (interest rates and grace periods). In this respect the staff regards the assumptions used in the scenarios as relatively optimistic ones.

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Table 1. Cyprus: Selected Economic Indicators, 1982-85

(Annual percentage change)

	1982	1983	1984 <u>1/</u>	1985 <u>2/</u>
Real demand and output				
Gross domestic expenditures <u>3/</u>	7.5	4.7	6.9	1.9
Private consumption	9.5	5.5	3.3	4.5
Public consumption	6.0	5.0	3.3	3.5
Gross fixed investment <u>3/</u>	1.0	2.1	20.2	-4.5
Increase in inventories <u>4/</u>	0.7	0.1	-0.6	0.2
Foreign balance <u>4/</u>	-3.8	-2.2	-3.0	0.6
GDP at market prices	4.8	3.0	4.9	3.1
Value added in manufacturing	4.0	2.6	4.8	2.5
Labor market				
Employment	0.9	1.8	1.6	1.2
Unemployment rate (level)	3.1	3.7	3.6	4.0
Average real wage rate	10.9	4.4	3.7	3.8
Average earnings in manufacturing	16.2	8.0	8.5	9.5
Productivity in manufacturing	5.3	2.5	4.1	2.5
Unit labor costs in manufacturing	10.4	5.4	4.4	6.8
Prices				
Consumer prices	6.4	5.1	5.6	6.0
GDP deflator	10.5	6.8	6.4	6.5
Income				
Private disposable income	14.1	10.5	9.0	10.0
Private savings rate (level)	28.7	28.3	28.2	27.6

Sources: Data provided by the Cypriot authorities; and Fund staff projections.

1/ Provisional estimates.

2/ Staff forecast.

3/ Adjusted for the purchase of airbus the rates of increase in domestic demand would be 2.4 percent in 1984 and 4.8 percent in 1985. The corresponding figures for fixed investment are 2.1 percent in 1984 and 5.4 percent in 1985, and those for the foreign balance 2.4 percent in 1984 and -2.4 percent in 1985.

4/ Contribution to GDP growth.

Table 2. Cyprus: Summary of the Balance of Payments, 1982-85

(In millions of Cyprus pounds)

	1982	1983	1984 <u>1/</u>	1985 <u>2/</u>
Exports, f.o.b.	238.1	230.7	300.0	324.0
Imports, f.o.b.	518.3	575.9	737.0	796.0
Merchandise trade balance	-280.2	-345.2	-437.0	-472.0
Services, net	174.2	212.0	276.0	306.0
Of which:				
Tourism, net	106.4	139.9	195.0	224.0
Investment income, net	-10.0	-23.4	-27.0	-37.0
Transfers, net	33.9	39.0	26.0	26.0
Current balance	-72.1	-94.2	-135.0	-140.0
As percent of GDP	(7.2)	(8.6)	(11.0)	(10.4)
Medium- and long-term capital	104.6	74.5	125.0	100.0
Short-term capital <u>3/</u>	12.0	22.5	27.5	28.0
Overall balance	44.5	2.8	17.5	-12.0
<u>Memorandum items :</u>				
(Percentage change)				
Market growth	1.5	3.0	5.5	5.0
Domestic exports, unit value (in local currency) <u>4/</u>	-2.2	-1.6	7.5	5.5
Domestic exports, volume <u>4/</u>	3.9	-7.0	19.0	2.5
Imports, c.i.f., unit value (in local currency) <u>4/</u>	0.1	1.7	6.0	6.0
Imports, c.i.f., volume <u>4/</u>	17.9	9.4	20.8	1.9
Effective exchange rate	1.9	2.3	...	...
U.S. dollar/Cyprus pound rate	-11.6	-9.8	-10.0 <u>5/</u>	-6.4 <u>5/</u>
Net international reserves (in millions of SDRs)	339.4	331.0	345.1 <u>6/</u>	...

Sources: Data provided by the Cypriot authorities; and staff estimates and projections.

1/ Provisional estimates.

2/ Staff forecast.

3/ Includes errors and omissions.

4/ Merchandise trade, customs basis.

5/ Based on the working assumption that the exchange rate would be stabilized at the average level prevailing in October 1984.

6/ End-June 1984.

Table 3. Cyprus: Consolidated Central Government Accounts, 1982-85

(In millions of Cyprus pounds, except as otherwise indicated)

	1982	1983	1984 <u>1/</u>	1985 <u>2/</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
					Percentage changes		
Current revenue	<u>232.7</u>	<u>275.4</u>	<u>318.7</u>	<u>356.0</u>	<u>18.4</u>	<u>15.7</u>	<u>11.7</u>
Of which:							
Direct taxes <u>3/</u>	95.0	113.4	134.1	152.0	19.4	18.3	13.3
Indirect taxes	94.0	110.1	130.3	142.0	17.1	18.4	8.7
Nontax revenue	43.7	51.9	54.3	62.0	18.8	4.6	14.2
Foreign grants							
Current expenditures	<u>249.7</u>	<u>301.0</u>	<u>333.5</u>	<u>382.0</u>	<u>20.5</u>	<u>10.8</u>	<u>14.5</u>
Of which:							
Wages, salaries, and goods and services	142.5	163.1	177.0	196.0	14.5	8.5	10.7
Subsidies and transfers	78.3	98.3	109.5	126.0	25.5	11.4	15.1
Interest payments	28.9	39.6	46.9	60.0	37.0	18.4	27.9
Current balance	<u>-17.0</u>	<u>-25.6</u>	<u>-14.8</u>	<u>-26.0</u>	<u>...</u>	<u>...</u>	<u>...</u>
As percent of GDP	(1.7)	(2.3)	(1.2)	(2.0)	...	...	...
Capital receipts and foreign grants	19.6	14.0	11.9	12.0	-28.6	-15.0	--
Capital expenditure <u>4/</u>	<u>61.4</u>	<u>65.7</u>	<u>73.4</u>	<u>86.0</u>	<u>7.0</u>	<u>11.7</u>	<u>17.2</u>
Of which:							
Fixed investment	33.8	41.8	48.2	60.0	23.7	15.3	24.5
Capital transfers	10.0	9.4	10.5	11.0	-6.0	11.7	11.7
Net lending	13.3	9.4	8.7	8.5	-29.3	-7.4	-2.3
Overall balance	-58.8	-77.3	-76.3	-100.0	...	...	...
As percent of GDP	(5.9)	(7.1)	(6.2)	(7.5)	...	...	...
External financing, net	49.0	28.2	13.3	44.0	...	...	...
Domestic financing, net	9.8	49.1	63.0	56.0	...	...	...
Of which:							
From banking system	-0.3	27.6	47.6	41.0	...	...	...
<u>Memorandum items:</u>							
Total taxes as percent of GDP	19.0	20.4	21.6	21.9	...	...	...
Total expenditure as percent of GDP	31.2	33.5	33.3	34.9	...	...	...
Share of indirect taxes in total taxes	49.7	49.3	49.3	48.3	...	...	...
Share of current expenditure in total expenditure	80.3	82.1	82.0	81.6	...	...	...

Sources: Data provided by the Cypriot authorities; and staff projections.

1/ Official estimate.

2/ Staff projection.

3/ Including social security contributions.

4/ Including net lending.

Table 4. Cyprus: Monetary Aggregates, 1982-85

	1982	1983	1984 <u>1/</u>	1985 <u>1/</u>
	(In millions of Cyprus pounds; at end of period)			
Net foreign assets	<u>188.2</u>	<u>196.2</u>	<u>213.7</u>	<u>202.0</u>
Net domestic credit	<u>630.7</u>	<u>721.2</u>	<u>833.7</u>	<u>951.0</u>
Public sector	<u>87.7</u>	<u>111.7</u>	<u>156.2</u>	<u>197.0</u>
Private sector	<u>543.0</u>	<u>609.5</u>	<u>677.5</u>	<u>754.0</u>
Broad money	<u>707.9</u>	<u>791.1</u>	<u>901.1</u>	<u>987.0</u>
Currency and demand deposits	<u>216.9</u>	<u>248.6</u>	...	...
Quasi-money	<u>491.0</u>	<u>542.5</u>	...	...
Other items, net	<u>-111.0</u>	<u>-126.3</u>	<u>-146.2</u>	<u>-166.0</u>
	(12-month percentage change)			
Total domestic credit	14.2	14.3	15.6	14.1
Credit to the private sector	17.4	12.2	11.2	11.3
Credit to public sector <u>2/</u>	-0.3	3.4	5.6	4.5
Broad money	17.9	11.8	13.9	9.5
Reserve money	24.0	15.9	...	...
Income velocity of M2 (level) <u>3/</u>	1.55	1.46	1.44	1.42

Sources: Data provided by the Cypriot authorities; and staff estimates and projections.

1/ Staff estimates and projections.

2/ Change in domestic bank credit to the public sector as percentage of initial money stock.

3/ Nominal GDP/average broad money stock.

Table 5. Cyprus: External Debt Outstanding and Debt Service Ratio, 1981-84

(In millions of Cyprus pounds; end of period)

	1981	1982	1983	<u>1984</u> June
Government <u>1/</u>	132.5	199.7	256.6	279.0
Public enterprises	71.5	92.6	105.0	159.0
Nonfinancial private sector	65.9	73.7	91.2	...
Total	<u>269.9</u>	<u>366.0</u>	<u>452.8</u>	<u>...</u>
Of which:				
Short-term	39.8	43.0	58.0	...
<u>Memorandum items:</u>		<u>(In percent)</u>		
Ratio of debt to GDP	31.4	36.8	41.5	...
Ratio of debt to gross official reserves	140.6	139.2	153.2	...
Share of short-term debt	14.7	11.7	12.8	...
Ratio of service on medium- and long-term debt to foreign exchange earnings <u>2/</u>	8.7	10.5	13.3	...

Source: Data provided by the Cypriot authorities.

1/ Excludes liabilities to the IMF.

2/ Foreign exchange earnings from exports of goods and nonfactor services.

Table 6. Cyprus: External Medium- and Long-Term Debt Scenarios, 1984-91

(In millions of Cyprus pounds or in percentages)

	1984	1985	1986	1987	1988	1989	1990	1991
A. Assumptions								
Percentage change in foreign exchange earnings ^{1/}	21.1	11.3	11.3	11.3	11.3	11.3	11.3	11.3
Percentage change in real domestic demand	6.4	1.5	1.8	3.9	3.9	3.9	3.9	3.9
Percentage change in imports of goods and services	23.3	6.9	7.2	10.9	10.9	10.9	10.9	10.9
Percentage change in real GDP	4.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Average interest rate on new external borrowing	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Results								
Current account deficit	-135	-116	-92	-100	-109	-119	-129	-140
As percent of GDP	11.0	8.7	6.3	6.2	6.2	6.1	6.1	6.0
Debt outstanding	547	620	668	722	781	847	921	1,002
As percent of GDP	44.8	46.3	45.4	44.7	44.1	43.6	43.2	42.9
Debt service ratio	11.9	13.4	12.6	14.0	15.2	14.9	14.5	14.7
Gross borrowing	195	217	194	226	261	281	304	336
B. Assumptions								
Percentage change in foreign exchange earnings ^{1/}	21.1	9.2	9.2	9.2	9.2	9.2	9.2	9.2
Percentage change in real domestic demand	6.4	2.6	2.8	5.0	5.0	5.1	5.1	5.1
Percentage change in imports of goods and services	23.3	6.9	7.2	10.9	10.9	10.9	10.9	10.9
Percentage change in real GDP	4.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Average interest rate on new external borrowing	10.5	10.5	10.5	11.0	11.0	11.0	11.0	11.0
Results								
Current account deficit	-135	-137	-136	-179	-227	-286	-357	-444
As percent of GDP	11.0	10.2	9.3	11.1	12.8	14.7	16.8	19.0
Debt outstanding	547	641	732	864	1,040	1,273	1,576	1,962
As percent of GDP	44.8	47.8	49.8	53.5	58.8	65.5	73.9	83.9
Debt service ratio	11.9	14.2	13.9	16.6	19.4	21.2	23.6	27.3
Gross borrowing	195	228	237	304	383	461	561	694
C. Assumptions								
Percentage change in foreign exchange earnings ^{1/}	21.1	9.2	9.2	9.2	9.2	9.2	9.2	9.2
Current account deficit	-135	-140	-150	-165	-145	-120	-110	-115
Average interest rate on new external borrowing	10.5	10.5	10.5	11.0	11.0	11.0	11.0	11.0
Results								
Debt outstanding	547	644	749	867	962	1,029	1,084	1,141
Debt service ratio	11.9	14.2	14.0	16.7	19.1	20.0	20.6	21.2
Gross borrowing	195	241	251	291	302	299	314	349
Permissible growth of imports of goods and services	...	7.2	8.2	8.2	5.6	5.8	7.6	8.9
D. Assumptions								
Percentage change in foreign exchange earnings ^{1/}	21.1	9.2	9.2	9.2	9.2	9.2	9.2	9.2
Current account deficit	-135	-100	-110	-120	-130	-142	-155	-170
Average interest rate on new external borrowing	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Results								
Debt outstanding	547	604	669	742	822	911	1,011	1,123
Debt service ratio	11.9	13.6	13.0	14.9	16.4	16.8	17.2	18.0
Gross borrowing	195	201	211	246	279	305	334	374
Permissible growth of imports of goods and services	...	3.4	8.9	8.8	8.7	8.8	8.8	8.9

Source: IMF staff calculations.

^{1/} Earnings from exports of goods and services (excluding interest receipts).