FOR AGENDA

SM/83/166

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August 1, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Cyprus - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Cyprus. A draft decision appears on page 14.

This subject has been tentatively scheduled for discussion on Friday, September 2, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Lorenzo L. Perez, ext. 60890.

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INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Article IV Consultation with Cyprus

Approved by L. A. Whittome and Subimal Mookerjee

July 29, 1983

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Messrs. E. Spitaeller L. Perez, and T. Catsambas, and as secretary, Ms. H. Walters (all EUR) visited Nicosia from May 18 to 31, 1983 to conduct Article IV consultation discussions. The mission met with the Minister of Finance, the Governor of the Central Bank and officials in the Ministries of Finance, Industry and Commerce and Labor, in the Planning Bureau and in the Central Bank. Mrs. Ter-Minassian and Mr. Spitaeller also met with the President of the Republic, Mr. Kyprianou. The last consultation discussions had taken place in October 1981 and the report was considered by the Executive Board on February 1, 1982.

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

II. Recent Economic Developments

Faced with a marked deterioration in the external accounts and with an acceleration of inflation, in reflection of excessive pressures of domestic demand and of labor costs, the Cypriot authorities introduced in mid-1980 a stabilization program which was supported by a stand-by arrangement with the Fund in the first credit tranche for the equivalent of SDR 8.5 million. The stabilization effort relied mainly on credit restraint, accompanied by a package of tax measures. These tax increases were, however, not sufficient to secure a reduction in the central government deficit since current expenditure rose much faster than projected. Thus, the brunt of the adjustment effort fell on the private sector, and significant declines were recorded in both consumption and investment in 1981 (Table 1). The program contributed to securing a substantial reduction in the current account deficit of the balance of payments from the equivalent of over 11 per cent of GDP in 1980 to about 7 per cent of GDP in 1981 (Table 2). The rate of consumer price inflation also decelerated from a peak of around 15 per cent in mid-1980 to below 11 per cent in 1981.

The rate of growth of GDP was sustained by a strong performance of exports of goods and services, and for 1981 as a whole it remained above 2 per cent.

The stance of financial policies was substantially relaxed in 1982, in response to the easing of external pressures and in order to promote a recovery in investment. At the beginning of the year the authorities eliminated the overall ceilings on bank credit to the private sector and reverted to the control of liquidity through changes in reserve requirements. The minimum liquidity ratio and the compulsory contributions to the Fund for Financing Priority Projects (FFPP) were raised in two steps from a combined total of 29 per cent of bank deposit liabilities to 32 per cent. Selective ceilings were maintained on credit for imports and domestic trade and on personal loans. The absence of penalties for excesses over the ceilings and, more importantly, a lack of flexibility in interest rates, which are set by law and which were barely positive in real terms, contributed to an acceleration in the growth of domestic bank credit to the private sector from about 14 per cent at the end of 1981 to over 17 per cent in 1982 (Table 3).

Some progress was recorded on the fiscal front, with the deficit of the Central Government (including the Social Security) declining from the equivalent of nearly 7 per cent of GDP in 1981 to 5.8 per cent of GDP in 1982. This decline reflected a relatively strong performance of tax revenue, which rose by over 1 percentage point in relation to GDP to around 18.7 per cent, an increase in nontax revenue from Central Bank profits and the containment of subsidies and of capital expenditure. Other current expenditure, notably transfers, interest payments on the public debt and the government wage bill, continued to increase at rates well in excess of the growth of nominal GDP. In 1982 there was also a substantial shift in the composition of financing of the public deficit. As the statutory limit on recourse by the Government to the Central Bank was being approached, and the inflexibility of interest rates prevented a significant increase in nonbank financing, the authorities stepped up sharply resort to external financing, and the Government's external debt rose by £C 88 million (over 8.5 per cent of GDP)(Table 5).

The easing of financial policies was quickly reflected in a sharp rebound in domestic demand, which was also boosted by an acceleration in the growth of real wages. Gross domestic expenditure rose by 6.6 per cent in 1982, following a decline of nearly 1 per cent in 1981. The most dynamic component of demand was private consumption which rose by 8.4 per cent, reflecting a strong growth of real disposable income and a small decline in the savings ratio. Fixed investment staged a moderate recovery from the sharp decline in 1981 but its growth appears to have been largely concentrated in the construction and services sector, as investment in manufacturing recovered only marginally, as a result of a continuing squeeze on profits of enterprises and of a downturn in merchandise exports.

The pickup in domestic demand led to a strong growth of imports, especially of consumer goods. Exports, on the other hand, decelerated markedly, in reflection not only of the weakening in external demand, especially from Arab countries, but also of the deteriorating trend in cost competitiveness (Chart 1). The poor performance of merchandise exports was, however, largely offset by a strong growth in exports of services. On the whole, GDP growth exceeded 4 1/2 per cent in 1982. Total employment rose by 1.5 per cent, while in the services sector it increased by over 4 per cent.

The recovery in demand and the maintenance of relatively tight labor market conditions (unemployment remains at just over 3 per cent of the labor force) contributed, along with the existence of a virtually full wage indexation mechanism, to the maintenance of a high rate of growth of nominal wages (around 17 per cent on average in the economy). Inflation, on the other hand, continued to decelerate in reflection of the moderation in external cost pressures and of the failure to adjust some administered prices. For the year as a whole, consumer prices rose by 6.4 per cent, resulting in an average real wage gain of 10 per cent and in a further squeeze on profits (Table 1).

Despite some improvement in the terms of trade, the trade deficit widened significantly in 1982, reflecting the deterioration in the real balance. These developments were largely offset by a marked improvement in the services account, especially tourism. The latter was, however, partly due to exceptional factors such as the influx of refugees from Lebanon in the wake of the hostilities in that country. The current account deficit rose slightly in absolute terms to £C 72 million (equivalent to about US$150 million) while stabilizing in relation to GDP at 7.2 per cent (Table 2). The net inflow of foreign capital, mainly in the form of direct investment and of official long-term borrowing, exceeded substantially the financing requirements of the current account, resulting in an overall surplus of £C 39 million. Gross official reserves increased by nearly US$100 million, to US$540 million (six months of f.o.b. imports) at the end of December 1982. Total external debt, as of the same date, amounted to the equivalent of US$750 million (over 36 per cent of GDP). The service payments on medium- and long-term debt are officially estimated to have risen to 10.5 per cent of exports of goods and services by 1982, compared with under 7 per cent in 1979 (Table 5).

The capital inflows contributed to the maintenance of the exchange rate at a relatively high level. In effective terms the Cyprus pound appreciated slightly (by about 2 per cent) in 1982, while vis-à-vis the U.S. dollar the depreciation was limited to 11 1/2 per cent. The real effective exchange rate, as measured by relative consumer prices, depreciated by 2 1/2 per cent, but competitiveness as measured by relative unit labor costs in manufacturing deteriorated significantly (by an estimated 4.5 per cent vis-à-vis industrial countries and by 5.4 per cent vis-à-vis the EC) (Chart 1).

III. Report on the Discussions

1. The overall economic policy strategy

In 1982 the Government presented the Fourth Emergency Economic Action Plan covering the period 1982-86. In contrast to the previous Plan for the period 1979-81, which laid emphasis on moderating demand pressures and on improving the balance of payments and the inflation performance, the Fourth Plan envisages a strategy aimed at securing a moderate growth in output (around 4 per cent a year), led by exports and investment, particularly in the manufacturing sector. The Plan also targets a continued moderation of inflation and a further reduction in the current account deficit of the balance of payments, to the equivalent of 4 per cent of GDP by 1986. The policy strategy in support of these objectives envisages steps to promote a shift in investment from housing toward other sectors of industry and services with good foreign exchange earning potential and to increase domestic savings, particularly through a reduction in the dissaving of the public sector.

The Cypriot representatives recognized that the economic performance in 1982 had fallen short of the Plan targets in various respects. Although GDP growth had exceeded expectations, it had been largely concentrated in the tertiary sector and had been led by consumption. Investment, especially in manufacturing, remained relatively depressed and domestic merchandise exports showed little, if any, growth. Also, no progress had been made in reducing public dissavings, as the reduction in the public deficit in relation to GDP had been achieved entirely through a containment of capital expenditures. The maintenance of a high rate of growth of real wages, well in excess of productivity, had contributed to the upturn in consumption and, through the attendant squeeze on profits, to the relatively poor performance of investment.

For 1983 the authorities' aim is to arrest some of the deteriorating trends in the economy, particularly as regards the composition of domestic demand, and to consolidate the progress made so far on the inflation front. More specifically, GDP is targeted to grow by 3 per cent, with investment rising by about 3 per cent, and inflation, as measured by consumer prices, to stabilize at around 6 1/2 per cent (Table 1). The balance of payments, on the other hand, is expected to show some deterioration, in reflection of a continued sluggishness of exports and of a sustained albeit decelerating growth of imports. Also expected are a deceleration in the growth of receipts from tourism and a significant increase in the interest burden on the external debt, contributing to an increase in the current account deficit to the equivalent of 8.5 per cent of GDP.

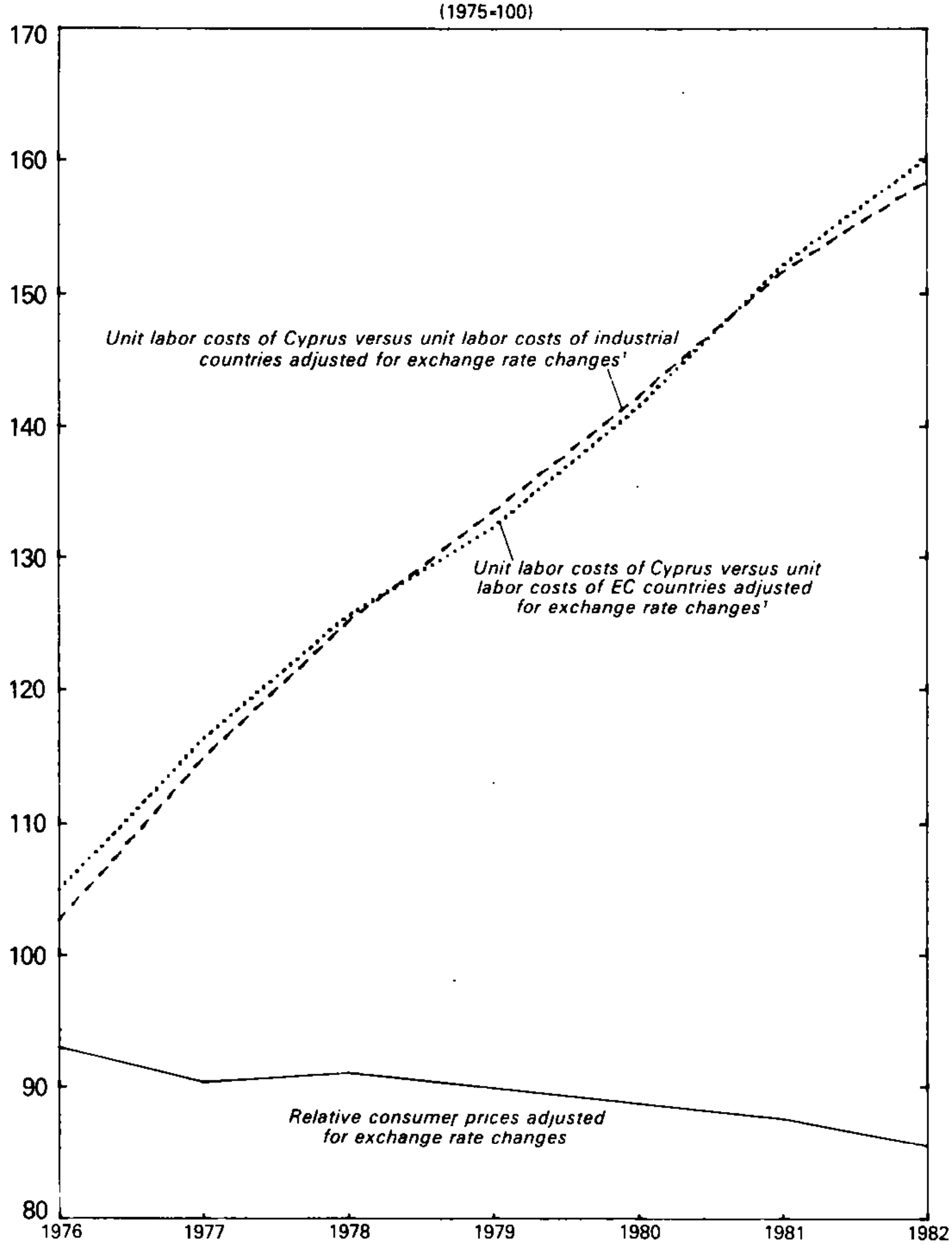
The announced policy strategy in support of the macroeconomic scenario outlined above encompasses a moderate tightening of monetary policy, a budget which targets the maintenance of the deficit of the Central

CHART 1

CYPRUS

REAL EFFECTIVE EXCHANGE RATE INDICES

(1975=100)



Sources: IMF, *International Financial Statistics*, data provided by the Cypriot authorities; and staff estimates

[1] The 1980 value is based on an interpolation between the 1979 and the 1981 data, due to a discontinuity in the employment series in that year

Government at the same level in relation to GDP as in 1982 and efforts to moderate the growth of real wages. Also contemplated are measures to promote exports, including increased but more selective incentives and efforts to achieve greater diversification of both products and markets.

The consultation discussions focused on an analysis of the announced policy stance, its consistency with the macroeconomic objectives for 1983 and the risks of slippages in its implementation.

2. Monetary policy

Recognizing the dangers that the continuation of rates of monetary expansion such as those recorded in 1982 would pose for the balance of payments and for inflation, the Cypriot authorities are targeting for 1983 a significant deceleration in the growth of monetary and credit aggregates. More specifically, the rate of growth of domestic credit to the private sector is to be reduced below 13 per cent, compared with 17.4 per cent in 1982 and the rate of increase in broad money is expected to decline to 12 per cent compared with 18 per cent in the previous year (Table 3). Domestic credit to the public sector is expected to increase sharply, reflecting a shift in financing of the central government deficit from external to domestic bank credit (Table 4). The monetary program is thought to be consistent with a loss in net foreign assets of the banking system equivalent to £C 17 million.

The Cypriot representatives recognized that, especially in the light of the existing degree of liquidity in the economy, the announced stance of monetary policy remained relatively accommodating. The projected rate of growth of M2 would imply a significant further decline in velocity, if the growth of nominal GDP were to be held at the official target. Moreover, the existing instruments of monetary control continue to be subject to significant weaknesses, although steps have been taken to increase their effectiveness. The present system of selective credit controls has been strengthened through the introduction of substantial penalties for excesses. Also, the ceilings on domestic bank credit for consumption and imports have been set at the same level as at the end of 1982. However, given that most importers are also engaged in domestic trade or in exports and that credit to those types of activity is not subject to ceilings, there remain significant loopholes in the system of credit control. A further weakness is the exclusion from the ceilings of credit extended by cooperative credit societies, which are likely to account for over a quarter of total consumer credit.

A more fundamental weakness in the system of indirect monetary controls is the existence of a legal maximum ceiling on interest rates, which has impeded the pursuit of an active policy of control of bank liquidity through open market operations. Thus, changes in the minimum liquidity ratio remain the principal instrument of monetary control. The Cypriot authorities recognized that any significant overrun in the budget deficit would endanger the achievement of the monetary objectives, as the inflexibility of interest rate policy prevented a sizable increase in the nonmonetary financing of the deficit. While they did not rule out the need for steps to absorb an excessive increase in bank liquidity later in the year, they were reluctant to tighten credit to the private sector at the present time, because, in their view, such a move would probably have an adverse impact on private investment.

3. Fiscal policy

For several years the consolidated budget of the Central Government has shown a rather high deficit in relation to GDP (Table 4). The tax ratio, albeit gradually rising, remains well below the level prevailing in most other countries at a comparable stage of development. This reflects widespread evasion, particularly of direct taxes on companies and on the self-employed, the absence of a broad-based consumption tax and a growing erosion of the tax base as a result of a pervasive system of fiscal incentives.

On the expenditure side, capital spending was boosted during the second half of the 1970s by the need to provide housing to refugees. While this is gradually decreasing, current spending continues to grow in relation to GDP. In particular, wages of civil servants have been rising at rapid rates, generally leading private sector wages. Subsidies, especially for grains and to wine producers, are relatively high and the interest burden on the public sector is increasing rapidly.

The 1983 budget targets the maintenance of the overall deficit of the consolidated Central Government at the same level (5.8 per cent) in relation to GDP as in 1982, which represented a significant reduction compared with 1981. This is to be achieved through a further small increase in the tax ratio (to just over 19 per cent of GDP) and through a sizable decline in capital spending in real terms, while current expenditure is projected to increase its share in GDP. The deficit is expected to be financed mainly by the domestic banking system. Financing by the nonbank public is expected to account for just over 15 per cent of the total borrowing requirements of the Central Government (Table 4).

The Cypriot representatives recognized that there were significant risks of an overrun in the projected deficit. The revenue forecasts imply a rate of growth of some tax items well in excess of the growth of the base. While for social security contributions this reflects increases in rates, as well as in the ceiling on taxable wages, for other tax items the projections are premised on a significant reduction in evasion. The authorities have completed a comprehensive study of needed improvements in tax administration and intend to proceed decisively in that area. However, the results of such an effort in the immediate future may be smaller than expected. Consideration was being given at the time of the consultation discussions to the possible introduction of a general sales tax and to increases in selected excise taxes, in order to curb consumer demand and to moderate the public deficit. The authorities noted however that the imminence of the summer Parliamentary recess would make it difficult to implement such measures before the fall.

On the expenditure side, significant risks of overruns exist in several items of current spending. There is considerable pressure by the civil servants' unions to gain additional wage increases. In the light of the current trends in international commodity prices and of the strength of the U.S. dollar, it also appears likely that additional appropriations will be needed for subsidies and for interest payments on the external debt of the Government. The authorities indicated a determination to resist demands for higher wage increases by the civil servants. They were also considering the possibility of raising prices of subsidized commodities in order to contain the subsidies to the targeted amounts.

The finances of the social security system in Cyprus do not give cause for immediate concern. A reform was introduced in 1980, which related both pensions and contributions to earnings. Pensions are adjusted in line with wages. The adjustment at the beginning of 1983, which reflected wage increases in the previous two years, resulted in a sharp (40 per cent) increase in pensions. Nevertheless, the system remains in a significant surplus, projected at £C 9.3 million in 1983. The medium-term outlook for the system is, however, very sensitive to demographic trends and to labor market developments, notably the evolution of unemployment and of wage increases.

A source of more immediate concern are the finances of some public enterprises, notably the Broadcasting Company and the Electricity Authority, both of which have recorded significant deficits, partly financed from abroad, in recent years. The financial position of the Electricity Authority has been substantially weakened by the fact that it is unable to collect revenues from the part of the island under Turkish occupation, to which it continues to provide electrical power.

4. Labor market and incomes policies

Labor market conditions have been relatively tight in Cyprus since the latter part of the 1970s. A rate of unemployment around 25 per cent immediately after the 1974 hostilities was rapidly reduced to just over 2 per cent by 1978, as a result of the high rates of growth of output prevailing during that period. The stabilization program and consequent deceleration in the growth rate resulted in an increase in unemployment in 1981 and, to a lesser extent, in 1982. The increase was concentrated in the industrial sector, both manufacturing and construction. However, at 3.1 per cent of the labor force, unemployment remains low by international standards. A large share of it (nearly one third) is accounted for by first job seekers, especially by university graduates. The authorities have instituted various training programs to improve labor mobility and to promote a better adaptation of labor supply to demand. They also provide subsidized loans to university graduates who start their own businesses and are promoting the development of consultancies, especially in Middle Eastern countries, as an outlet for university graduates.

The tightness of labor market conditions has been reflected in the rapid growth of real wages from an admittedly low level in 1975. Between that year and 1982 average earnings are estimated to have increased by nearly 100 per cent in real terms, as against a cumulative growth in productivity of around 50 per cent over the same period (Chart 2). These increases in real wages have reflected relatively high contractual settlements, individual increases and, especially in the public sector, job reclassifications. In addition, the purchasing power of workers, as measured by the relative price index, is assured by a full indexation mechanism with semiannual frequency. The authorities are conscious of the rigidities introduced in the economic system by a full wage indexation mechanism and in particular of the fact that the latter reduces the effectiveness of policy instruments such as the exchange rate and changes in indirect taxes or administered prices. They have repeatedly attempted to modify the indexation mechanism, so far unsuccessfully because of strong opposition by the unions. This opposition is partly motivated by the fact that the burden of direct taxation is heavily concentrated on labor income, because of widespread tax evasion by nonwage earners and of a relatively generous tax treatment of profits.

The Cypriot representatives noted that the lag in the indexation mechanism, in the face of a decelerating rate of inflation had contributed to a large increase in real wages in 1982. The rate of growth of wages was projected to decline significantly in 1983 (Table 1), as inflation was expected to remain around 6 per cent and wage settlements to moderate, as indicated by those concluded in the first few months of this year.

5. External policies

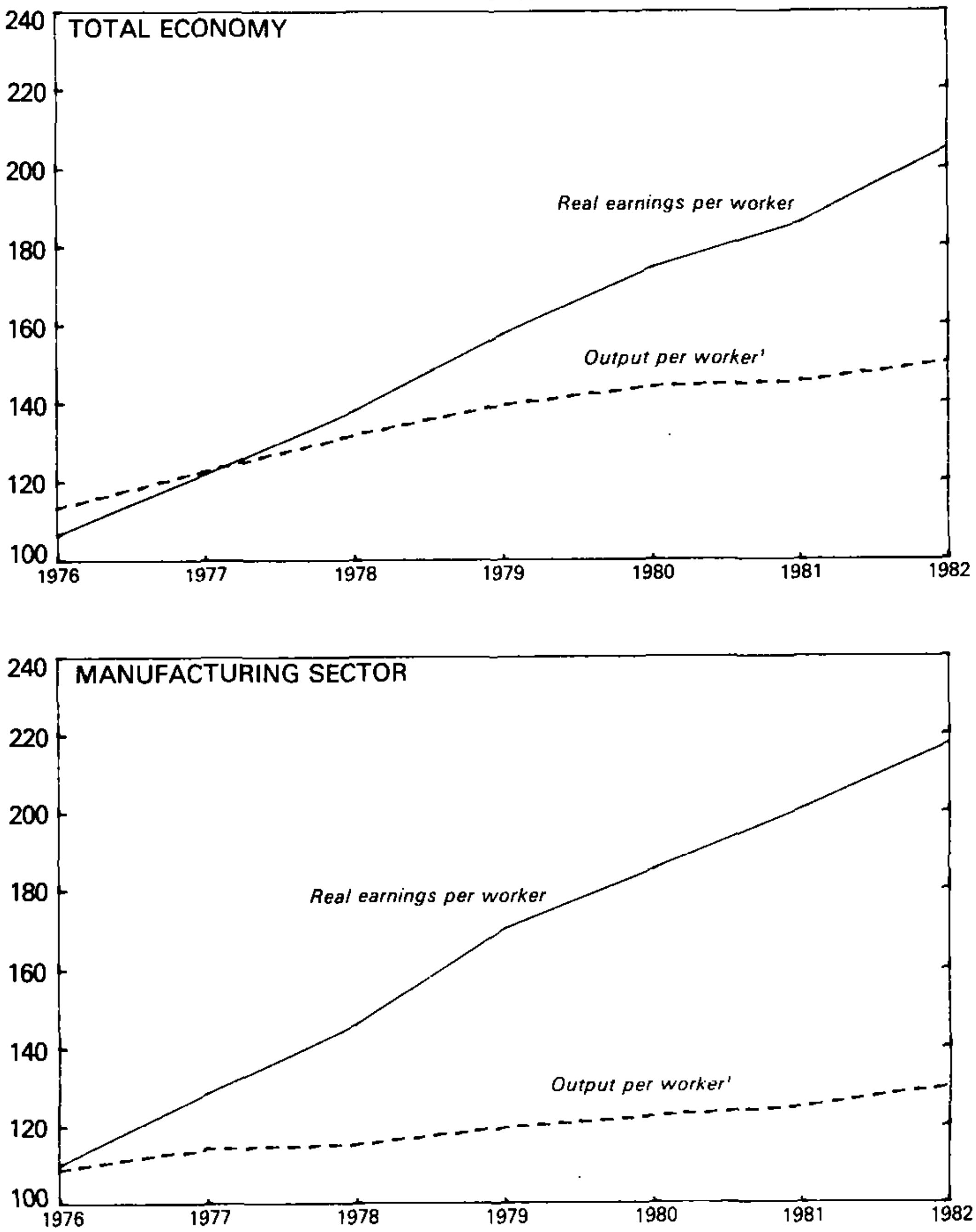
For several years, the stated objective of the Cypriot authorities has been the broad stabilization of the nominal exchange rate vis-à-vis a basket of partner countries' currencies. Nevertheless, the exchange rate appreciated in effective terms by about 4 per cent in the course of the last two years. During the same period the real effective exchange rate, as measured by relative consumer prices, depreciated by about 3 per cent. However, relative unit labor costs in manufacturing adjusted for exchange rate changes, which are a better indicator of competitiveness in the tradable sector, have deteriorated substantially not only vis-à-vis industrial countries but also with respect to such competitors as Greece, Spain, Portugal and some Far Eastern countries. The deterioration in relative unit labor costs may have been partly offset by other factors, such as lower real interest rates and a lower tax burden on profits in reflection of widespread fiscal incentives and tax evasion. Nevertheless, it is likely that the compression of profits in the manufacturing sector has played an important role in the deteriorating trend of merchandise exports.

CHART 2

CYPRUS

LABOR INCOME AND PRODUCTIVITY TRENDS

(1975=100)



Sources: Data provided by the Cypriot authorities, and staff estimates

[1] The value shown for 1980 is the result of an interpolation between the 1979 and 1981 values, due to a discontinuity in the employment series.

The Cypriot authorities recognize that a stable effective exchange rate could not be maintained indefinitely in the face of a growing divergence in costs between Cyprus and its main trading partners. They are, however, acutely aware of the fact that, given the large impact of import prices on domestic prices and the full and relatively rapid response of wages to price increases, the effects of an exchange rate depreciation are likely to be largely dissipated within one year. Thus, they see a substantial moderation in labor costs as the preferred way of maintaining competitiveness. They also noted that Cypriot exporters enjoy some advantages such as a favorable location at the crossroads between Europe and the Middle East, which partly compensates for cost differentials. They furthermore saw a potential for considerable improvements in marketing techniques which would, in their view, contribute to a recovery in exports. In this respect they noted the recent establishment of an Export Promotion Board which was charged with coordinating efforts in this area. Finally, they indicated their intention to increase export incentives, while making them more selective to stimulate new lines of export.

Receipts from tourism have traditionally accounted for a sizable share of foreign exchange earnings. Tourism has grown rapidly in volume during the last several years, contributing to the expansion of output and employment in the tertiary sector as well as in construction. Hotel capacity, as measured by the number of beds, is expected to almost double over the next two years, if the on-going and approved hotel construction is completed. The authorities are conscious of the risks that additional increases in capacity would create, particularly for the quality of tourist services, and instead intend to promote investment in infrastructure and recreational facilities which would help attract higher quality tourism.

Cyprus's external debt, at the equivalent of 36 per cent of GDP, remains relatively low but has risen at a very rapid rate in recent years, in reflection of high current account deficits and, in 1982, of a policy of financing most of the government deficit abroad. The Government accounted in 1982 for 55 per cent of the debt outstanding and the public enterprises for a further 25 per cent (Table 5). Illustrative staff projections of the evolution of the debt service burden over the rest of the 1980s indicate that, on the assumption of a relatively modest real growth of exports of goods and services (3.5 per cent a year) and with the current account deficit of the balance of payments remaining at around 8 per cent of GDP, the debt service ratio would average 13.5 per cent during the period. In that scenario, however, imports could only grow in volume by 3.5 per cent, i.e., at a rate well below that consistent with the medium-term growth objectives of the Cypriot authorities. A rate of growth of imports around 5 per cent a year would lead to an increase of the current account deficit to almost 19 per cent of GDP and of the debt service ratio to over 22 per cent by 1990 (averaging over 16 per cent during the period). On the other hand, if exports were to grow by a significantly higher rate (6 per cent a year), a sustained rate of growth of imports (also 6 per cent) would be consistent with the maintenance of the debt service ratio at 13 per cent on average during the period (Table 6). It is to be noted that these projections are based on relatively optimistic assumptions regarding real interest rates abroad and the inflow of nondebt capital, particularly direct investment.

III. Staff Appraisal

The trends apparent in the Cypriot economy in 1982 and the prospects for 1983 give cause for concern in a number of respects. The progress made in the adjustment of the economy after the introduction of a stabilization program in 1980 was largely interrupted in 1982. While the maintenance of satisfactory rates of growth of output and employment last year is to be welcomed, it is clearly a source of concern that growth was mainly sustained by domestic demand, especially by private consumption. Investment in manufacturing virtually stagnated and the performance of merchandise exports weakened sharply. The decline in exports, along with the upswing in imports particularly of consumer goods, led to a sharp deterioration in the trade deficit, only partially offset by an improvement in tourism which, however, was in part due to exceptional factors that cannot be counted upon to persist in the future. The deceleration in 1982 of the rate of inflation, as measured by the retail price index, was mainly a reflection of the moderation of external pressures and of the postponement of increases in some administered prices. The rate of growth of domestic costs remained relatively high and wages rose in real terms at a rate far in excess of productivity growth as well as of comparable increases in Cyprus's main trading partners.

The expansionary stance of financial policies in 1982 was largely responsible for the maintenance of rates of growth of domestic demand and costs which, in an international perspective, appear to be unsustainable over the longer term. On the fiscal side, although the deficit of the consolidated central government budget showed a small decline, partly in reflection of exceptional factors, it remained high in relation to GDP and continued to provide a significant impulse to domestic demand and to liquidity in the economy. On the monetary side, there remained significant weaknesses in the instruments of monetary control, especially the inflexibility of interest rates and the lack of penalties for noncompliance with the selective credit ceilings. In this context the abolition of the general credit ceilings led to a sharp acceleration in the growth of credit to the private sector, which financed mainly consumption and imports.

There are indications that domestic demand will continue to grow rapidly, and substantially faster than abroad, in 1983 sustained mainly by consumption, which in turn will boost imports. The volume of merchandise exports will at best grow modestly and the growth of tourism will lose some momentum. Accordingly, the deficit of the current account of the balance of payments is likely to deteriorate substantially, perhaps exceeding the equivalent of 9 per cent of GDP. Inflation is unlikely to decelerate further and could even show a reacceleration in the course of the year, in reflection of the continued pressure of domestic demand, of a further buildup of liquidity in the economy, and of the maintenance of a rapid rate of growth of labor costs.

Moreover, there are serious dangers of slippages in the implementation of the announced policy stance. In the fiscal area, there appear to be risks of overruns in the budgeted expenditures for wages and salaries of civil servants and for subsidies. Any significant excess in the budget deficit over the initial target would confront the monetary authorities with a difficult choice between tightening credit to the private sector or allowing an excessive degree of domestic credit expansion. Furthermore, given the statutory limit on government borrowing from the Central Bank and the present limited scope for nonmonetary financing, pressures would arise for additional recourse to external borrowing, thus adding to the rapidly growing burden of the foreign debt. There are also considerable risks of overruns in the targeted growth of credit to the private sector, due to the various existing loopholes in the system of credit control and to the inflexibility of interest rates.

In the light of these trends, a comprehensive and well-coordinated corrective policy effort appears to be called for. This effort should aim at restoring the conditions for a sustained growth of foreign exchange earnings, at substantially moderating the growth of domestic demand and at improving its composition. The required policy package should include measures to reduce the rate of growth of labor costs, a more flexible use of exchange rate policy to preserve competitiveness, a significant reduction in the budget deficit, and the containment of the growth of liquidity in the economy. It is also essential that this effort be continued into 1984 and not be relaxed before the current account deficit has been reduced to a more sustainable level.

As the staff projections of the external debt and its service over the next several years have highlighted, it is important to secure a rapid growth of foreign exchange earnings, and in particular of manufacturing exports, if the necessary reduction of the current account deficit is not to result in a severe compression of imports and consequently of GDP growth over the medium term. In this respect, the staff would stress the importance of an improvement in the relative profitability and competitiveness of Cypriot exports. Available indicators suggest that these have been significantly eroded in recent years by the rapid rise in unit labor costs at rates substantially higher than in competitor countries.

The moderation of labor costs, in an economy as open as that of Cyprus, is crucial to the maintenance of sustained rates of growth of output and employment. In this respect, the adjustment of the Cypriot economy is greatly hampered by the existence of a system of full wage indexation, on which have been superimposed in recent years large increases in contractual wages, in excess of productivity growth. The existing indexation mechanism also has the well-known disadvantage of reducing the effectiveness of policy instruments such as indirect taxes, administered prices, and the exchange rate. The staff would urge the authorities to seek the social partners' consensus to a modification in the indexation system, at this time when inflation has decelerated to a relatively low level. The desirable reduction in the degree of indexation could take the form of the exclusion from the cost-of-living index of the effects of changes in indirect taxes and in the terms of trade, along the lines followed by some other countries. The modification of indexation should be accompanied by moderation in contractual wage settlements, so as to contain the growth of nominal and real wages.

In order to ensure a substantial deceleration in the rate of growth of domestic demand and of imports, it is necessary to adopt promptly measures designed to absorb disposable income and to contain the growth of liquidity in the economy. The absorption of disposable income could probably best be effected through the introduction of a broad-based consumption tax and through increases in the rates of selected excise taxes. Other measures that would help moderate the growth of disposable income and of consumption, as well as the budget deficit, would be increases in prices of subsidized commodities, notably feed grains, and of some oil products. The latter would also help reduce the recent rapid growth in energy consumption. It also is important that the growth of other items of expenditure, notably wages and salaries of civil servants, be effectively moderated, thus setting an example for wage negotiations in the private sector. In a longer-term perspective, the required reduction in the government deficit should be sought, on the revenue side, mainly through improvements in tax administration and enforcement, a broadening of the tax base, the introduction of a value-added tax and a comprehensive review of the existing system of tax incentives to make them more selective and cost-effective. On the expenditure side, the effort should be concentrated on the containment of public consumption and subsidies and on a moderation of the growth of social transfers, which have escalated in recent years.

As regards monetary policy, it appears essential that, as a minimum, the present monetary program be strictly adhered to. The targeted expansion of domestic credit is likely to result in a significant overall deficit of the balance of payments even if the projected decline in the velocity of circulation of money from an already historically low level does materialize. Any excess over the target would most probably be reflected in a further deterioration of the balance of payments. To ensure adherence to the monetary program, a significant strengthening of the available instruments of monetary control appears necessary. The most important step in this respect would be the lifting of the existing ceilings on interest rates. The staff would urge the authorities to renew efforts to secure early approval by Parliament of this measure, at a time when the inflation rate has substantially moderated. The elimination of this rigidity in the system would have several beneficial effects. It would help contain the demand for credit and direct the flow of bank credit to the most profitable uses. It would enhance the attractiveness of holding domestic as opposed to foreign financial assets and over time contribute to an increase in the savings rate. It would also provide the monetary authorities with a much needed flexibility to diversify the sources of domestic financing of the government deficit and to begin an active policy of control of liquidity through open market operations. Also important, especially in the current conditions of interest rate rigidity, is the strict enforcement of penalties for excesses over the selective credit ceilings as well as the extension of the ceilings to activities such as domestic trade, and to lending by the cooperative credit societies.

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. Residents travelling abroad for business qualify for an additional business travel allowance of up to £C 100 per day. The authorities are maintaining the tourist travel restriction with a view to raising the limit in the future, and to eliminating it as soon as circumstances permit. However, in light of present political uncertainties, the weakness of the balance of payments and the need to guard against illegal capital flows, the authorities find it difficult to take immediate action. Under these circumstances, the staff recommends that approval of the restriction on allocation of foreign exchange for tourist travel continue to be granted until the next Article IV consultation, which is to take place on the standard 12 months cycle.

V. 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 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.

Fund Relations with Cyprus

(As at July 13, 1983)

Quota:	SDR 51 million
Use of Fund resources:	During 1974-76 Cyprus purchased its full entitlement under the oil facility (SDR 30.1 million) and 50 per cent of 1976 quota (SDR 13.0 million) under the compensatory financing facility. In January 1979, Cyprus purchased an additional SDR 9.9 million under the compensatory financing facility, and in August 1980 made a purchase of SDR 8.5 million under a stand-by arrangement in the first credit tranche.
Fund holdings of Cyprus pounds:	SDR 59.0 million (115.6 per cent of quota), of which SDR 3.7 million (7.2 per cent of quota) were under the compensatory financing facility, and SDR 4.2 million (8.3 per cent of quota) under the stand-by arrangement.
SDR position:	SDR 0.426 million, equivalent to 2.2 per cent of net cumulative allocation (SDR 19.4 million).
Direct distribution of profits for gold sales:	Cyprus received US$4.1 million in the first and second distribution.
Gold distribution:	Cyprus acquired 22,251.563 fine ounces of gold.
Exchange rate system:	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 0.4 per cent in 1981, and 1.8 per cent in 1982. On May 31, 1983 the rate of the Cyprus pound was £C 1 = SDR 1.8040.

Last consultation: The previous Article IV consultation took place in October 1981 and the report was discussed by the Executive Board on February 1, 1982 (SM/82/4, 1/7/82; SM/82/12, 1/20/82). On that occasion the following decision was adopted 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 1981 Article XIV consultation with Cyprus, in the light of the 1981 Article IV consultation with Cyprus conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the relaxation as of January 1, 1982 of the restriction on the amount of foreign exchange made available for tourist travel as described in SM/82/4. This exchange restriction will be reviewed on the occasion of the next Article IV consultation with Cyprus, and in the circumstances of Cyprus, the Fund grants approval for the retention of this exchange restriction until the conclusion of the next Article IV consultation with Cyprus."

Basic Data

Area and population		
Area (whole island)	9,251 square kilometers	
Population (end-1981; whole island)	637,000	
GNP per capita (end-1982)	£C 1,623.5	

Income and expenditure in 1982 (at current prices)	In millions of Cyprus pounds	In per cent
Private consumption	636.9	63.3
Public consumption	170.3	16.9
Gross capital formation	333.8	33.2
Gross domestic expenditure	1,141.0	113.4
Exports of goods and services	527.0	52.4
Imports of goods and services	662.3	65.8
GDP at market prices	1,005.7	100.0

Selected economic indicators (annual percentage change)	1980	1981	1982
GDP (at constant market prices)	5.7	2.3	4.6
Private consumption (at constant prices)	5.1	-1.4	8.4
Gross fixed investment (at constant market prices)	1.5	-7.8	3.3
Manufacturing output	7.1	6.5	4.2
Unit labor costs in manufacturing	...	17.9	10.2
Consumer prices	13.5	10.8	6.4

Public sector accounts (as per cent of GDP	1980	1981	1982
Consolidated Central Government			
Tax revenue	17.2	18.3	18.9
Current expenditure	28.4	24.5	25.3
Current balance	-2.0	-2.5	-2.2
Overall balance	-7.0	-6.9	-5.8

Balance of payments (in millions of SDRs)	1980	1981	1982
Exports, f.o.b.	376	432	453
Imports, f.o.b.	830	888	998
Trade balance	-454	-456	-545
Net invisibles	269	329	408
Current account balance	-185	-127	-137
Medium- and long-term capital	188	176	192
Short-term capital	--	13	19
Overall balance	3	62	74
Foreign exchange reserves, year-end	305	382	490
External debt outstanding, year-end	440	536	680
Effective exchange rate (percentage change)	1.1	0.4	1.9

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

Table 1. Cyprus: Selected Economic Indicators, 1979-83

(Annual percentage change)

	1979	1980	1981	1982 1/	1983 2/
Real demand and output					
Gross domestic expenditures	7.9	4.1	-0.9	6.6	5.3
Private consumption	7.1	5.1	-1.4	8.4	6.5
Public consumption	9.6	5.0	17.3	4.9	3.5
Gross fixed investment	9.7	1.5	-8.4	4.1	3.1
Increase in inventories 3/	0.1	0.1	--	-0.1	--
Foreign balance 3/	1.4	2.2	3.3	-1.9	-1.2
GDP at market prices	8.8	5.7	2.3	4.6	3.0
Value added in manufacturing	7.9	7.1	6.5	4.2	3.0
Labor market					
Employment	3.0	... 4/	1.5	1.5	1.5 5/
Unemployment rate (level)	2.1	2.2	2.9	3.1	3.1 5/
Average real wage rate	14.4	12.1	6.8	10.0	4.2
Average earnings in manufacturing	27.7	23.6	20.0	15.1	12.0 5/
Productivity in manufacturing	3.7	... 4/	1.8	4.4	3.0
Unit labor costs in manufacturing	23.3	... 4/	17.9	10.2	8.7
Prices					
Consumer prices	9.5	13.5	10.8	6.4	6.5
GDP deflator	12.4	13.8	13.1	10.3	8.8
Income					
Private disposable income	...	18.3	16.5	13.9	11.6
Private savings rate (level)	28.4	27.8	32.4	31.2	30.3

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

1/ Provisional estimates.
2/ Official forecast.
3/ Contribution to GDP growth.
4/ Discontinuity in the employment series.
5/ Staff projections.

Table 2. Cyprus: Summary of the Balance of Payments, 1979-83

(In millions of Cyprus pounds)

	1979	1980	1981	1982 1/	1983 2/
Exports, f.o.b.	149.5	172.7	213.9	237.3	234.0
Imports, f.o.b.	321.2	381.0	439.4	523.0	563.0
Merchandise trade balance	-171.7	-208.3	-225.5	-285.7	-329.0
Services, net	72.1	97.7	136.1	177.4	201.0
Of which:					
Tourism, net	34.1	51.9	78.3	108.0	125.5
Investment income, net	-5.3	-5.8	-8.9	-11.3	-20.5
Transfers, net	25.4	25.9	26.5	36.3	33.0
Current balance	-74.2	-84.7	-62.9	-72.0	-95.0
As per cent of GDP	(11.9)	(11.3)	(7.2)	(7.2)	(8.5)
Medium- and long-term capital	45.2	76.7	79.5	94.0	60.0
Short-term capital 3/	14.7	8.0	12.4	17.0	18.0
SDR allocation	1.7	1.6	1.6	--	--
Overall balance	-12.6	1.6	30.6	39.0	-17.0
Memorandum items: (percentage change)					
Market growth	4.0	4.2	5.6	1.4	2.4
Export, f.o.b., unit value (in local currency) 4/	7.0	8.6	22.5	8.0	-1.9
Export, f.o.b., volume 4/	15.5	7.1	6.4	2.7	0.9
Import, c.i.f., unit value (in local currency) 4/	10.7	14.4	13.2	6.3	2.5
Import, c.i.f., volume 4/	14.2	3.7	1.9	12.0	5.8
Effective exchange rate	0.8	1.1	0.4	1.9	...
U.S. dollar/pound rate	5.3	0.4	-15.9	-11.5	-7.2 5/

Source: Data provided by the Cypriot authorities.

1/ Provisional estimates.
2/ Official 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 May 1983.

Table 3. Cyprus: Monetary Aggregates, 1980-83

	1980	1981	1982	1983 1/
	(In millions of Cyprus pounds; at end of period)			
Net foreign assets	104.4	139.9	188.7	171.7
Net domestic credit	466.7	552.1	630.1	745.1
Public sector 1/	62.0	89.7	87.4	132.4
Private sector	404.7	462.4	542.7	612.7
Broad money	501.2	601.4	709.5	794.5
Currency and demand deposits	153.3	188.3	218.4	...
Quasi-money	347.9	413.1	491.1	...
Other items, net	-69.9	-90.6	-109.3	-122.3
	(12-month percentage change)			
Total domestic credit	20.1	18.3	14.1	18.3
Credit to the private sector	13.5	14.3	17.4	12.9
Credit to public sector 2/	6.8	5.5	-0.4	6.3
Broad money	15.9	20.0	18.0	12.0
Reserve money	27.6	25.2	24.0	13.8
Income velocity of M2 (level)	1.61	1.58	1.53	1.48

Source: Data provided by the Cypriot authorities.

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

Table 4. Cyprus: Consolidated Central Government Accounts, 1980-83

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

	1980	1981	1982	1983 1/	1981	1982	1983
					Percentage changes		
Current revenue	161.1	191.2	232.2	265.5	18.7	21.4	14.3
Of which:							
Direct taxes 2/	59.4	83.3	95.1	110.5	40.2	14.2	16.2
Indirect taxes	69.9	75.9	93.4	104.7	8.6	23.1	12.1
Nontax revenue	31.8	32.0	43.7	50.3	0.6	36.6	15.1
Current expenditure	176.0	213.4	254.6	290.8	21.3	19.3	14.2
Of which:							
Wages, salaries, and goods and services	97.8	124.4	143.1	156.5	27.2	15.0	9.4
Subsidies and transfers	65.4	92.1	106.7	131.3	40.8	15.9	23.1
Current balance	-14.9	-22.2	-22.4	-25.3	...	...	...
As per cent of GDP	-2.0	-2.5	-2.2	-2.2	...	...	...
Capital receipts and foreign grants	12.6	12.2	19.1	16.7	-3.2	56.6	-12.6
Capital expenditure 3/	50.0	49.7	55.1	56.3	-0.6	10.9	2.2
Of which:							
Fixed investment	34.3	36.1	33.5	38.8	5.2	-7.2	15.8
Capital transfers	10.0	9.1	9.6	10.0	-9.0	5.5	4.2
Net lending	5.7	4.5	12.0	7.5	-21.0	166.7	-37.5
Overall balance	-52.3	-59.7	-58.4	-64.9	...	...	...
As per cent of GDP	-7.0	-6.9	-5.8	-5.8	...	...	...
External financing, net	31.1	27.5	53.7	10.6	...	...	...
Domestic financing, net	21.7	36.5	9.4	57.9	...	...	...
Of which:							
From banking system	19.5	29.0	-1.1	47.9	...	...	...
Memorandum items:							
Total taxes as per cent of GDP	17.2	18.3	18.9	19.1			
Total expenditure as per cent of GDP	30.0	30.2	30.8	30.8			
Share of direct taxes 2/ in total taxes	45.9	52.3	50.6	51.3			
Share of current expenditure in total expenditure	77.9	81.1	82.2	83.8			

Source: Data provided by the Cypriot authorities.

1/ Official projection.
2/ Including social security contributions.
3/ Including net lending.

Table 5. Cyprus: External Debt Outstanding and Debt Service Ratio, 1979-82

(In millions of Cyprus pounds, end of period)

	1979	1980	1981	1982 (Prov.)
	Total			
Government 1/	63.8	95.2	132.5	199.7
Public enterprises	40.6	48.0	71.5	92.6
Nonfinancial private sector	51.2	61.7	65.9	74.0
Total	155.6	204.9	269.9	366.3
Of which:				
Short-term	36.4	38.5	39.8	43.0
Memorandum items: (in per cent)				
Ratio of debt to GDP	24.9	27.2	31.0	36.4
Ratio of debt to gross official reserves	120.3	144.4	140.3	138.8
Share of short-term debt	23.4	18.8	14.7	11.7
Ratio of service on medium- and long-term debt to foreign exchange earnings 2/	6.8	8.2	8.7	10.5

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: Medium-Term External Debt Projections, 1983-90 1/

(In per cent)

	1983	1990	1983-90 Average
Scenario A			
Export growth	...	...	3.5
Import growth	...	...	3.5
GDP growth	...	...	2.3
Current account deficit as a percentage of GDP	6.7	7.9	8.1
Debt service ratio	10.3	14.4	13.5
Scenario B			
Export growth	...	...	3.5
Import growth	...	...	5.0
GDP growth	...	...	3.3
Current account deficit as a percentage of GDP	7.6	18.7	13.4
Debt service ratio	10.4	22.2	16.2
Scenario C			
Export growth	...	...	6.0
Import growth	...	...	6.0
GDP growth	...	...	4.0
Current account deficit as a percentage of GDP	6.7	8.2	8.1
Debt service ratio	10.1	13.5	12.7

Sources: Bank of Cyprus; and staff projections.

1/ The rate of growth of exports, imports and GDP are real rates of growth. The projections are based on the assumptions of no change in the terms of trade or in the terms of borrowing. In addition, borrowing at concessional terms is assumed to grow by 5 per cent in nominal terms, and nondebt capital inflows by 10.2 per cent, also in nominal terms.