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INFORMATION

January 7, 1982

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Cyprus - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Cyprus. A draft decision appears on page 13.

It is proposed to bring this subject to the agenda for discussion on Monday, February 1, 1982.

Att: (1)

Other Distribution:  
Department Heads

INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 1981 Article IV Consultation

Prepared by the Staff Representatives for the  
1981 Article IV Consultation with Cyprus

Approved by L. A. Whittome and W. A. Beveridge

January 6, 1982

I. Introduction

A staff team consisting of Messrs. H. Ungerer, U. Dell'Anno, E. Spitaeller, I. Simon (all EUR), M. Hadjimichael (EP) and Mrs. P. Padmore (EUR) as secretary, visited Nicosia from October 22 to November 2, 1981 to conduct Article IV consultation discussions. The Cypriot representatives were led by Mr. C.G. Stephani, Governor of the Central Bank of Cyprus, and included officials from the Central Bank, the Ministries of Finance, of Commerce and Industry, and of Labor and Social Insurance, and the Planning Bureau. The mission met with the Minister of Finance, Mr. A.C. Afrentiou, and the head of mission was received by the President of the Republic, Mr. S. Kyprianou.

In July 1980 Cyprus obtained a stand-by arrangement from the Fund in the first credit tranche, equivalent to SDR 8.5 million (ERS/80/142, 6/24/80) purchased in August 1980.

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

II. Recent Economic Developments

1. Background

In the wake of the mid-1974 hostilities, Cyprus witnessed an abrupt fall in output, and a sharp rise in unemployment due in large measure to the inflow of refugees. Yet, already during the years 1976 and 1977, its economy recovered rapidly, aided by expansionary financial policies. The industrial base was broadened and tourism revived. Real GDP grew at an annual average rate of more than 20 per cent while unemployment shrank from 25 per cent in late 1974 to less than 4 per cent in 1977. At the same time, internal and external stability were largely maintained.

In the late 1970s, however, signs of mounting imbalance appeared. Inflation accelerated, with the rate of increase in consumer prices rising from about 4 per cent in 1976 to some 15 per cent by mid-1980, while

the deficit of the current account in the balance of payments widened from 1.3 per cent of GDP in 1976 to 16 per cent in the first half of 1980. Although rising energy prices and a generally adverse international economic environment played an important role in these developments, they were partly attributable to domestic supply constraints which limited the growth of real GDP to 8.8 per cent in 1978 and 8.5 per cent in 1979. Unused labor had largely been absorbed, the initially strongly expansionary impact of big investments in industry and tourism had run its course, and productivity, which had gained sharply up to 1977, registered significantly lower rates of increase in the following years. At the same time, growth in domestic demand did not slow down but continued unabated. It was stimulated by continued large increases in nominal wages and salaries, and by substantial and rising deficits on the consolidated central government budget. 1/

## 2. The stabilization program

In response to the deterioration in the economic situation, the authorities embarked on a financial stabilization program in the first half of 1980. This program formed the basis for a first credit tranche stand-by arrangement with the Fund equivalent to SDR 8.5 million, for the period July 1980/June 1981. Ruling out exchange rate action, mainly because of the existing system of full wage indexation, the authorities opted for demand management as the principal tool of adjustment. Credit expansion over the program year was to be confined to £C 72 million, equivalent to 16 per cent of the stock of broad money as estimated for the end of June 1980, compared with 29 per cent in the previous 12 months (Table 1).

The credit targets for the private sector were implemented by the imposition of quantitative ceilings on the lending of individual banks, limiting for the period January 1980 to June 1981 the expansion of credits to the private sector to 20.5 per cent of their December 1979 base. Exempted from the bank credit ceilings--but taken into account in the determination of the overall ceilings--were projects aimed at import substitution and productive investment, to be financed by a separate fund.

Budgetary policy was to ensure a reduction in consumption and to limit credit expansion to the public sector. The ratio of the overall budget deficit to GDP was to be brought down from 6.3 per cent in the 12 months ending June 1980 to about 2.9 per cent during the program period 2/, requiring a cut in the deficit from £C 43.5 million to some

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1/ The central government budget consolidates the operations of the ordinary budget, the development budget, the Public Loans Fund, the Social Insurance Funds and the Special Relief Fund for Displaced Persons.

2/ Due to a reformulation of the budget format, the 2.9 per cent of GDP deficit (£C 23.2 million) under the new presentation is equivalent to the 1.2 per cent deficit envisaged in the stabilization program (£C 9.4 million).

EC 23.2 million. The program envisaged also a 2 percentage point increase in the tax ratio to 18.7 per cent of GDP and a substantial improvement in public sector savings. Accordingly, the Government introduced a package of indirect tax measures, including selected increases in custom duties, excise taxes on petroleum products and motor vehicles, taxes on immovable property and capital gains, as well as a new earnings-related social insurance scheme. In addition, the Government decided to impose a hiring freeze on the civil service and undertook to assess the feasibility of a 10 per cent reduction in budget expenditure across the board.

The stabilization program achieved its broad objectives. The external current account deficit for the program period was reduced to less than 8 per cent of GDP, the rise in consumer prices decelerated to 10 per cent in the second quarter of 1981, and real growth was on target. The overall target for credit expansion was met, but domestic credit to the public sector grew much faster than envisaged while credit expansion to the private sector remained well below its limit (Table 1).

The uneven mix of policies in the implementation of the program shifted the major burden of adjustment to the private sector, affecting particularly productive investment. Total domestic liquidity, targeted to increase by some 12 per cent, actually grew by some 19 per cent due to a strong rise in net foreign assets which had been expected to fall. The rise in net foreign assets was the result of much larger than anticipated public sector borrowing from abroad, which became necessary as the overall budget deficit in the program period turned out to be larger than projected: it was equivalent to 7 per cent of GDP as against the target of 2.9 per cent. The main reason for the large deficit was the overrun in current expenditure which increased by nearly one fifth more than planned, due, predominantly, to the rapid expansion of subsidies and transfers. Public sector current revenue also fell somewhat short of budgeted levels on account mainly of lower than expected indirect tax receipts.

### 3. Fiscal Policy

An analysis of budgetary outturns on an annual basis indicates that the worrisome features of fiscal developments in the program period July 1980/June 1981 are a continuation of unfavorable trends that started earlier. In the period since 1979, total budget expenditure has been rising faster than nominal GDP, raising the ratio of total expenditure to GDP from near 28 per cent in 1979 to an estimated 32 per cent in 1981 (Chart 1). At the same time, current expenditure increased its share in total expenditure at the expense of capital expenditure which fell short of its modest targets (Table 2). The acceleration of current expenditures reflects the substantial increases in wages and salaries and in subsidies and transfers; subsidies, in particular, increased from EC 3 million in 1978 to an estimated EC 21 million in 1981, <sup>1/</sup> while interest payments on the expanding domestic and foreign central government debt nearly tripled during the same period.

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<sup>1/</sup> Consumer subsidies on grain account for more than two thirds of the total, and producer subsidies to vine growers for the rest.

Domestic revenue, on the other hand, increased slightly faster than nominal GDP, raising the ratio of domestic revenue to GDP from less than 20 per cent in 1979 to some 22 1/2 per cent in 1981. This improvement was due entirely to the revenue situation of the Social Insurance Fund--with receipts rising much faster than expenditure following the introduction in October 1980 of the new earnings-related social insurance scheme--and of the Special Relief Fund for Displaced Persons. The growth of direct and indirect ordinary tax revenue slowed down in the past two years, particularly in 1981. The slow growth of direct ordinary budget revenue in 1981 is partly due to the tax relief measures introduced in early 1981 to reduce fiscal drag. The levelling off of excise tax revenues reflects a decline in motor vehicles registration and movement toward registration of smaller vehicles.

Current expenditure grew on average faster than current revenue, resulting in an increase of public dissavings from 1.2 per cent of GDP in 1979 to an estimated 3 per cent in 1981. The overall budget deficit increased from fC 38.8 million in 1979 (6.2 per cent of GDP) to fC 57.1 million in 1980 (7.6 per cent of GDP) and an estimated fC 66.8 million in 1981 (7.8 per cent of GDP). The overall budget deficit was financed for more than 95 per cent by monetary means (foreign and domestic bank borrowings) since the interest rate ceiling, fixed by law, allowed only minor sales of government securities to the nonbank public. Central bank financing has approached in 1981 its legal limit of 55 per cent of the estimated ordinary budget revenue, necessitating an increasing resort to foreign borrowing. Net foreign borrowing increased from 1.7 per cent of GDP in 1979 to 4 per cent in 1980 and an estimated 5 per cent in 1981, raising the ratio of external government debt to GDP to 15.6 per cent. Debt service payments on external central government debt (excluding IMF credits), equivalent to less than 4 per cent of exports of goods and services in 1981, are still low but they have almost trebled in the last three years.

#### 4. Monetary policy

In the period from 1979 to the end of the third quarter of 1981 total liquidity grew rapidly, at year-on-year rates of 18 1/2 per cent by the end of 1979, some 16 per cent a year later and around 20 per cent by the end of September 1981 (Chart 2 and Table 3). As for the components of total liquidity, narrow money shows a decline in growth of 7 percentage points over the period, attributable largely to reduced expansion in demand deposits, while quasi-money registered a rise of 5 percentage points in its rate of growth as a result, in particular, of an accelerating build-up of time deposits in 1981.

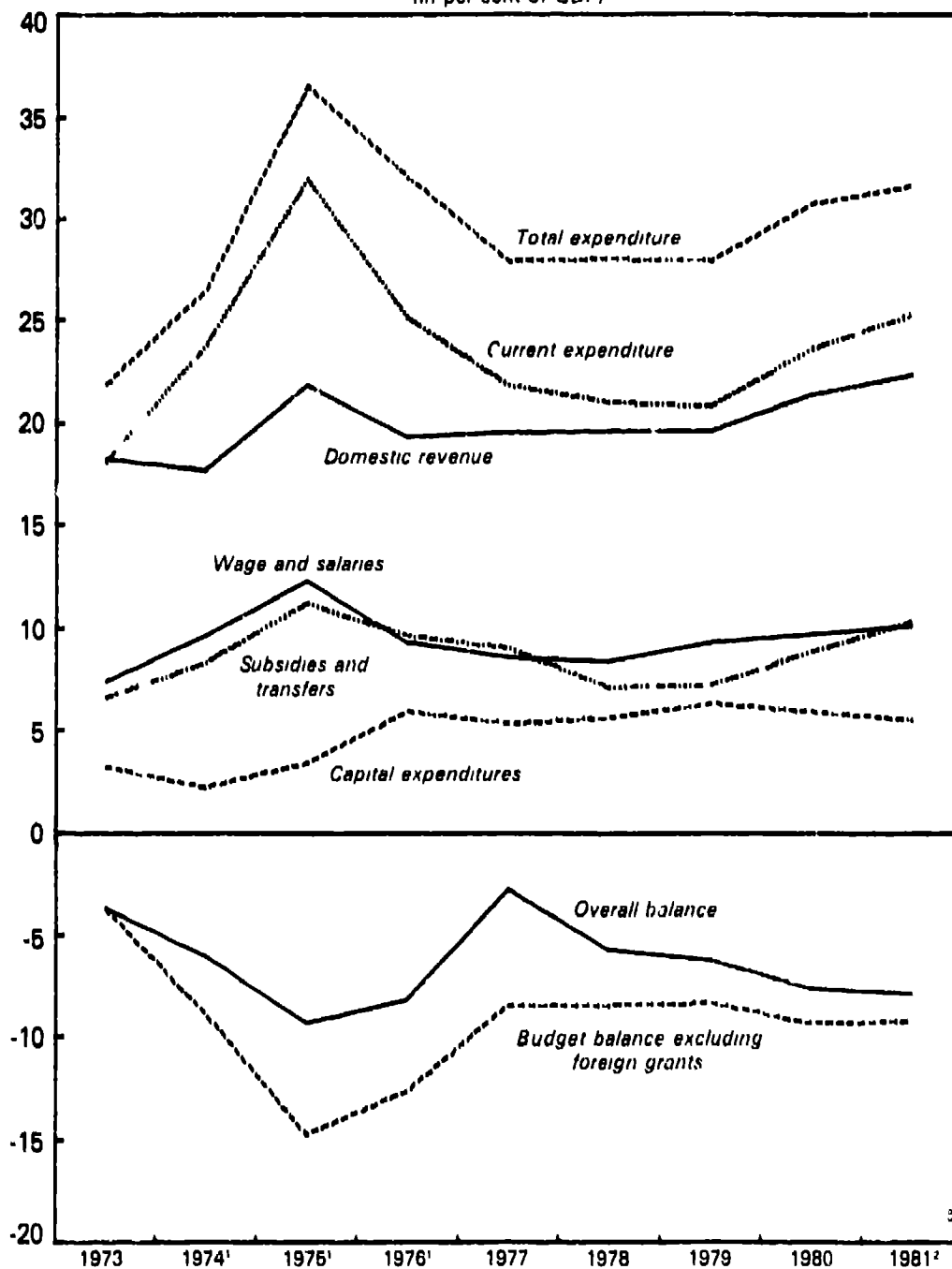
As a result of the credit restrictions, the contribution of net domestic credit to liquidity growth has been much reduced, by the end of the third quarter of 1981 it had fallen to about half of what it had been at end-1979. In contrast, the contribution of net foreign assets has turned from contractionary to expansionary as the balance of payments

CHART 1

CYPRUS

CONSOLIDATED CENTRAL GOVERNMENT BUDGET, 1973-81

(In per cent of GDP)



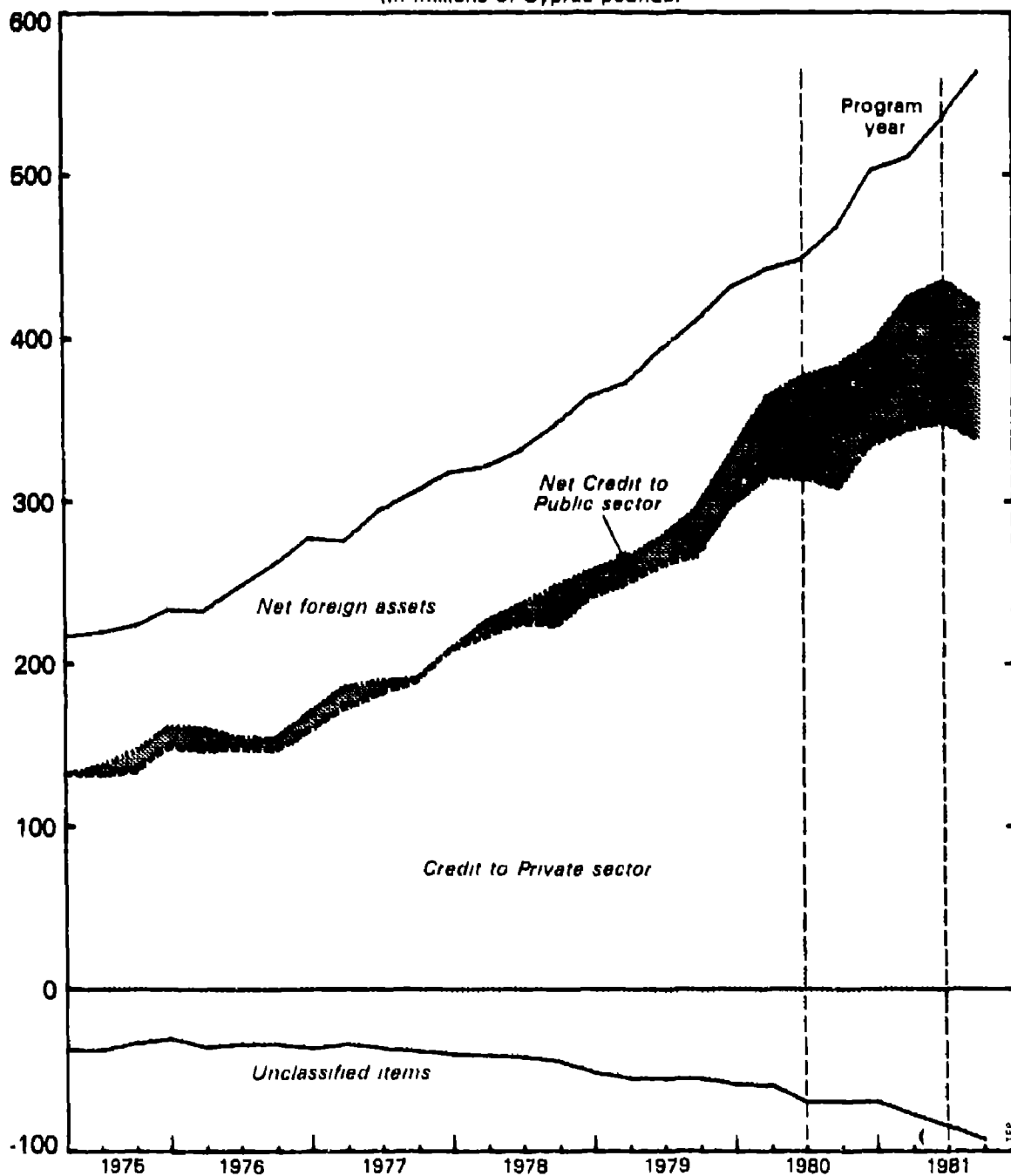
Source: Data provided by the Cypriot authorities

<sup>1</sup>For these years all ratios are atypical because of the sharp decline in nominal GDP in 1974 and 1975  
nominal GDP in 1976 was still lower than its 1973 level

<sup>2</sup>Estimates

CHART 2  
CYPRUS  
MONETARY DEVELOPMENTS, 1975(I)-81(III)

(In millions of Cyprus pounds)



Sources: Central Bank of Cyprus Bulletin and data provided by the Cypriot authorities

improved and the Government had increasing recourse to foreign borrowing. In fact, owing to its substantial borrowing at home and abroad, the Government has recently come to account for about half of the growth in total liquidity.

In view of the expansionary fiscal policy, monetary policy could do no more than insist on strict application of the ceilings on credit expansion to the private sector. However, the fact that these ceilings were not even reached--except in instances of individual banks--is not exclusively attributable to monetary restriction. Both the improvement in the balance of payments and the large government borrowing provided the economy with ample liquidity; the rise in private savings and the general prohibition of additional personal loans reduced the demand for credit; in addition, the stabilization program came on top of an already weakening investment demand, particularly in construction and inventory accumulation.

When credit ceilings were extended from end-June 1981 to end-December 1981, the overall ceiling on credit expansion to the private sector was put at fC 26 million. Ceilings were made more restrictive, and at the same time, more selective. Personal loans and loans to the trading sector--except for exports--were to remain at their end-June levels for the rest of the year. On the other hand, loans for priority projects, which are financed from a special fund and which were equivalent to 8 1/2 per cent of direct bank lending to the private sector in the period December 1979 to June 1981, were exempted from the ceilings.

Interest rates to date stand unchanged from their levels prevailing since end-1975, with maximum lending and deposit rates of 9 per cent and 7 per cent, respectively. At the time, with inflation at around 4 1/2 per cent, real interest rates were positive. Subsequently, until mid-1980, they became increasingly negative; since then they improved somewhat as a result of decelerating inflation. Treasury paper has meanwhile been made more attractive; it is currently issued at 8 per cent.

#### 5. The domestic economy

Real growth of the economy in 1980 and 1981 slowed down to less than 5 per cent and some 3 per cent, respectively, compared with about 8 1/2 per cent in both 1979 and 1978. The main stimulus came from exports of goods and services, which in real terms, increased by 10 per cent in 1980 and 9 per cent in 1981, while the growth of imports of goods and services fell to 4 per cent in 1980 and to about 1 per cent in 1981. In 1980, real domestic demand still accounted for about half of the growth in GDP despite a sharp slow down during the second half of the year in response to the stabilization measures. In 1981 domestic demand on average stagnated (Chart 3).

The volume of gross investment, the bulk of which is private, fell by about 2 1/2 per cent in 1980 and nearly 3 per cent in 1981. The stance of monetary policy affected residents' demand for housing, which declined in both 1980 and 1981. The fall in gross investment was also



due to the authorities' conscious policy to achieve a substantial reduction in inventories through credit restraint. While the policy of exempting the priority sectors from the credit ceilings on bank lending succeeded in fostering a further expansion in hotel capacity, it failed to spur investment in manufacturing. Entrepreneurs were faced with sharply rising labor and energy costs that forced them to reduce their profit margins in order to preserve competitiveness. The tax incentives introduced in March 1981 to encourage productive investment had not had as yet any significant effect on investment outlays in manufacturing.

Real private consumption expenditure, which for 1980 as a whole was still rising at a rate close to that of real GDP, stagnated in 1981. This development was associated with both a deceleration in the growth of real private disposable income and a further increase in the already high gross private savings ratio to GDP (28 per cent in 1981). By contrast, real consumption expenditure by the public sector increased at a somewhat faster rate than real GDP in both 1980 and 1981.

With the rate of increase in total aggregate demand drastically curtailed since the second half of 1980, the real gap between aggregate demand and supply was reduced by some 7 percentage points to around 12 per cent of GDP between 1979 and 1981. The most important supply development during this period was provided by the construction sector, comprising 14 per cent of GDP in 1980, which registered a decline in 1981 for the first time since 1976. Growth in the manufacturing sector abated somewhat as capacity limits were reached in a number of industries, but still approached 8 per cent in both years. A high rate of growth was also posted by the services sector, where activity continued to be sustained by the tourist industry. The unemployment rate rose from 2 per cent in 1979 to 3 per cent in 1981 (Chart 3).

The rate of increase of consumer prices peaked at 16 per cent in July of 1980 under the impact of rising energy prices, excessive wage settlements, and strong domestic demand pressures still in existence during the first half of 1980. However, it later decelerated to about 10.5 per cent in the third quarter of 1981, reflecting the easing of domestic demand pressures, the relative stability of the price of imported oil, and increased supplies of domestically grown foodstuffs. There was also a deceleration in the rate of increase of nominal wages. Average wage rates which had risen by an exceptional 28 per cent in 1980 increased by some 20 per cent in 1981, still ensuring that real wage rises remained well above productivity gains (Chart 3).

## 6. Energy policy

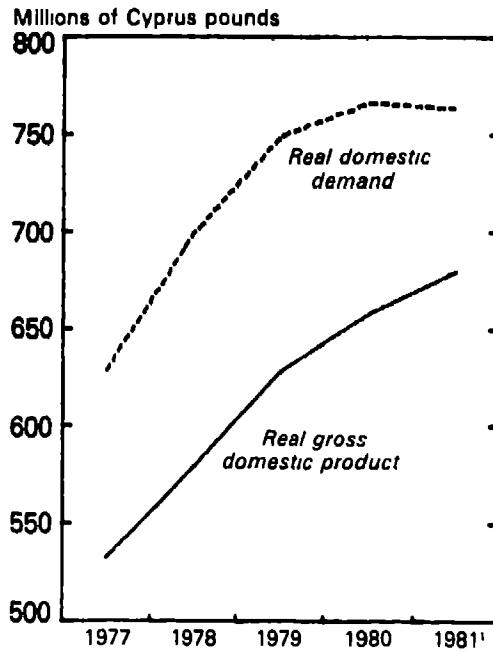
Cyprus is almost entirely dependent on imported sources of energy to satisfy its primary energy needs. In 1980 its oil import bill rose to the equivalent of 18 1/2 per cent of total imports from 12 1/2 per cent a year earlier. Reliance on domestic sources of energy, notably solar and wind energy, is increasing, but they offer only limited scope.

CHART 3

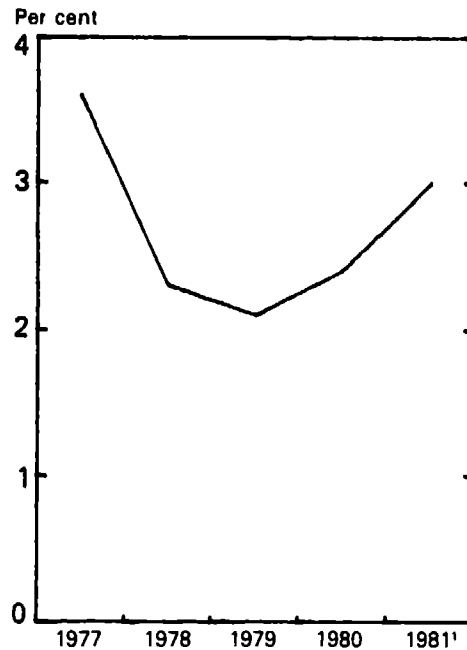
CYPRUS

SELECTED ECONOMIC INDICATORS

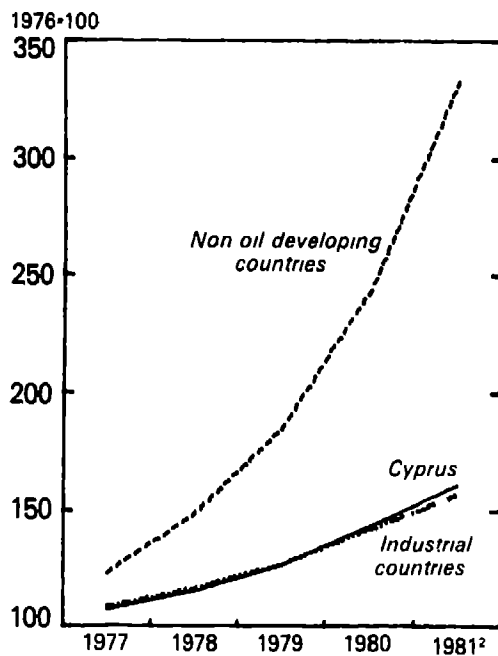
A. REAL DOMESTIC DEMAND AND SUPPLY



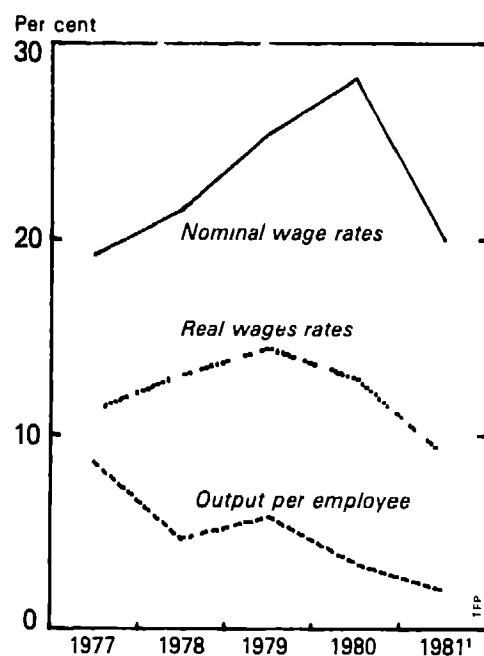
B. UNEMPLOYMENT RATE



C. RETAIL PRICE INDICES



D. CHANGES IN AVERAGE WAGE RATES



Sources: Central Bank of Cyprus *Bulletin*; IMF *International Financial Statistics* and data provided by the Cypriot authorities

<sup>1</sup>Estimates

<sup>2</sup>August 1981

Efforts to reduce dependence on oil have so far centered on conservation measures including the introduction of speed limits and of daylight saving time. Relatively most effective, however, have been the pricing policies--gasoline prices almost doubled in 1980--the increases in customs duties, and the imposition of a graduated excise tax on automobiles. Energy consumption in 1980 and in the first half of 1981, increased only modestly, in contrast to increases of about 9 per cent in both 1978 and 1979.

#### 7. The external sector

The development of the balance of payments over the past years mirrors the achievements of the reconstruction and diversification of the economy following the events of mid-1974, the emergence of constraints on the expansion of the economy in the late 1970s, and finally, the results of the stabilization program of 1980.

Following sharp declines in 1974 and 1975, the volume of merchandise exports grew rapidly thereafter, reaching in 1979 a level 2 1/4 times that of 1975. In 1980 the volume of exports increased again by 7 per cent and a further 9 per cent increase is estimated for 1981. While agricultural exports--mainly to EC countries, particularly the United Kingdom--remained important, the rapid growth of exports was chiefly due to the expansion of exports of manufactures such as clothing, footwear and cement to the Arab countries. The volume of merchandise imports increased substantially in 1976 and 1977, reflecting the vigorous expansion of the economy. Their growth continued, albeit at lower rates, in the subsequent period up to the first quarter of 1980. The adoption of the stabilization program in mid-1980 helped to curtail the demand for imports, and growth in real imports decelerated sharply to 4 per cent in 1980 and an estimated 2 per cent in 1981, compared to 14 per cent in 1979 (Chart 4).

The terms of trade deteriorated significantly in 1979 and 1980, thus contributing to the widening of the deficit in the trade balance. They are expected to deteriorate only slightly in 1981 as the rise in the cost of oil imports is abating.

Invisible transactions have traditionally resulted in a large surplus, the main item being receipts from tourism which has registered strong increases: 50 per cent in 1979, 40 per cent in 1980, and an estimated 36 per cent in 1981. On a net basis, tourism accounts for nearly half of the surplus on invisibles in 1981, compared to about one third in 1979 and about one fifth in 1976 (Table 4).

The deficit of the current account rose steadily between 1976 and mid-1980, amounting to £C 73 million in 1979 and to £C 59 million in the first half of 1980 alone, equivalent to some 16 per cent of GDP. The substantial improvement of the current account for the second half of 1980 resulted in a reduction of the current account deficit for 1980 as a whole to 11 per cent of GDP, and for 1981 it is estimated to decline further to 8.7 per cent of GDP (Table 4).

The main items in the capital balance over recent years have been direct investment, mainly coming from Cypriots living abroad, and official long-term loans. While the former increased steadily over the years, the latter did not change substantially until 1980 and 1981, when large-scale foreign borrowing became necessary to help finance the rising overall budget deficit. The corresponding large surpluses in the capital account led to an overall payments surplus of £C 3.5 million in 1980 and of an estimated £C 18 million in 1981 (Chart 5).

Reflecting the substantial expansion of external public debt in both 1980 and 1981, the total external debt increased from £C 161.1 million in 1979 to £C 288.0 million in 1981, or a ratio to GDP, from 25.6 per cent to 33.5 per cent. The ratio of debt service payments to exports of goods and services, which is still low by international standards, rose from 5.6 per cent in 1979 to 8.0 per cent in 1981.

Official gross foreign reserves increased in 1980 by £C 14.8 million, and by another £C 50.4 million in the first nine months of 1981. <sup>1/</sup> As of October 1981, they amounted to £C 192.9 million (SDR 387.3 million), equivalent to about 4.8 months of imports.

The Cyprus pound is pegged to a basket of 16 currencies representing about two thirds of Cyprus' foreign trade in 1975. Adjustments of the exchange rate for the Cyprus pound are made on a daily basis and are mostly automatic, although discretion is occasionally used. Tentative calculations of the Central Bank of Cyprus, based on a basket of 27 currencies, indicate that a moderate effective appreciation of the Cyprus pound in the period 1976 to 1979 was followed by virtual stability in 1980 and some effective depreciation during the first half of 1981; changes in real terms were minimal.

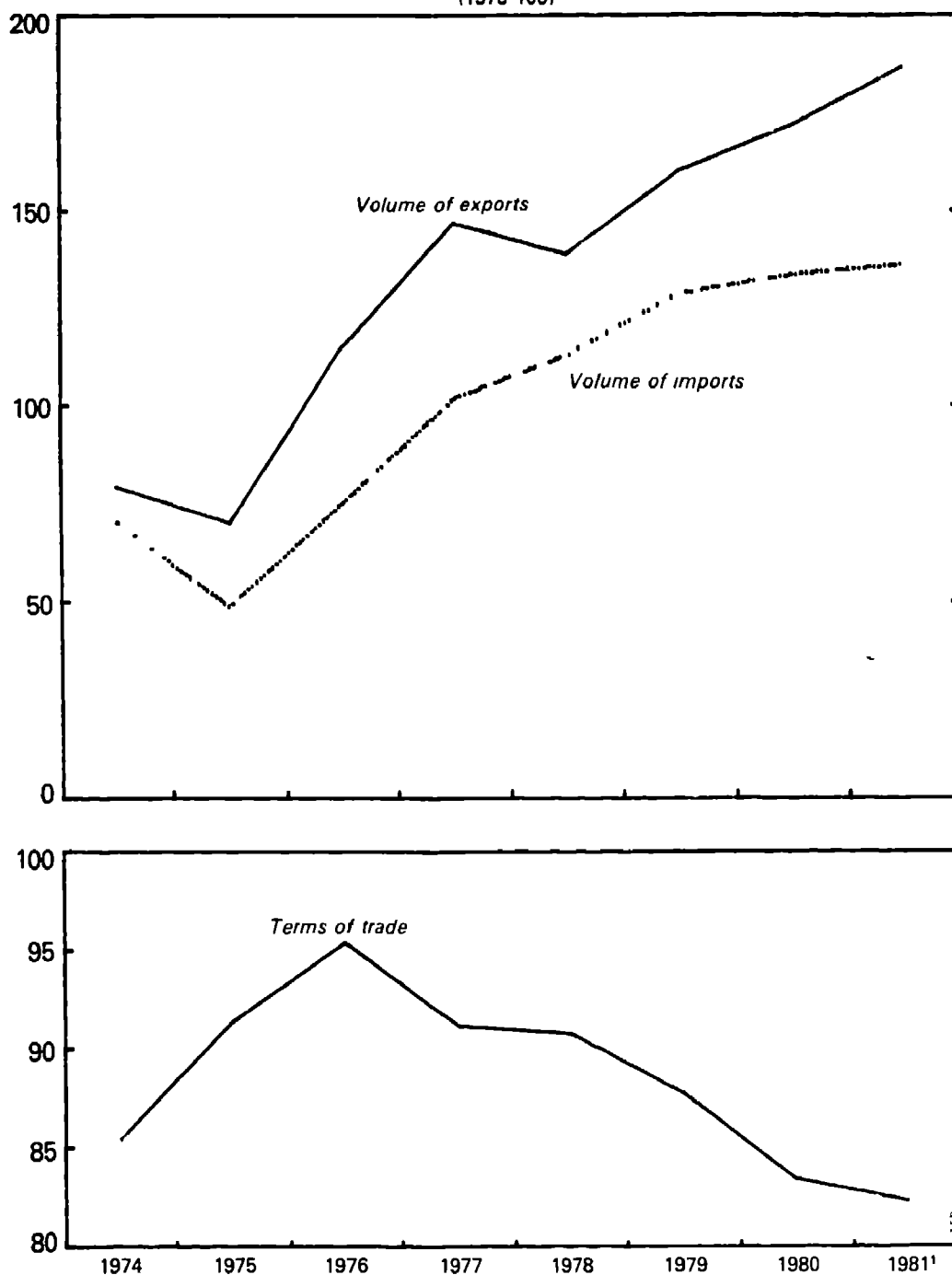
Since the last consultation, the only remaining bilateral payments agreement with the People's Republic of China was terminated. As of January 1, 1982, the authorities raised the basic annual travel allowance for tourists from £C 300 to £C 350 per person, the level in effect before mid-1974; the restriction may be waived in exceptional instances. Residents also have a right to a business travel allowance of up to £C 100 per day. The Cypriot representatives considered it necessary to maintain the restriction on travel expenditure in view of the unsettled political situation of the country, the need to guard against the always-present danger of illegal capital outflows and the uncertainties surrounding the balance of payments. Nevertheless, even with the present travel allowances, there was a substantial increase in tourist expenditure abroad due to the rising number of Cypriot citizens travelling to other countries.

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<sup>1/</sup> Changes in gross official reserves differ significantly from the overall payments surplus because the latter does not include net changes in monetary capital.

CHART 4  
CYPRUS  
VOLUME OF EXPORTS AND IMPORTS,  
AND TERMS OF TRADE

(1973=100)

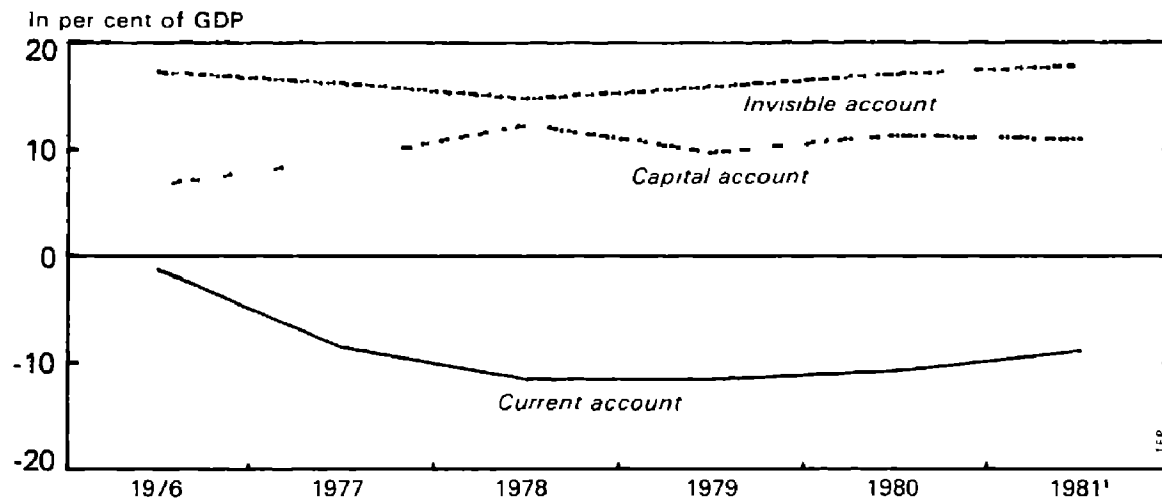
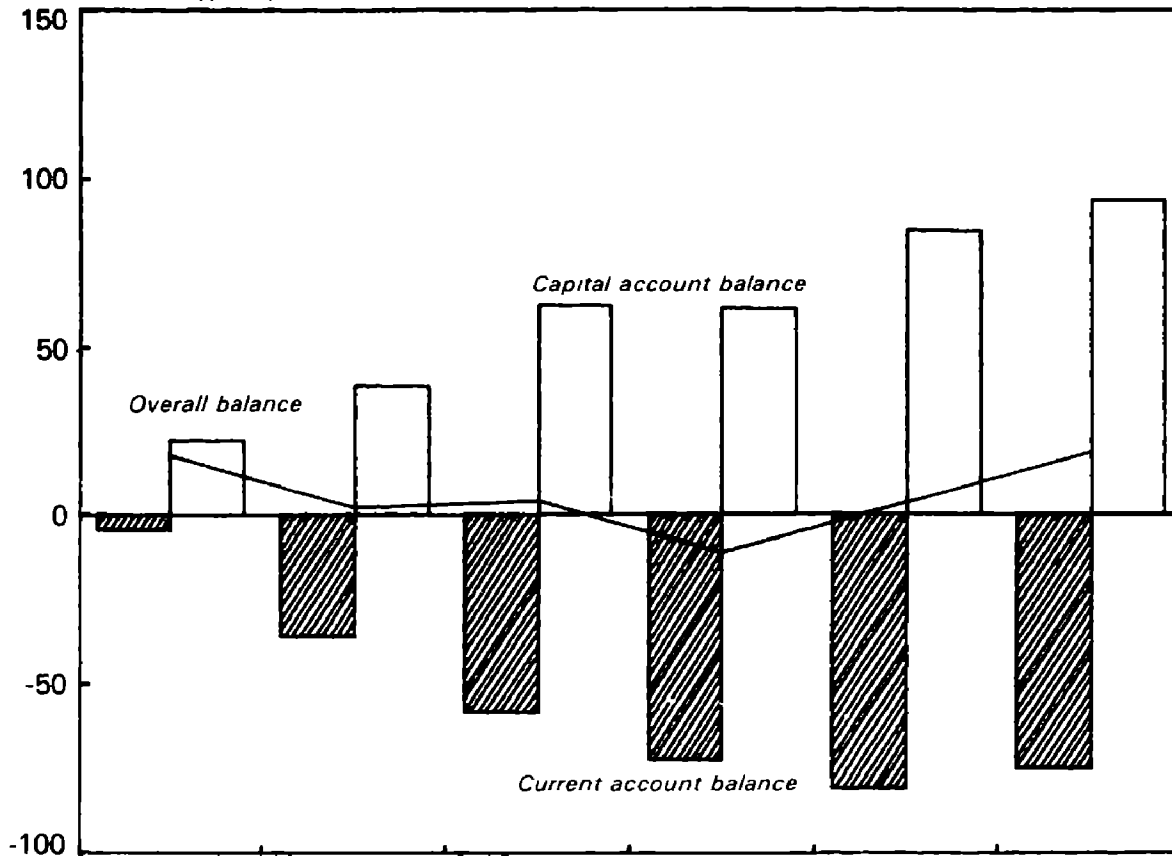


Sources: Central Bank of Cyprus *Bulletin* and Ministry of Finance *Imports and Exports Statistics*

<sup>1</sup>Estimates

CHART 5  
CYPRUS  
BALANCE OF PAYMENTS

In millions of Cyprus pounds



Sources: Central Bank of Cyprus *Bulletin*. Data provided by the Cypriot authorities.

<sup>1</sup>Estimates

### III. Future Policies and Prospects

The Cypriot representatives, while pleased with the positive overall result of the stabilization program, expressed disappointment about the major shortcomings in the areas of wages and salaries, and public finance. They observed that only the significantly stronger than expected fall in private demand during the program period made it possible to attain the overall objectives. Therefore, the improvements in the external current account and with regard to inflation could prove temporary if in 1982 no determined efforts were made to constrain the expansionary influence of the public sector and to limit the rise of wages and salaries. They also felt that it was crucial to maintain the currently high level of private savings.

Accordingly, the authorities intend to undertake strong efforts in the fields of monetary, fiscal, and incomes policies to contain the growth of domestic demand in 1982. Monetary policy will again have to bear major responsibilities. A system of selective ceilings on bank lending is intended for 1982 which would discourage private consumption but leave more room for credits for productive purposes. The Cypriot representatives acknowledged that, in the longer run, credit ceilings could lead to distortions and attempts of evasion, but felt that at present no practical policy alternatives existed. Banks do not seek refinancing from the Central Bank, the present organization and scope of domestic financial markets does not allow an open market policy, and the present design of minimum reserve requirements is not geared toward overall objectives of monetary policy. A number of measures are planned to raise real interest rates on longer-term paper with a view to support private savings and, at the same time, facilitate an increase in the share of nonmonetary domestic financing of the public sector deficit. Most importantly, a bill which would lift the present legal ceiling on nominal interest rates is at present before Parliament, and there seems to be a fair chance for positive action.

As for the 1982 consolidated central government budget, the authorities indicated that their policy aims at reducing the overall budget deficit both in absolute size and relative to GDP. They conceded that success would not come easily, in particular in a year which precedes presidential elections scheduled for early 1983. Without measures to boost revenue and to limit the rise of expenditure, the public sector deficit would show another substantial increase in 1982 in absolute terms as well as in relation to GDP, exerting thus a strong expansionary effect on the economy. It is expected that nonmonetary domestic financing can be extended in 1982 but even under optimistic assumptions would cover only a relatively small part of the deficit. Recourse to central bank financing has nearly reached its statutory limit, and will therefore be limited by the increase in ordinary budget revenue. With banks being at present quite liquid, there is room for additional sales of Treasury bills. Otherwise, financing has to come from international credit markets where Cyprus is, for the time being, not encountering any difficulties.

The third area in which the authorities have taken the initiative is that of wage and salary policy. The Minister of Finance has recently participated in the negotiations for the remunerations of employees in the pace-setting semipublic sector so as to impress on the parties the need for moderation. Furthermore, the authorities are at present engaged with the trade unions and the employers' federation in discussions of ways to modify the procedures determining income from dependent work, in particular, the wage indexation system. The aim is to ensure greater consistency with productivity developments and to take proper account of changes in the terms of trade and indirect taxes. However, in view of strong resistance in various quarters, the Cypriot representatives were not optimistic as to an early success.

The Cypriot representatives provided the mission with an assessment of the prospects for the balance of payments and the economy for 1982 under the assumption that sufficiently restrictive action in the fields of monetary and, in particular, fiscal policies would be taken. Imports would increase by 10-11 per cent in value but little in volume, the expected stability of oil prices allowing higher imports of consumer goods. The value of merchandise exports would grow by about 13 per cent, due to a continued good performance of the manufacturing sector. The surplus on invisible transactions would rise by about 20 per cent; in particular, receipts from tourism and transportation would continue to rise strongly. This implies a real increase in total exports stemming, in particular, from services. On the basis of these projections, the current account deficit would amount to some £C 60-65 million, equivalent to about 7 per cent of GDP, compared with an estimated £C 75 million for 1981 (8.7 per cent of GDP). Autonomous capital inflows, such as direct investment and credits contracted for specific development projects, could be expected to cover about £C 55 million of the projected current account deficit. The Cypriot representatives pointed out that the remaining £C 5-10 million could be financed without problem by a fall in reserves, but in view of the public sector financing needs, an increase in official reserves would be the more likely outcome.

On the basis of the various assumptions discussed above, real GDP in 1982 could grow by about 3 per cent with the GDP deflator rising by about 10 per cent. Much as in 1981, economic growth would be export led, with imports remaining unchanged in real terms. Because of an expected improvement in the investment climate, investment should recover somewhat. There would be room for real consumption to grow modestly. The Cypriot representatives expect disposable nominal income to grow again strongly, and emphasized that the projections for consumption and imports in real terms thus hinge on the maintenance of a high rate of private savings.

#### IV. Staff Appraisal

The economic problems the Cypriot authorities have to cope with at the present juncture are quite different from those after the mid-1974 events. At that time, the task was one of reconstruction and of integrating a large number of refugees into the economy. Today, in view of



the generally tight labor market and other constraints on the expansion of the economy, the task is to contain the rise in domestic demand while at the same time encouraging productive investment.

For such an undertaking, the Cypriot economy is in a good position. It has successfully broadened its industrial base and greatly extended its tourist facilities. The stabilization program introduced in early 1980 succeeded in reducing the external current account deficit and inflation to more manageable levels. However, a good deal remains to be done and continued determination is needed in pursuing the objectives of more lasting internal and external stability. While the immediate objectives of the stabilization program were broadly met, total liquidity and domestic nominal income continued to expand much faster than the real base of the economy, due to strongly rising wages and salaries and large budget deficits. At the same time, there was a shift in the composition of domestic demand from the private to the public sector and from investment to consumption.

The quantitative ceilings on bank lending to the private sector, were not reached as private demand was already declining. On the other hand, the authorities did not succeed in stemming the rise in public expenditures, particularly on salaries and wages, subsidies and transfers, and current expenditure far outpaced revenue. The resulting large overall budget deficits in 1980 and 1981 were financed overwhelmingly by recourse to domestic monetary financing, and by substantial foreign borrowing. As a consequence, about half of the creation of additional domestic liquidity in the recent past was on account of the public sector.

The foreign borrowing by the Government for the financing of the budget deficit greatly extended capital inflows and led to an overall balance of payments surplus in both 1980 and 1981. Continued foreign borrowing on a large scale could jeopardize control over domestic liquidity and become unsustainable over the medium term. But there was also genuine improvement in the external situation following adoption of the stabilization measures. Real imports grew only modestly while real exports, in particular of manufactured goods, continued their marked expansion. Tourism was again very successful in both 1980 and 1981, and in 1981 the current account deficit as a ratio to GDP is expected to be significantly below the levels registered before the stabilization program.

Developments in 1982 and beyond will crucially depend on the stance of policies in various areas. In order to reduce the current external deficit to a level that can be financed by autonomous capital inflows, and to avoid a reacceleration of inflation, it will be of great importance to moderate the rise in wages and salaries and to reduce substantially the overall budget deficit. Credit policy will remain generally restrictive aiming at the containment of private consumption while leaving enough room for productive investment. In the field of incomes policy, the authorities are actively engaged in a campaign to impress on the social partners the need for restraint and for a more flexible wage indexation

system. Since these efforts may not yield immediate results so that income from dependent labor may continue to rise faster than productivity, it is important that the currently high private savings ratio be preserved. In this connection, measures to increase the level of real yield on Treasury paper are to be welcomed and it is important that the legal limits on interest rates be lifted.

The area where the authorities can exercise direct influence is the budget. Measures have been taken or are under consideration to improve revenues. However, tangible results can only be expected in the medium-term. It is the expenditure side which is of special concern and requires particular efforts. Every attempt should be made to slow down the rise in personnel expenditure and to cut subsidies. Otherwise the authorities will be faced in 1982 with a large deficit that would require substantial monetary domestic and foreign financing. The attending creation of liquidity, which would more than offset any positive results of credit restraint on the private sector, could cause severe internal and external imbalances. If the overall objectives are not to be compromised, failure to act in this one area of economic policy would necessitate greater efforts in other areas, entailing the risk of distortions which would impair a balanced development of the economy in the longer run.

The effective exchange rate of the Cyprus pound has been kept broadly stable over the last four years, a policy aimed at assisting efforts to contain inflationary pressure. Custom and excise duties on some luxury goods--in particular larger-sized cars--were increased in connection with the stabilization program, mainly in order to dampen private consumption and to promote energy conservation. The only remaining bilateral payments agreement with the People's Republic of China was terminated. In view of existing uncertainties in the political situation and in the balance of payments, the authorities did not consider it advisable to remove the restriction on travel allowance but instead they raised the amount from £C 300 to £C 350 as of January 1, 1982. The staff recommends that the Fund approve this restriction as amended until the conclusion of the next consultation with Cyprus.

V. Proposed Decision

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

1. The Fund takes this decision relating to Cyprus' 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.

Table 1. Cyprus: Performance Under  
the Stabilization Program for July 1980/June 1981

(In millions of Cyprus pounds)

	1979/80 Actual	1980/81 Program	1980/81 Outturn
<b>1. Objectives</b>			
Current external deficit	-104.2	-77.7	-63.1
In per cent of GDP	-15.0	-9.7	-7.9
Consumer price index			
Percentage change between second quarters	15.0	... 1/	10.0
<b>2. Instruments</b>			
Change in domestic credit	113.7	72.0	73.0
Change in per cent 2/	29.0	16.0	16.3
Change in credit to the private sector	68.0	62.0	49.2
In per cent of total credit	59.2	86.1	67.4
Change in credit to the public sector	45.7	10.0	23.8
In per cent of total credit	40.2	13.9	32.6
Overall budget deficit	-43.5	-23.2 3/	-55.7
In per cent of GDP	-6.3	-2.9 3/	-7.0
Memorandum items:			
(Percentage changes)			
<b>Real sector</b>			
Real GDP at market prices	6.3	3.5	3.2
Real private consumption	8.8	-1.3	-3.9
Real gross investment	11.3	-7.5	-10.0
<b>Fiscal sector</b>			
Current receipts (including grants)	34.0	19.3	15.1
Current expenditure 4/	32.2	8.1	28.3
Tax ratio to GDP (level)	17.0	18.7	17.8
<b>Monetary sector</b>			
Broad money	14.4	12.0	19.3
Income velocity (level)	1.63	1.68	1.62
<b>Balance of payments</b>			
Volume of domestic exports	3.9	6.0	11.5
Volume of imports	16.3	-5.3	-3.3

Source Data provided by the Cypriot authorities.

- 1/ No quantitative target for inflation was set; the objective was to lay the foundation for a decline in the rate of inflation.
- 2/ Percentage change in domestic credit over initial money stock.
- 3/ Because of a restructuring of the format of the consolidated central government budget, the EC 23.2 million (2.9 per cent of GDP) overall budget deficit is equivalent to the EC 9.4 million (1.2 per cent of GDP) deficit envisaged by the program under the old budget format.
- 4/ As defined under the program (i.e., excluding unallocable expenditure).

Table 2. Cyprus: Consolidated Central  
Government Budget, 1/ 1978-81

(In millions of Cyprus pounds)

	1978	1979	1980	1981	
		Outturn		Budget 2/	Estimated Outturn
1. Revenue	99.7	123.2	160.8	201.2	192.4
Of which:					
Tax	78.9	101.5	129.8	170.4	158.6
Direct	31.7	41.1	59.8	87.5	83.2
Indirect	47.2	60.4	70.0	82.9	75.4
2. Expenditure	135.2	170.4	221.6	229.3	264.2
Current expenditure	106.6	130.7	177.2	179.1	217.0
Of which:					
Wages and salaries	42.9	58.3	72.6	86.6	86.8
Subsidies and transfers	36.3	45.4	66.2	65.6	88.7
Capital expenditure	28.6	39.7	44.4	50.2	47.2
3. Net lending	7.2	4.7	8.8	5.6	7.0
4. Total expenditure (2+3)	142.4	175.1	230.4	234.9	271.2
5. Foreign grants 3/	13.7	13.1	12.5	13.1	12.0
6. Overall budget balance (1-4+5)	-29.0	-38.8	-57.1	-20.6	-66.8
7. Financed by:					
Net domestic borrowing	23.1	34.5	35.0	.	30.9
Bank financing	20.5	12.4	25.1	.	.. 4/
Foreign borrowing (net)	12.9	11.0	31.1	...	42.5
Use of cash balances					
(increase (-))	-0.7	-9.2	-8.6	...	-3.5
Net IMF transactions	-7.7	2.5	-0.4	...	-3.1
Memorandum items:					
Current savings (in per cent of GDP)	-1.4	-1.2	-2.2	2.5	-2.9
Total expenditure (in per cent of GDP)	28.0	27.9	30.7	27.4	31.6
Domestic revenue (in per cent of GDP)	19.6	19.6	21.4	23.4	22.4
Overall balance (in per cent of GDP)	-5.7	-6.2	-7.6	-2.4	-7.8

Source Data provided by the Cypriot authorities

1/ The consolidated central government budget includes the ordinary budget, the development budget, the Public Loans Fund, the Social Insurance Fund, and the Special Relief Fund for Displaced Persons

2/ As amended by tax measures introduced in early 1981.

3/ Grants from Greece and from the United Nations High Commission for Refugees.

4/ By September 1981, credit to the public sector (including credit to government agencies) increased by £C 21.0 million.

Table 3. Cyprus: Monetary Developments  
1979-81 (September)

(In millions of Cyprus pounds)

	1981 September End of period	1979	1980 June Dec. Changes from previous year		1981 June Sept.	
Net foreign assets	141.9	-5.3	-42.4	2.1	27.9	56.4
Domestic credit	513.7	80.0	113.7	78.1	73.0	60.8
To private sector	430.7	63.9	68.0	48.2	49.2	52.5
To public sector <u>1/</u>	83.0	16.2	45.7	29.9	23.8	8.3
Other items, net	-92.4	-7.1	-14.7	-11.6	-14.5	-22.6
Broad money	563.3	67.6	56.5	69.9	86.4	94.6
Memorandum items:			(In per cent)			
Changes at annual rates in:						
Narrow money		26.6	18.0	18.4	21.5	19.8
Quasi money		15.4	13.0	14.8	18.4	20.4
Broad money		18.5	14.4	15.9	19.3	20.2
Contribution to growth of broad money <u>2/</u>						
Domestic credit to private sector		17.5	17.3	11.1	11.0	11.2
Domestic credit to public sector		4.4	11.7	7.0	5.3	1.8
Foreign assets, net		-1.5	-10.8	0.5	6.2	12.0
Other items, net		-1.9	-3.8	-2.7	-3.2	-4.8

Sources: Central Bank of Cyprus, Bulletin; and data provided by the Cypriot authorities.

1/ Including lending to government agencies, in addition to the financing of the consolidated deficit of the Government.

2/ Change in domestic credit, foreign assets and other net items over the preceding twelve months as per cent of initial money stock.

Table 4. Cyprus: Balance of Payments, 1979-81

(In millions of Cyprus pounds)

	1979	1980	1981 <sup>1/</sup>	1980		1981	
				I	II	I	II <sup>1/</sup>
Exports, f.o.b.	149.5	172.7	208.5	86.1	86.6	106.9	101.6
Imports, f.o.b.	-321.2	-381.0	-436.5	-200.1	-180.9	-215.8	-220.7
Trade balance	-171.7	-208.3	-228.0	-114.0	-94.3	-108.9	-119.1
Invisible receipts	195.1	241.9	290.3	108.6	133.9	131.1	159.2
Of which:							
Tourism receipts	50.1	70.5	96.0	26.7	43.8	38.0	58.0
Invisible payments	-96.0	-114.5	-137.6	-53.8	-60.9	-63.6	-74.0
Invisible balance	99.1	127.4	152.7	54.8	68.0	67.5	85.2
Current account balance	-72.6	-80.9	-75.3	-59.2	-21.7	-41.4	-33.9
(In millions of SDRs)	-158.6	-176.4	-151.8	-129.2	-47.2	-85.5	-66.3
Direct investment	25.0	30.0	30.0	15.0	15.0	15.0	15.0
Private long-term loans	8.2	15.9	34.0	2.5	9.4	17.4	16.6
Official long-term loans	12.0	31.3	26.5	4.8	27.3	--	26.5
Short-term capital <sup>2/</sup>	16.0	7.2	2.8	7.0	3.8	-3.5	6.3
Capital balance	61.2	84.4	93.3	29.3	55.1	28.9	64.4
(In millions of SDRs)	133.7	183.6	185.6	63.9	119.7	59.7	125.9
Overall balance	-11.4	3.5	18.0	-29.9	33.4	-12.5	30.5
(In millions of SDRs)	-24.9	7.4	33.8	-65.2	72.6	-25.8	59.6
Memorandum items:							
Current account balance/GDP	-11.5	-10.8	-8.7	-16.2	-5.7	-10.0	-7.6
Balance of Trade/GDP	-27.3	-27.8	-26.6	-31.1	-24.6	-26.3	-26.8
Merchandise imports/GDP	51.1	50.8	50.8	54.6	47.1	52.1	49.7
Merchandise exports/GDP	23.8	23.0	24.2	23.5	22.6	25.8	22.9
Tourist receipts/trade deficit	29.2	33.8	42.1	23.4	46.4	34.9	48.9

Sources: Central Bank of Cyprus, Bulletin; data provided by the Cypriot authorities, and IMF, International Financial Statistics.

<sup>1/</sup> Official estimates based on developments through the first half of the year.

<sup>2/</sup> Including net errors and omissions.

**Fund Relations with Cyprus**

(As of October 31, 1981)

**Status:** Article IV.

**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 the 1976 quota (SDR 13.0 million) under the compensating financing facility; in January 1979 Cyprus purchased an additional SDR 9.9 million under the compensating financing facility. In July 1980 Cyprus obtained a stand-by arrangement from the Fund in the first credit tranche, and a purchase of SDR 8.5 million was made in August 1980.

(Fund holdings of Cyprus pounds)

	Amount (In millions of SDRs)	In per cent of quota
Total	73.5	144.1
Of which:		
Credit tranches (including SBA)	4.2	8.3
Oil facility	8.4	16.4
Compensatory financing	9.9	19.4

Cyprus' repurchases due in 1982 amount to SDR 9.3 million, including the equivalent of SDR 5.6 million on account of the oil facility purchases, and SDR 3.7 million on account of drawings under the compensatory financing facility. Repurchases made during 1981 amounted to SDR 9.9 million.

**SDR department:** SDR 0.4 million holdings, equivalent to 2.1 per cent of net cumulative allocations (SDR 19.4 million).

**Direct distribution of profit from gold sales:** Cyprus received US\$4.1 million.

**Gold distribution:** Cyprus acquired 22,251.563 fine ounces of gold in the first four phases.



**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 its main trading partners. On December 9, 1981, the rate of Cyprus pound was £C 1 = SDR 1.991.

**Last consultation and Cyprus request for a stand-by arrangement:**

The last consultation discussions under Article IV were held in May 1980 and the Executive Board in concluding the Article IV consultation, along with a discussion of the Cyprus request for a stand-by arrangement, adopted the following decisions on July 16, 1980:

**a. 1980 Article IV Consultation**

1. The Fund takes this decision in concluding the 1980 Article IV consultation with Cyprus, in the light of the 1980 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 as described in SM/80/155. The Fund notes the intention of the authorities to review this exchange restriction with the Fund before the end of the period of the stand-by arrangement proposed in EBS/80/142, and, in the circumstances of Cyprus, grants approval for the retention of this exchange until July 16, 1987. The Fund hopes that Cyprus will terminate its payments agreement with the People's Republic of China at an early date.

**b. Stand-by arrangement**

1. The Government of Cyprus has requested a stand-by arrangement for a period of one year beginning July 16, 1980, for an amount equivalent to SDR 8.5 million.
2. The Fund approves the stand-by arrangement attached to EBS/80/142.
3. The Fund waives the limitation in Article V Section 3 (b) (iii) of the Articles of Agreement.

Decision No. 6566-(80/155),  
adopted at July 16, 1980.

Cyprus--Basic Data

Area (whole island) 9,251 square kilometers  
 Population (1980) 510,800 (whole island 628,500)  
 GNP per quota (1980) £C 1,518 or SDR 3,305

<u>Output by sector in 1980 at current prices</u>	<u>In millions of £C</u>	<u>In per cent</u>
Primary sectors	84.4	12.1
Agriculture	74.3	10.7
Industry	235.0	33.8
Manufacturing	124.6	17.9
Construction	100.1	14.4
Services	375.9	54.1
GDP at factor cost	695.3	100.0

<u>National accounts</u>	<u>1980</u>		<u>1979 1980 1981 1/</u>		
	<u>In millions of £C at current market prices</u>	<u>In per cent</u>	<u>Percentage changes at constant 1979 prices</u>		
Private consumption	504.5	67.3	6.4	4.4	-0.1
Public consumption	107.6	14.3	9.1	5.0	4.7
Gross investment	270.0	36.0	8.2	-2.4	-2.8
Gross domestic expenditure	882.1	117.6	7.2	2.3	-0.4
Exports of goods and services	343.6	45.8	20.7	10.0	8.8
Imports of goods and services	-475.7	-63.4	14.1	4.0	0.7
GDP at market prices	250.0	100.0	85.	4.7	3.2

<u>Selected economic data, average change in per cent</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981 1/</u>
Average earnings	21.7	24.9	25.5	18.0
Retail prices	7.4	9.5	13.5	11.1 2/
Domestic credit (end-year data)	24.0	25.9	20.1	10.0 3/
Money and quasi money (end-year date)	14.9	18.5	15.9	20.2 3/
Employment	3.4	3.0	1.3	...
Unemployment rate (in per cent; yearly average)	2.3	2.1	2.4	3.0

<u>Selected economic data, in per cent of GDP</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981 1/</u>
Gross national saving	26.6	27.4	26.9	26.5
Private	25.3	26.6	27.4	28.0
Public	1.3	0.8	-0.5	-1.5
Gross domestic investment	35.4	36.5	34.8	33.2
Consolidated central government budget:				
Domestic revenue	19.6	19.6	21.4	22.4
Total expenditure (including net lending)	28.0	27.9	30.7	31.6
Budget balance	-8.4	-8.3	-9.3	-9.2
Foreign grants	2.7	2.1	1.7	1.4
Overall balance	-5.7	-6.2	-7.6	-7.8

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u> <u>1/</u>
External public debt (year-end) <u>4/</u>	17.1	16.6	19.1	25.2
Of which:				
Central government debt	10.3	10.1	12.7	15.6
Debt service payments on external public debt as a ratio to exports of goods and services <u>4/</u>	3.5	4.8	5.6	6.6
Of which:				
Payments on central government debt as a ratio to exports of goods and services	1.5	1.8	2.6	3.8
<u>Balance of payments, in millions of SDRs</u>				
Exports, f.o.b.	261.1	326.7	376.0	419.3
Imports, f.o.b.	-546.6	-701.8	-829.6	-877.1
Trade balance	-285.5	-375.1	-453.6	-457.8
Net invisible payments	160.1	216.5	277.2	306.0
Current account balance	-125.4	-158.6	-176.4	-151.8
(In per cent of GDP)	-11.5	-11.5	-10.3	-8.7
Long-term capital	115.2	98.7	73.6	89.9
Short-term capital, including errors and omissions	18.6	35.0	10.8	2.8
Overall balance	8.4	-24.9	7.4	33.8
Gross official reserves (year-end)	281.0	284.0	305.0	387.3 <u>5/</u>
Months of imports, c.i.f. equivalent)	5.5	4.3	4.0	4.8 <u>5/</u>
SDR/Cyprus pound exchange rate (end of period)	2.185	2.196	2.149	2.008 <u>5/</u>
U.S. dollar /Cyprus pound exchange rate (end of period)	2.847	2.893	2.741	2.311 <u>5/</u>

Source: Data provided by the Cypriot authorities and staff estimates.

1/ Estimates.

2/ August 1981.

3/ September 1981.

4/ Central government (excluding IMF credits) and semi-public organizations.

5/ October 1981.