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March 26, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Cyprus - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Cyprus, which is tentatively scheduled for discussion on Wednesday, April 16, 1986. A draft decision appears on page 14.

Mr. Manison (ext. 7186) or Mr. Nellor (ext. 8835) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

CYPRUS

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Article IV Consultation

Approved by Brian Rose and J. T. Boorman

March 25, 1986

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Messrs. L. Manison, D. Nellor, A. Lopez-Claros and, as secretary, Ms. K. Moran (all EUR) visited Nicosia on January 14-24, 1986 to conduct Article IV consultation discussions. The mission met with the Minister of Finance, Mr. C. Mavrellis, the Governor of the Central Bank of Cyprus, Mr. A. Afxentiou, and with officials of the Ministries of Finance, Commerce and Industry and Labor, of the Planning Bureau and of the Central Bank of Cyprus, as well as, at the request of the Cypriot authorities, with the leadership of the Employers' Association and of two major trade unions.

The previous consultation discussions had taken place in Nicosia in October 1984 and the staff report was considered by the Executive Board on December 19, 1984. Cyprus continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement.

II. Report on the Discussions

I. Recent economic developments

Cyprus' economic performance in the last several years has been characterized by the maintenance of a relatively high rate of growth of GDP--around 5 percent on average during the first half of the 1980s, nearly 3 1/2 percentage points higher than the average of its main trading partners. The rate of unemployment has remained below 4 percent through this period. Real GDP growth was mainly sustained by a rapid growth of domestic demand (which rose by 4 1/4 percent on average during the period) and especially of consumption, which increased by nearly 5 1/2 percent a year on average. The real foreign balance made a relatively small contribution to growth, mainly reflecting a strong performance of tourism and of other exports of services. The relatively high rate of growth of domestic demand contributed importantly to the maintenance of large current account deficits in the balance of payments, which averaged the equivalent of over 8 percent of GDP during the first

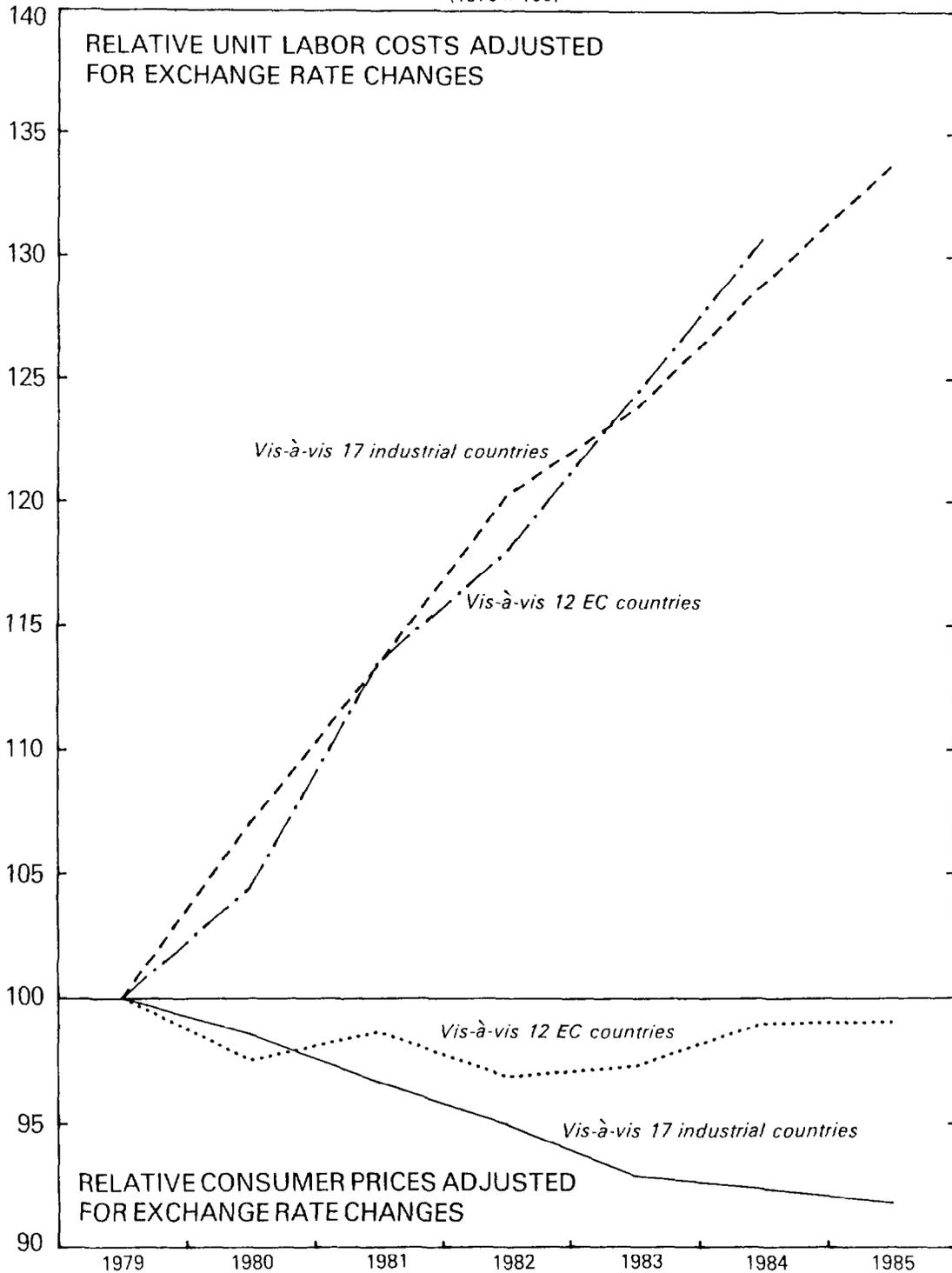
half of the 1980s, leading to a sizable accumulation of foreign debt--estimated to have reached 44 percent of GDP by end-1985--despite considerable nondebt capital inflows, mainly in the form of residential investments in Cyprus by Cypriot expatriates.

The rapid growth of domestic demand was fueled by rather expansionary financial and budgetary policies, which accommodated a sharp increase of wages and of households' disposable income. Real wages rose cumulatively by 33 percent (18 percentage points in excess of the growth of productivity) between 1980 and 1985 and real disposable income increased by 29 percent as inflation was moderated by inter alia the relative strength of the exchange rate--estimated to have appreciated in effective terms by about 10 percent during the period. This appreciation, in conjunction with a growth of unit labor costs substantially in excess of the average of Cyprus' main trading partners, also led to a marked erosion of cost competitiveness (Chart 1), only partly offset by the maintenance of relatively low capital costs and of generous tax incentives for enterprises.

Developments in 1985 were broadly in line with the underlying trends of the last few years, although they were also partly affected by special factors of a nonrecurrent nature. The rate of growth of domestic demand decelerated markedly from 8 percent to 1.5 percent in 1985. This decline was, however, almost entirely due to a reduction in purchases of aircraft by Cyprus Airways (which amounted to the equivalent of 2 percent of GDP in 1985, compared with 4 1/2 percent of GDP in 1984). The rate of growth of domestic demand, excluding these purchases, registered only a small deceleration (Table 1), concentrated in investment. The growth of private consumption actually accelerated to an estimated 4 1/2 percent, reflecting a significant fall in the savings ratio of households from an historically high level in 1984. The foreign balance--excluding imports of aircraft--made only a small contribution to growth in 1985, as the favorable impact of a marked slowdown in imports, especially in the second half of the year, was largely offset by the deceleration of exports of goods and services. Although tourism continued to be relatively buoyant--with tourist arrivals increasing by over 9 percent for the year as a whole--domestic merchandise exports fell by an estimated 8.7 percent in volume terms. This decline was partly a reflection of a 40 percent decline in exports of potatoes (which in 1984 had accounted for about 9 percent of merchandise exports) due to adverse weather conditions. Exports, however, were also affected by the downturn in demand in some important markets such as Libya and by the erosion of competitiveness, referred to above. Re-exports, which had been boosted in previous years by the crisis in neighboring Lebanon, also declined as conditions improved in that country.

Preliminary information indicates that the terms of trade recorded a 3 percentage point loss in 1985, following a sizable gain in 1984. This loss was also in large part attributable to a sharp fall in potato prices. On the whole, the trade deficit declined slightly in relation

CHART 1
CYPRUS
REAL EFFECTIVE EXCHANGE RATE INDICES
(1979 = 100)



Source: IMF, *International Financial Statistics*, data provided by the Cypriot authorities.



to GDP (from 31 1/2 percent of GDP in 1984 to 30.2 percent in 1985). However, after adjusting for the differential impact of purchases of aircraft in the two years, the deficit rose in 1985 by the equivalent of over 1 percentage point of GDP. The traditional surplus on invisibles rose by the equivalent of 1.6 percent of GDP, mainly reflecting the strong performance of tourism. The interest burden on the external debt was moderated by the decline in interest rates abroad and by the relative strength of the exchange rate--estimated to have appreciated by 3.7 percent in nominal effective terms on average for the year. The current account deficit declined from £C 117 million (about 9 percent of GDP) in 1984 to an estimated £C 89 million (6 1/4 percent of GDP) in 1985 (Table 2). However, the overall balance shifted from a sizable surplus in 1984 to a £C 17.6 million deficit in 1985, reflecting a marked decline in foreign borrowing and a short-term capital outflow, primarily on account of delays by Libya in payments for exports. The external debt at the end of 1985 is estimated to have reached the equivalent of US\$1.15 billion (44 percent of GDP). The debt service ratio in 1985 rose to 14 percent of foreign exchange earnings (Table 3). Gross international reserves were equivalent to SDR 598 million at end-November 1985 (over 5 1/2 months of imports).

The stance of financial policies remained relatively accommodating in 1985. The deficit of the consolidated central government budget declined slightly in relation to GDP, to 5.3 percent. The rate of growth of revenue, which had been boosted in 1984 by increases in the rates of various indirect taxes, decelerated markedly in 1985, as no new tax measures were introduced, the growth of the tax base slowed down and foreign grants continued to fall. The impact of this deceleration in revenues was, however, more than offset by a moderation in the growth of current expenditures, excluding those on wages and purchases which accelerated instead. The relative moderation of expenditures was partly a reflection of favorable external factors, namely lower import prices of subsidized grain products and interest payments on the external debt. A slight decline in investment expenditures was largely due to delays in the implementation of a major water management project (the Southern Conveyor Project). These delays are expected to be made up in 1986.

The total (domestic bank and external) financing of the deficit is estimated to have contributed 6 1/2 percentage points to the growth of broad money in 1985, compared with almost 8 percentage points in 1984 (Table 5). The growth of bank credit to the private sector accelerated to nearly 14 percent in 1985--entailing an increase of 8 1/2 percent in real terms--and a sizable (about 4 percentage points) overshooting of the target envisaged in the initial monetary program of the Central Bank of Cyprus. In an effort to check the growth of credit to the private sector, the authorities increased the minimum liquidity ratio of banks by 1 percentage point in January 1985 (to 27 percent) and by a further percentage point in October 1985. In the course of the year the Central Bank also tightened the enforcement of penalties on banks registering shortfalls in the liquidity ratio. These measures were, however,

largely ineffective in checking the demand for bank credit which continued to be supported by relatively low real lending rates--there is a legal ceiling of 9 percent on interest rates--and reportedly in part by the need to finance unintended inventory accumulation in export industries facing a sharp decline in orders. In addition, credit extended by nonbank financial entities, including the cooperative credit societies, which is equivalent to over 35 percent of total domestic credit to the private sector, continued to expand at an even faster rate than bank credit (see Recent Economic Developments paper, Chapter III, to be issued shortly).

The accommodating stance of financial policies was at least in part responsible for the continued relatively rapid growth of nominal wages which, given the deceleration of inflation, led to a renewed pickup in the growth of real wages, following some moderation in 1984 (Table 1). The growth of unit labor costs in the manufacturing sector accelerated to an estimated 8 percent in 1985, from around 6 percent in 1984, reflecting a slowdown in productivity growth. The impact of higher unit labor costs on inflation was moderated by the marked slowdown in import prices and, according to preliminary estimates, by a decline in profit margins, which was especially pronounced in export-oriented industries.

2. Economic policies and prospects

a. The "on present policies" prospects for 1986

Tables 1 and 2 present staff projections of developments in the main macroeconomic aggregates and the balance of payments, respectively, based on the initial budget proposal and monetary program for 1986. The 1986 budget proposal, which is based on existing legislation and is currently under discussion in the House of Representatives, envisages a small increase in the overall deficit of the Central Government (including the social security transactions) from the equivalent of 5.3 percent of GDP in 1985 to 5.7 percent in 1986 (Table 4). No new tax measures are proposed in the budget, and the 1/2 percentage point increase in tax revenues relative to GDP mainly reflects the impact of the progressivity of the personal income tax. The Cypriot authorities regard the revenue projections as relatively cautious, since they make no allowance for improved tax enforcement and collections of arrears. On the expenditure side, the budget foresees a marked increase in fixed investments, on account of a postponement from 1985 of outlays for the Southern Conveyor Project. Of greater quantitative relevance is an expected further acceleration in the growth of expenditures on wages and purchases of goods and services. This projection is predicated on the assumption that civil servants would be granted a salary increase of 2 percent as from the beginning of 1986 and a further 2 percent effective in July 1986, in addition to the cost of living adjustment. The budget projects a significant deceleration in the growth of outlays on subsidies and transfers, but there may be risks of slippages in this area, especially as concerns social security benefits. The financing of the budget deficit is projected to contribute 7 1/2 percentage points to

the growth of broad money in 1986 (compared with 6 1/2 percentage points in 1985). In order to limit the growth of M2 to below 11 percent the authorities are targeting a reduction of nearly 5 percentage points in the rate of growth of credit to the private sector to 9 percent, roughly in line with the growth of nominal GDP. The authorities regard a minimum liquidity ratio of 28 percent on average for the year as consistent with the targeted credit expansion and, to promote banks' compliance with the minimum liquidity requirement, they are considering allowing a limited variation of this ratio during the year to reflect seasonal fluctuations in banks' liquidity.

In the absence of modifications to the existing wage indexation mechanism (which involves a full adjustment of wages to price changes with a lag of six months) and assuming that contractual increases in the private sector broadly follow the pattern of the public sector, wage rates are likely to rise by about 10 percent on average in 1986. Given the prospect of a slight further deceleration of inflation, reflecting an expected decline of import prices in domestic currency, the projected increase in nominal wages would involve an increase of over 5 percent in real terms, once again well in excess of the growth of productivity (Table 1). The attendant rise of unit labor costs in manufacturing would again be significantly higher than the average of competitor countries, leading to a further deterioration in cost competitiveness.

In these circumstances, the main impulse to GDP growth would be provided once again by consumption. The budget would probably have a net positive impact on disposable income of households, which would rise in real terms by over 4 percent. Investment is likely to fall, partly reflecting a pause in the program of purchases of aircraft by Cyprus Airways. ^{1/} The depressed outlook for demand in the Middle Eastern countries, which are important trading partners for Cyprus, and the unfavorable prospects for competitiveness make it unlikely that merchandise exports would recover significantly from the low level of 1985 (Table 2). However, leading indicators such as hotel bookings point to a continued strong growth of tourism, which is also expected to benefit from some easing of restrictions on charter flights from the United Kingdom. The growth of imports is expected to accelerate significantly in 1986, reflecting both the pickup in domestic demand and the marked decline in the prices of imported goods relative to domestic goods. The projected deterioration in the real trade balance will, however, be largely offset by a marked improvement in the terms of trade, mainly reflecting a projected decline of over 35 percent in the price of oil in local currency--oil imports accounted for about 18 percent of total merchandise imports (c.i.f.) in 1985. Given the projected increase in the net surplus on services, the current account deficit is likely to show a significant decline from the 1985 level, to around the equivalent

^{1/} Four new aircraft (A-320's) are expected to be delivered in 1989 at a total cost of about US\$150 million.

of 4 percent of GDP. After adjustment for the differential impact of the purchases of aircraft in the two years, however, the deficit would remain nearly unchanged in relation to GDP.

b. The scope for corrective action

The Cypriot authorities recognize that the prospects for 1986 in the absence of corrective measures would be unsatisfactory in various respects, as they would involve a continuation of the trends evident in recent years of too rapid a growth of consumption, nearly stagnant industrial investment and declining merchandise exports. The expected small improvements in the performance of inflation and the balance of payments would be wholly a reflection of favorable, and in all likelihood temporary, external factors, as domestic costs would, if anything, tend to accelerate, leading to a further weakening of the industrial structure and the competitiveness of the economy. At the time of the consultation discussions the authorities were in the process of defining and articulating an economic policy strategy that would, on the one hand, secure a containment of the growth of consumption in the near term and, on the other hand, set the basis for a sustained improvement in the cost performance and competitiveness over the longer term. They stressed that the scope for corrective action especially in the near term was significantly constrained by the existing political situation. The recent (December 1985) parliamentary elections had kept the government party in a minority in the House of Representatives, making it difficult to rely in the adjustment program on measures requiring the approval of Parliament.

In an effort to contain the budget deficit and to curb the growth of disposable income, in January 1986 the Government submitted to Parliament two proposals for increases in taxation. One bill proposed raising the rate of the so-called defense levy--a special income tax--from 0.5 percent to 3 percent, while the other envisaged an automatic adjustment of the rate of taxation on gasoline to fill the positive gap between the selling price of the latter and its cost. The price of gasoline in Cyprus has remained unchanged since 1981 and is significantly lower than in most European countries, including some with lower per capita income than Cyprus. The defense levy bill was approved by the House with the tax rate increase limited to 1 percent, which should yield approximately £C 6 million (0.4 percent of GDP) additional revenue on a full year basis. The oil tax bill had to be withdrawn in the face of opposition in Parliament and was resubmitted in a modified form, earmarking 50 percent of the revenue increase to subsidize energy for industry. ^{1/} If passed in this modified form, the bill is projected to reduce the budget deficit by about £C 10 million (0.6 percent of GDP) in 1986, assuming the maintenance of current (February 1986) oil prices and

^{1/} In the Cypriot authorities' view, heavy industrial users of electricity are put at a competitive disadvantage by the relatively high rates for electricity needed to compensate for the unbilled electricity consumption in the Turkish occupied area.

exchange rates. The authorities intend to supplement these tax (e.g. fees for public services) measures with increases in nontax revenues and with steps to speed up the collection of tax arrears and to improve taxpayers' compliance, following the recommendations of a special commission on tax enforcement. They also envisage over a somewhat longer time horizon--12-18 months--the introduction of a value-added tax (VAT).

On the expenditure side, the authorities have negotiated with the civil servants' trade union, measures--such as reductions in entry level wages and in paid holidays, increased mobility and flexibility in working hours--which will significantly moderate the growth of the public sector wage bill over the next few years. They are also considering raising the prices of subsidized grain products--which have remained unchanged since 1974--to phase out over a period of five years the grain subsidies which are currently equivalent to nearly 2 percent of GDP. The authorities intend to review critically current and proposed public investment projects, with a view to concentrating financial resources on those with proven high rates of return.

A significant reduction of the public sector deficit below the currently projected level would greatly facilitate securing a substantial deceleration in the growth of monetary and credit aggregates. The Cypriot authorities recognized that the initial monetary program, even if implemented in full, would imply a sizable further decline in velocity and present obvious risks for the balance of payments and/or the inflation performance if such a decline did not materialize. Moreover, the implementation of the program itself may well be hampered by the paucity of monetary instruments at the authorities' disposal. The existence of a relatively low (9 percent) ceiling on interest rates severely limits the scope for control of the monetary base through open market operations and of credit to the private sector through changes in the cost of credit. The authorities stressed that their experience with selective credit ceilings in the early 1980s had been unsatisfactory, because of the distortions in the allocation of credit engendered by these ceilings, and had led to their abolition as from the beginning of 1985. The authorities were also reluctant to consider introducing general credit ceilings because of foreseeable problems in their enforcement. They indicated their intention to submit to Parliament in the near future a bill proposing the abolition or at least a significant increase in the ceiling on interest rates but were unsure of the degree of parliamentary support for such a proposal. The authorities also said that they intended to move quickly toward submitting the cooperative credit societies, which currently are not under the Central Bank's control, to the same regulations as commercial banks, thus enhancing the effectiveness of the minimum liquidity ratio requirement as an instrument of monetary control.

The authorities recognize the importance of securing a substantial deceleration in the growth of wages to improve the prospects for competitiveness and exports over the medium term. They also recognize that, in a relatively tight labor market like the Cypriot one and with over

80 percent of the labor force unionized, the scope for securing such a deceleration lies essentially in a reduction of automaticity in wage adjustments, since significant contractual increases are inevitably added to the cost of living adjustment and to virtually automatic increments for seniority. The Employers' Association has recently taken for the first time the position that the principle of full and automatic adjustment of wages to increases in the cost of living should be renegotiated with the unions. While the latter have publicly opposed a reduction of the degree of indexation, there are indications that they are increasingly concerned by the prospects for exports and the related adverse effects on employment in industry, and are aware of the need to moderate their wage demands. The authorities indicated that they intend to press for a modification of the wage indexation mechanism--e.g. by excluding increases in indirect taxes and in import prices from the cost of living index. The specific strategy in this respect is, however, still under discussion within the Government.

The authorities stressed that the existence of a mechanism entailing a full and relatively rapid adjustment of wages to prices severely limits the effectiveness of changes in the exchange rate as an instrument of external adjustment. In their management of the exchange rate in recent years, they have placed greater weight on moderating the impact of external pressures on domestic prices than on promoting export competitiveness, as indicated by the choice of import shares alone as weights for the effective exchange rate index which they have broadly aimed at stabilizing. They are now considering modifying this approach by using a trade-weighted index which would take into account changing patterns of exports, as well as those of imports.

c. Medium-term prospects and issues

1986 marks the last year of the fourth so-called Economic Emergency Action Plan (1982-86). The Cypriot representatives noted that, on the basis of the record up to 1985, the objectives of the Plan with respect to growth and inflation are likely to be more than met. However, the determinants and composition of growth would differ significantly from the Plan's projections, with domestic demand providing a greater stimulus to growth than targeted and the share of services in output increasing substantially faster than projected, at the expense of agriculture and especially manufacturing. The current account deficit in the balance of payments and the level of the external debt would also exceed the Plan targets. Although the process of preparation of the fifth Plan is in its initial stages, the Cypriot authorities expect that this Plan will place greater emphasis on securing a sustainable external position and a more balanced growth than the previous one. They feel that, while the growth of some services (e.g. tourism, financial, accounting and legal services) will continue at sustained rates, albeit lower than in recent years, economic policies (at both the macro and

micro level) should be aimed at promoting the growth of those sectors in agriculture and industry which would have a good export potential--e.g. production of early mediterranean crops, on the one hand, and intermediate technology manufactures, on the other.

The outlook for the medium term will be importantly influenced by the ongoing negotiations for a customs union with the EC. These negotiations gathered new momentum in late 1985 and are expected to be concluded in 1986. It is expected that the process of integration of Cyprus into a full customs union with the Community will take place over a period of ten years, although the pace of dismantling trade barriers is yet to be agreed. ^{1/} The Cypriot authorities recognize that, given the relatively high degree of tariff protection enjoyed by domestic enterprises in many sectors of industry, the process of integration into a customs union will probably involve difficult adjustments--including the closing of less efficient units of production, and the reorganization and amalgamation of others. The scope for mitigating the impact of these adjustments on employment will in turn depend crucially on the prospects for creation of new jobs in more competitive lines of production. The authorities see an important role for foreign direct investment in this respect. They recognize that, with fiscal incentives for foreign investments already relatively generous (see Recent Economic Developments paper, Appendix II, to be issued shortly), the prospects for a rapid growth of these investments hinge crucially on the moderation of labor costs.

With a view to analyzing the extent of the likely external constraints on growth over the medium term and the broad stance of macro-economic policies that would be consistent with a sustainable growth path, the staff has prepared two scenarios of developments in the main economic aggregates in Cyprus over the next seven years based on alternative assumptions about the external environment and the course of economic policies. The methodology and assumptions underlying these scenarios are discussed in greater detail in Appendix III, and the main results are presented in Tables 6a and 6b. The first scenario postulates a path for the current account deficit of the balance of payments consistent with the broad stabilization of the debt/GDP ratio and the debt service ratio over the medium term. On the basis of relatively optimistic assumptions about the external environment, it appears that the current account deficit would have to be contained to well below the equivalent of 3 percent of GDP, and that this would be consistent with a moderate growth of GDP (around 3 1/2 percent a year on average) only if a rate of growth of exports of goods and services of over 5 percent a year in volume could be achieved (implying significant gains in market shares). This underscores the importance of maintaining an adequate competitive position over the medium term through a substantial moderation of costs. The scenario also highlights the need to moderate imports, which, given the foreseeable reduction in protection, would

^{1/} For greater details see Chapter IV of the Recent Economic Developments paper, to be issued shortly.

imply the need to restrain the growth of domestic demand. Through the framework of a medium-term financial program, the staff has further derived the path of credit and monetary expansion and of the budget deficit consistent with the growth and inflation targets. These calculations point to the need to rapidly reduce the public sector deficit to below 3.5 percent of GDP through a gradual increase in the tax ratio and/or a significant moderation in the growth of noninterest expenditure (Table 6a).

The alternative scenario explores the consequences for the current account of the balance of payments and for external debt of a continuation of current trends, namely a declining growth rate of exports with the growth of output sustained through an acceleration of domestic demand. Under these assumptions both the current account deficit and the external debt would escalate rapidly to clearly unsustainable levels (Table 6b). This scenario is clearly purely illustrative as it is likely that a drastic corrective effort would be forced upon the authorities by the lack of external financing before the foreign debt and its service reached the levels indicated by the scenario.

III. Staff Appraisal

The performance of the Cypriot economy in 1985 was less than satisfactory in various respects. The rate of growth of real GDP, although still comparing favorably with the average of Cyprus' trading partners, decelerated markedly to an estimated 3 1/2 percent, compared with 7 1/2 percent in 1984. Moreover, the composition of growth worsened, with the main impulse stemming from consumption, which resumed its rise as a proportion of GDP, while the share of investment in the manufacturing sector continued its trend decline. The foreign sector, excluding imports of aircraft, made very little contribution to the growth of GDP. The rate of inflation fell slightly from 1984 but this was mainly attributable to the decline in foreign prices and to the weakening of the U.S. dollar during the year. The growth of domestic unit labor costs accelerated once again to a rate nearly double the average prevailing in the main trading partners of Cyprus.

The most worrisome feature of the economic performance of 1985 concerns merchandise exports which are estimated to have declined by nearly 9 percent in volume terms. This development highlights the costs of the reliance of Cypriot exports on markets, like some oil exporting countries, which are unlikely to resume a sustained growth in the near future. Cyprus' dependence on these markets has increased in recent years, as rapidly rising labor costs and an inadequate growth of productivity have increasingly priced Cypriot exports out of the more competitive European markets. The poor performance of merchandise exports is largely responsible for the maintenance in 1985 of the current account

deficit of the balance of payments at a relatively high level (6 1/2 percent of GDP), higher than in 1984 excluding the purchases of aircraft, despite a continued strong growth of tourism and exports of other services.

In view of the likely shrinkage of Middle Eastern markets in 1986, it would seem essential to secure some recovery of exports to Europe through an improvement in the competitiveness of Cypriot products. Unfortunately, the current prospects are for a further deterioration of competitiveness as unit labor costs in Cyprus' manufacturing sector may well continue to rise at nearly twice the rate (around 3 1/2 percent) projected for its main trading partners. The impact of a further decline in merchandise exports on the current account of the balance of payments could be masked for a time by a favorable development of the terms of trade and of tourism. This in turn could create the temptation for policy makers to accommodate the renewed acceleration in domestic demand and imports, which, in the staff's view, is to be expected in the absence of timely and firm corrective measures. Domestic demand is likely to be boosted in 1986 by a further pickup in the growth of real wages, by the ample liquidity currently existing in the economy and by the fact that, in the absence of measures, the public sector would provide a positive net impulse to the growth of disposable income of households, while public consumption would increase its share in GDP. In these circumstances the current account deficit of the balance of payments could well reach the equivalent of 4.5 percent to 5 percent of GDP and lead to either a further increase in the ratio of the external debt to GDP, which is already rather high by international standards, or to losses of international reserves.

The Government has recognized the need to prevent a sharp acceleration of consumption and has proposed measures to moderate the growth of disposable income by increasing the tax on gasoline and the defense levy. The staff welcomes these proposals and hopes that the House of Representatives will approve them expeditiously. These measures should be complemented by increases in various fees and charges for public services, stepped up efforts to improve tax enforcement, the prompt introduction of a VAT, and a thorough review of the existing system of tax exemptions, rebates, and incentives. The proliferation of the latter has severely eroded the tax base in recent years and has contributed to the maintenance of some highly inefficient and ultimately non-viable productive units. The staff would also urge the Cypriot authorities to take prompt steps to moderate the projected growth of wages in the civil service, and to continue their efforts to improve the utilization of manpower in that sector. It is also important to proceed quickly with the proposed phasing out of subsidies for grain products through an adequate increase in their sale prices which have not been adjusted since 1974.

A prompt and decisive effort to reduce the public sector deficit by at least the equivalent of 1 percentage point of GDP in 1986 from the already high level of 1985, should be complemented by a tightening of

monetary policy. It is to be expected that the high rates of growth of liquidity in recent years, if unabated, would continue to finance a rapid growth of nominal incomes, ultimately leading to pressures on the balance of payments and inflation. The staff welcomes the intention of the monetary authorities to secure a significant moderation in the growth of credit to the private sector. It is, however, concerned by the paucity of effective instruments of monetary control currently available to the authorities. The inflexibility of interest rates, engendered by the existence of a legal ceiling on the maximum lending rate, prevents the management of reserve money through open market operations and the development of monetary and financial markets, and fosters the maintenance of exchange controls which hinder the integration of Cyprus into international financial markets. Interest rates on both loans and financial assets currently stand in Cyprus at levels which in real terms are significantly (at least 2-3 percentage points) lower than in major industrial countries. The lack of adequate market mechanisms of monetary control may make inevitable an increased resort over time to administrative controls on credit, despite their well known distortive effects. The staff therefore urges the Cypriot authorities to resume promptly their efforts to secure political agreement to a lifting of the interest rate ceiling, a task that should be facilitated by the current prospects for a further deceleration of inflation. It is also important to improve the efficacy of existing mechanisms of monetary control through, inter alia the strict enforcement of penalties on banks for liquidity shortfalls and by bringing promptly the cooperative credit societies under the supervision of the Central Bank.

A firmer stance of financial policies is an essential condition for securing a moderation in the growth of labor costs. In addition, the staff would see the need for a more active role by the Government in fostering such a moderation through its example as the largest employer in Cyprus and by promoting the social partners' agreement to modifications in the cost of living adjustment mechanism designed to significantly reduce the degree of indexation. This would help create room for some contractual increases within the constraint of the needed deceleration in the growth of nominal and real wages.

Securing a substantial deceleration in labor costs is especially important given the authorities' intention to broadly stabilize the nominal effective exchange rate. The staff appreciates the merits of such a policy in an economy characterized by downward rigidity in real wages. However, the limitations of the exchange rate as an instrument of adjustment in the current economic context of Cyprus make correspondingly greater the need for alternative ways of safeguarding the competitiveness of the economy, namely wage moderation, increases in productivity and improvements in the quality of exported products.

The importance of maintaining an adequate competitive position is further heightened by the prospect of the progressive integration of Cyprus into a customs union with the EC over the next few years. This union, by requiring a steady reduction of the high degree of effective

protection hitherto afforded to domestic industries by the existing tariff and nontariff barriers, will in all likelihood entail losses of jobs in the less efficient productive units. Wage moderation can make an important contribution to the creation of new employment opportunities in the more competitive sectors of industry and services.

The illustrative medium-term scenarios prepared by the staff clearly indicate that the achievement in the next few years of a moderate but steady growth of real GDP in Cyprus, along with a good performance of inflation and the maintenance of manageable levels of the external debt and its service, hinge crucially on a sustained growth of exports and on the moderation of domestic demand and imports. The conditions for such a performance are a marked deceleration in labor costs, a prompt and lasting reduction of the public sector deficit, and a significant reduction in the rate of growth of the monetary aggregates. Unless measures are taken soon to establish these conditions, Cyprus' economic performance can be expected to worsen, necessitating ultimately a more drastic adjustment with adverse effects on employment and the living standards of the population.

An appropriate macroeconomic policy framework should be complemented by structural measures, including institutional reforms, aimed at promoting a more balanced sectoral composition of growth, the exploitation of the full potential of agriculture, a redirection of resources (both labor and capital) toward sectors with good export potential, the attraction of foreign investment and the modernization of the fiscal and financial systems. The staff hopes that the new economic plan for 1987-91 will set out the specific nature of and timetable for these measures.

Cyprus maintains a restriction on current payments subject to Fund approval under Article VIII in the form of a maximum allowance for tourist travel. This restriction was significantly liberalized in 1985 (see Recent Economic Development paper, Appendix III). The authorities consider the maintenance of such a restriction necessary in the current condition of political uncertainty and balance of payments weakness. The staff recommends that approval of this restriction be granted until the next Article IV consultation.

It is recommended that the next Article IV consultation with Cyprus be held on the standard 12-month cycle.

IV. 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 1986 Article XIV consultation with Cyprus, in the light of the 1986 Article IV consultation with Cyprus conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Cyprus maintains a restriction on the amount of foreign exchange made available for foreign travel. The Fund notes that the authorities have liberalized this restriction and, in the light of the current circumstances of the country, it grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Table 1. Cyprus: Selected Economic Indicators, 1983-86

(Annual percentage change)

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
Real demand and output				
Gross domestic expenditures <u>3/</u>	3.4	8.0	1.5	2.2
Private consumption	5.1	4.0	4.5	5.0
Public consumption	5.2	4.1	3.5	4.0
Gross fixed investment <u>3/</u>	-1.3	18.9	-5.4	-5.5
Increase in inventories <u>4/</u>	--	0.4	-0.1	0.3
Exports of goods and services	8.7	16.1	0.5	2.5
Imports of goods and services	6.9	17.4	-3.3	1.8
GDP at market prices	5.0	7.5	3.5	3.0
Labor market				
Employment	2.0	1.6	0.9	0.5
Unemployment rate (level in percent)	3.6	3.7	3.8	4.0
Average real wage rate	4.4	2.8	4.3	5.3
Average earnings in manufacturing	8.0	8.9	9.0	10.0
Productivity in manufacturing	1.3	2.6	0.9	1.0
Unit labor costs in manufacturing	6.6	6.1	8.0	9.0
Prices				
Consumer prices	5.1	6.0	5.0	4.5
GDP deflator	5.4	8.9	4.8	6.0
Income				
Private disposable income	11.1	15.2	7.5	9.0
Private savings rate (level in percent)	27.1	30.2	28.7	28.2

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

1/ Provisional estimates.

2/ Staff projections on present policies.

3/ Adjusted for the purchases of airbuses, the rates of increase in domestic demand would be 3.9 percent in 1984, 3.5 percent in 1985 and 4.1 percent in 1986. The corresponding figures for fixed investment are 2.5 percent in 1984, 1.7 percent in 1985, and 2.0 percent in 1986, and those for imports 10.5 percent in 1984, -0.4 percent in 1985, and 5 percent in 1986.

4/ Contribution to GDP growth.

Table 2. Cyprus: Summary of the Balance of Payments, 1983-86

(In millions of Cyprus pounds)

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
Exports, f.o.b.	230.7	307.5	256.5	245.0
Imports, f.o.b.	575.9	720.7	687.8	680.0
Merchandise trade balance	-345.2	-413.2	-431.3	-435.0
Services, net	212.8	271.0	317.4	350.0
Of which:				
Tourism, net	139.9	170.2	190.7	219.0
Investment income, net	-23.4	-23.8	-24.0	-28.0
Transfers, net	39.0	25.5	24.7	23.0
Current balance	<u>-93.4</u>	<u>-116.7</u>	<u>-89.2</u>	<u>-62.0</u>
As percent of GDP	<u>(8.3)</u>	<u>(8.9)</u>	<u>(6.3)</u>	<u>(4.0)</u>
Medium- and long-term capital	71.8	130.8	70.5	...
Short-term capital <u>3/</u>	24.4	30.0	1.1	...
Overall balance	2.8	44.1	-17.6	...
<u>Memorandum items:</u>				
(Percentage change)				
Market growth	1.0	-2.3	-2.3	0.6
Domestic exports, unit value	-1.6	10.3	-0.9 <u>5/</u>	--
(in local currency) <u>4/</u>				
Domestic exports, volume <u>4/</u>	-7.0	17.3	-8.7 <u>5/</u>	-4.3
Imports, c.i.f., unit value	1.7	8.0	2.3 <u>5/</u>	-3.0
(in local currency) <u>4/</u>				
Imports, c.i.f. volume <u>4/</u>	9.4	6.5	-3.0 <u>5/</u>	2.0
Nominal effective exchange	1.4	2.6	3.7	...
rate <u>6/</u>				
U.S. dollar/Cyprus	-9.8	-10.4	-3.7	12.0
pound rate				
Gross official reserves	511.9	567.6	597.7 <u>7/</u>	...
(in millions of SDRs)				

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

1/ Provisional estimates.

2/ Staff projections on present policies.

3/ Includes errors and omissions.

4/ Merchandise trade, customs basis.

5/ First ten months of 1985 over similar period in 1984.

6/ Trade weighted average of exchange rates expressed as units of foreign currency per Cyprus pound. The weights are based on the average distribution of export and import trade with 17 partner countries during 1980-84.

7/ End-November 1985.

Table 3. Cyprus External Debt Outstanding and Debt Service Ratio, 1982-85

(In millions of Cyprus pounds; end of period)

	1982	1983	1984	1985 <u>1/</u>
Government <u>2/</u>	199.7	248.6	325.9	328.8
Public enterprises	92.6	105.0	157.3	178.6
Nonfinancial private sector	73.7	90.0	115.6	116.6
Total	<u>366.0</u>	<u>443.6</u>	<u>598.8</u>	<u>624.0</u>
Of which:				
Short-term	43.0	58.0	74.0	88.0
	<u>(In percent)</u>			
<u>Memorandum items:</u>				
Ratio of debt to GDP	36.0	39.5	45.5	43.7
Ratio of debt to gross official reserves	139.2	148.7	168.2	177.6
Share of short-term debt	11.7	13.1	12.4	14.1
Ratio of service on medium- and long-term debt to foreign exchange earnings <u>3/</u>	9.7	12.2	11.1	14.1

Source: Data provided by the Cypriot authorities.

1/ Provisional.

2/ Excludes liabilities to the IMF.

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

Table 4. Cyprus: Consolidated Central Government Accounts, 1983-86

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

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>	1984	1985	1986
					Percentage changes		
Current revenue	288.7	344.2	389.2	428.9	19.2	13.1	10.2
Of which:							
Direct taxes <u>3/</u>	113.3	143.0	164.5	183.7	26.2	15.0	11.7
Indirect taxes	110.2	131.5	145.8	160.8	19.3	10.9	10.3
Nontax revenue	51.4	58.7	68.4	76.2	14.2	16.5	11.4
Foreign grants	13.8	11.0	10.5	8.2	-20.3	-4.5	-21.9
Current expenditure	306.2	352.0	392.5	436.4	15.0	11.5	11.2
Of which:							
Wages, salaries and goods and services	163.1	176.4	196.2	221.0	8.2	11.2	12.6
Subsidies and transfers	98.5	114.1	128.7	139.7	15.8	12.8	8.5
Interest payments	39.6	46.7	52.0	59.1	17.9	11.3	13.7
Current balance	-17.5	-7.8	-3.3	-7.5	...	...	...
As percent of GDP	1.6	0.6	0.2	0.5	...	...	...
Capital receipts	0.7	0.1	0.2	0.2	...	...	...
Capital expenditure <u>4/</u>	61.5	66.3	72.4	81.7	7.8	9.2	12.8
Of which:							
Fixed investment	41.7	47.0	46.7	58.9	12.7	-0.6	26.1
Transfers	9.4	10.5	13.8	11.0	11.7	31.4	-20.3
Net lending	10.4	8.8	11.9	11.8	-15.4	35.2	-0.8
Overall balance	-78.3	-74.0	-75.5	-89.0	...	...	...
As percent of GDP	7.0	5.6	5.3	5.7	...	...	...
External financing, net	25.9	38.2	19.5	6.3	...	...	...
Domestic financing, net	52.4	35.8	56.0	82.7	...	...	...
Of which:							
From the banking system	29.8	23.4	50.5	81.4	...	...	...
<u>Memoranda items:</u>							
Total taxes as percent of GDP	19.9	20.9	21.7	22.2	...	...	...
Total expenditure as a percent of GDP <u>4/</u>	32.7	31.8	32.6	33.4	...	...	...
Share of indirect taxes in total taxes	49.3	47.9	47.0	46.7	...	...	...
Share of current expenditure in total expenditure	83.3	84.2	84.4	84.2	...	...	...

Source: Data provided by the Cypriot authorities.

1/ Preliminary estimate.

2/ Official forecast.

3/ Including social security contributions.

4/ Including net lending.

Table 5. Cyprus: Monetary Aggregates, 1983-86

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
(In millions of Cyprus pounds; at end of period)				
Net foreign assets	<u>196.4</u>	<u>225.7</u>	<u>206.8</u>	<u>196.9</u>
Net domestic credit	<u>717.4</u>	<u>823.7</u>	<u>970.2</u>	<u>1,123.0</u>
Public sector	<u>108.5</u>	<u>135.0</u>	<u>185.5</u>	<u>266.9</u>
Private sector	<u>608.9</u>	<u>688.7</u>	<u>784.7</u>	<u>856.1</u>
Broad money	<u>790.6</u>	<u>899.4</u>	<u>994.4</u>	<u>1,101.8</u>
Currency and demand deposits	<u>248.1</u>	<u>259.8</u>	<u>282.0</u>	...
Quasi-money	<u>542.5</u>	<u>639.6</u>	<u>712.4</u>	...
Other items, net	<u>-123.2</u>	<u>-149.9</u>	<u>-182.6</u>	<u>-218.1</u>
(12-month percentage change)				
Total domestic credit	14.3	14.8	17.8	15.7
Credit to the private sector	12.1	13.1	13.9	9.1
Broad money	11.7	13.8	10.6	10.8
Credit to public sector <u>3/</u>	8.8	8.0	6.5	7.5
Income velocity of M2 (level) <u>4/</u>	1.50	1.56	1.52	1.49

Source: Data provided by the Cypriot authorities.

1/ Preliminary estimates.

2/ Official projections.

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

4/ Nominal GDP/average of broad money stock at beginning and end of year.

Table 6(a). Cyprus: Alternative Medium-Term Scenarios

A. Programmatic Scenario

(Percentage changes in local currency except as otherwise specified)

	1986	1987	1988-92 Average
Main assumptions:			
Foreign exchange earnings <u>1/</u>	6.4	10.2	10.3
Current account deficit as percent of GDP	1.9	2.4	2.9
Import prices	-3.0	4.0	5.0
Elasticity of imports to aggregate demand	1.1 <u>2/</u>	1.3	1.2
Interest rate on foreign debt (level)	8.6	8.3	8.3
Nondebt capital inflow (LC m) <u>3/</u>	56.0	58.8	68.2
GDP deflator	6.0	5.0	5.0
Broad money (M2)	10.3	9.7	9.4
Income velocity of M2 (level)	1.49	1.48	1.46
Domestic credit to private sector	9.1	9.2	8.9
Government revenues as a percent of GDP	29.1	29.3	29.7
Results:			
Import volume	4.1 <u>2/</u>	7.1	5.4
Domestic demand	1.4	5.1	3.9
GDP	3.0	4.0	3.7
External debt/GDP (level in percent)	40.1	38.2	36.3
Debt service ratio (in percent)	14.3	14.0	12.3
Domestic bank credit	12.1	8.8	8.8
Domestic credit to public sector	24.9	7.3	8.2
Central Government deficit as percent of GDP	2.9	2.8	3.3
Noninterest expenditures as a percent of GDP	28.2	28.3	29.6

Source: IMF staff calculations.

1/ It is assumed that exports of goods, after declining by 2 percent in 1986, rise in volume by 2 percent in 1987 and 4 percent thereafter; that exports of nonfactor services rise by 7 percent in 1986 and 1987 and by 6 percent thereafter. Prices of exports of goods are constant in 1986, (and increased by 4.5 percent in 1987 and 5 percent thereafter; those of services rise by 4 percent in 1986 and 5 percent thereafter. Private transfers increase by 5 percent a year and official transfers decline by 5 percent a year.

2/ Figures refer to imports excluding purchases of aircrafts.

3/ It is assumed that foreign exchange reserves increase to maintain a constant ratio to imports.

Table 6(b). Cyprus: Alternative Medium-Term Scenarios

B. Scenario on Present Trends

(Percentage changes in local currency except as otherwise specified)

	1986	1987	<u>1988-92</u> Average
Main assumptions:			
GDP	4.0	4.0	4.0
GDP deflator	6.0	6.0	6.8
Elasticity of imports to aggregate demand (level)	1.32 <u>2/</u>	1.32	1.38
Foreign exchange earnings <u>1/</u>	4.9	8.0	7.6
Import prices	-3.0	4.0	4.0
Interest rate on foreign debt (level)	8.6	9.0	9.9
Nondebt capital inflow (LC m) <u>3/</u>	56.0	58.2	65.6
Results:			
Import volume	7.4 <u>2/</u>	6.8	7.9
Domestic demand	4.9	5.6	6.6
Current account deficit as percent of GDP	4.3	6.0	13.7 <u>4/</u>
External debt/GDP (level in percent)	42.3	43.3	62.6 <u>5/</u>
Debt service ratio (in percent)	14.2	14.6	17.8 <u>6/</u>

Source: IMF Staff calculations.

1/ It is assumed that exports of goods, after declining by 2 percent in volume in 1986, remain unchanged in 1987 and rise by 2 percent thereafter; the rate of growth of exports of nonfactor services is assumed to be 7 percent in 1986, 6 percent in 1987 and to decline to 3.8 percent by 1992. Prices of exports of goods are constant in 1986 and increase by 4 percent thereafter; those of services rise by 4 percent throughout. Private transfers increase by 3 percent a year and official transfers decline by 6 percent a year.

2/ Figures refer to imports excluding aircraft.

3/ It is assumed that foreign exchange reserves increase to maintain a constant ratio to imports.

4/ The current account deficit as a percent of GDP is 20.2 percent in 1992.

5/ The external debt/GDP ratio is equal to 83.7 percent in 1992.

6/ The debt service ratio is equal to 22.5 percent in 1992.

Fund Relations with Cyprus

(As of January 31, 1986; in millions of SDRs)

I. Membership status

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

A. Financial Relations

II. General department

- (a) Quota: SDR 69.7 million.
- (b) Total Fund holdings of Cyprus pounds: SDR 65.03 million (93.30 percent of quota).
- (c) Reserve tranche position: SDR 4.675 million.
- (d) Current operational budget: no use of the Cyprus pound is planned in the current budget.
- (e) Lending to the Fund: Cyprus is not a participant.

III. Stand-by or Extended Arrangements and Special Facilities

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

IV. SDR Department

- (a) Net cumulative allocation: SDR 19.4 million.
- (b) Holdings: SDR 0.42 million or 2.14 percent of net cumulative allocation.
- (c) Current designation plan: Cyprus is not included in the current plan.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange rate arrangements

Since July 1973, the market rate for the Cyprus pound has been adjusted daily to maintain its effective relationship with the currencies of the main trading partners. The nominal effective rate appreciated by 1.4 percent in 1983, 2.6 percent in 1984 and the further 3.7 percent in 1985. On January 31, 1986 the rate of the Cyprus pound was £C 1 = SDR 1.6869.

VIII. The last Article IV consultation discussions were held in October 1984 and the staff report (SM/84/263, 11/29/84) was discussed by the Executive Board on December 19, 1984. At that time the following decision was adopted:

1. The Fund takes this decision relating to Cyprus's exchange measures subject to Article VIII, Section 2 and in concluding the 1984 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 foreign travel. The Fund notes that the authorities have decided to raise the amount of the allowance effective January 1, 1985 and, in the light of the current economic circumstances of the country, it grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Cyprus is on a 12-month consultation cycle.

IX. Technical assistance

Mission on possible introduction of a VAT (November 1984).

Cyprus--Basic Data

Area and population

Area (whole island)	9,251 square kilometers
Population	532,000
GNP per capita (1983)	£C 2,154

Income and expenditure in 1985
(at current prices)

	In millions of Cyprus pounds	In percent
Private consumption	894	62.6
Public consumption	224	15.7
Gross capital formation	405	28.4
Gross domestic expenditure	1,553	108.8
Exports of goods and services	743	52.0
Imports of goods and services	891	62.4
GDP at market prices	1,428	100.0

Selected economic indicators
(annual percentage change)

	1983	1984	1985
GDP (at constant market prices)	5.0	7.5	3.5
Private consumption (at constant prices)	5.1	4.0	4.5
Gross fixed investment (at constant market prices)	-1.3	18.9	-5.4
Manufacturing output	2.9	6.8	2.0
Unit labor costs in manufacturing	6.6	6.1	8.0
Consumer prices	5.1	6.0	5.0

Public sector accounts (as percent of GDP)

Consolidated Central Government			
Tax revenue	19.9	20.9	21.7
Current expenditure	27.2	26.7	27.5
Current balance	-1.6	-0.6	-0.2
Overall balance	-7.0	-5.6	-5.3

Monetary data (annual percentage change)

Domestic credit	14.3	14.8	17.8
Public sector ^{1/}	8.8	8.0	6.5
Private sector	12.1	13.1	13.9
Broad money	11.7	13.8	10.6

Balance of payments (in millions of SDRs)

Exports, f.o.b.	410	511	410
Imports, f.o.b.	1,024	1,198	1,121
Trade balance	-614	-687	-711
Net invisibles	448	493	558
Current account balance	-166	-194	-153
Medium- and long-term capital	128	217	133
Short-term capital	43	50	40
Overall balance	5	73	20
Foreign exchange reserves, year-end	512	568	598 ^{2/}
External debt outstanding, year-end	789	995	1,007
Nominal effective exchange rate (percentage change)	1.4	2.6	3.7

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

^{1/} Change in domestic bank and external credit to the public sector as a percentage of initial money stock.

^{2/} End November 1985.

Illustrative Scenarios of Medium-Term Developments

This appendix explains the methodology and the results of two simulations of developments in the main economic aggregates for Cyprus over the next seven years, based on alternative assumptions about various external factors and policy courses. The results of these scenarios depend crucially on some of the assumed parameters (e.g. the elasticity of imports with respect to aggregate demand, the velocity of circulation of broad money) and on the hypotheses concerning the external environment. Time limitations have prevented extensive sensitivity analysis of these assumptions. Therefore, the results should be taken as no more than broad indications of the consequences of alternative policy courses.

The first scenario can be characterized as a programmatic one. The starting point in its construction is the selection of a path for the current account deficit of the balance of payments which (on given assumptions about nondebt capital inflows, a target for the accumulation of foreign exchange reserves, and the level of the average cost of external credit for Cyprus) ensures the broad stabilization of the external debt in relation to GDP and of the debt service (interest payments plus amortizations of medium- and long-term debt) in relation to exports of goods and nonfactor services. The staff calculations suggest that on relatively optimistic assumptions about the external environment, the objective of maintaining the external debt indicators at acceptable levels would require the maintenance of the current account deficit in the balance of payments at well below the equivalent of 3 percent of GDP in the next several years.

The next step is the derivation of the rate of volume growth of imports of goods and nonfactor services consistent with the current account objective and the assumed rates of growth of exports of goods and services and of international trade prices. These assumptions are presented in Table 6a. The projected growth of exports presupposes a steady gain in market shares in the period 1987-92, which would require a significant improvement in the price competitiveness and quality of Cypriot exports. This, in turn, requires a definite break in current trends of rapid wage increases and declining productivity growth. The, possibly optimistic, assumption of no change in the terms of trade in 1987-92 (following a significant improvement in 1986) is also made.

Next from the "permissible" growth of imports, on the basis of an assumption about import elasticity, the "permissible" growth rates of total demand, domestic demand, and GDP are derived. The assumed level of the import elasticity (1.2) is probably low in the perspective of substantial reductions in protection during the transition to customs union with the EC. The calculations point to a growth of GDP around 3 1/2 percent on average over the period under consideration.

The next step consists in the derivation of a framework for financial policies which, in very broad and aggregate terms, can be

viewed as consistent with the target rates of growth of GDP and inflation. The latter is projected at around 5 percent on average, broadly in line with rates prevailing abroad. "Permissible" rates of growth of money and domestic bank credit are derived based on assumptions about income velocity of M2 and the target accumulation of net foreign assets of the banking system (selected in step 1 above). Finally, on the assumption that domestic bank credit to the private sector would grow in line with nominal GDP, domestic credit to the public sector is derived residually. To derive targets for the overall public sector deficit, further assumptions are made about the growth of nonbank financing to the public sector and about the share of foreign capital inflows absorbed by the government. On the relatively optimistic assumption of a continued, albeit small, decline in velocity of M2 (i.e., of a steadily rising demand for domestic financial assets relative to GDP), the scenario points to the need to keep the public sector deficit to the equivalent of around 3.5 percent of GDP on average during the period. A final step consists in calculating the growth of noninterest expenditures consistent with the deficit and an assumed trend in the ratio of revenues to GDP.

The methodology outlined above could obviously be refined and improved by disaggregating the public sector accounts and incorporating explicitly into the framework of analysis the links between various categories of public sector revenues and expenditures and the national accounts (demand components, disposable income, and the price level). While this framework is a very imperfect substitute for an articulated and empirically estimated macroeconomic model, it provides a broad check on the consistency of main economic policies with the important objective of securing a viable external position for the country over the medium term.

The second scenario is designed to highlight the consequences of: (a) a continuation of the trend of deteriorating competitiveness, leading to steady losses in market shares, and (b) an attempt at offsetting the impact of the poor export performance on GDP growth and employment through a faster growth of domestic demand, involving continued sizable increases in real wages, and an expansionary stance of financial and fiscal policies. Specifically, it is assumed that GDP growth is maintained at 4 percent throughout the period, inflation rises gradually to around 7 1/2 percent by the end of the period, and exports record a steady loss in market shares (Table 6b). The main results of the exercise are that the current account deficit rises rapidly, to over 20 percent of GDP by 1992, while by that year the external debt reaches 84 percent of GDP, and the debt service ratio 23 percent of exports of goods and nonfactor services. A completely unmanageable (and obviously unrealistic) situation emerges in the three following years. It is clear that such a scenario is purely illustrative as it is to be expected that a drastic corrective effort would be forced upon the authorities by the lack of external financing before foreign debt and its service burden reached the levels referred to above. In this sense the scenario is mainly useful to illustrate the importance of restoring

in the near future the conditions for a sustained growth of exports and the futility of attempting to sustain the growth of output and employment if these conditions are not restored.

Statistical Issues

1. Outstanding statistical issues

a. Real sector

The wholesale price index is based on 1972 weights. A rebased industrial production index (base 1980), covering data through 1983, has recently been submitted to the Bureau of Statistics and will be published in a forthcoming issue of IFS.

b. Monetary accounts

The Central Bank of Cyprus informed the Bureau of Statistics at the end of 1983 that a number of foreign-owned banks had applied for licenses to commence offshore banking operations in Cyprus. In December 1984, the central bank indicated that data would be sent to the Bureau as soon as regular and consistent time series of the relevant data were available. No data have been received to date.

c. Government finance

The February 1986 issue of IFS and the 1985 GFS Yearbook contain data on consolidated central government through 1983. In the GFS Yearbook, the presentation is complete except for data on local governments which are available only through 1976. Data are regularly reported but the reply to the 1985 questionnaire letter including data for 1984 was not received in time for publication in the 1985 GFS Yearbook.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Cyprus in the February 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Cyprus which, during the past year, have been provided on a timely basis. Data for national accounts are outdated.

Status of IFS Data

		<u>Latest Data in February 1986 IFS</u>
Real sector	- National accounts	1983
	- Prices: CPI	November 1985
	WPI	July 1985
	- Production: Industrial	1982
	Mining	October 1985
	- Employment	n.a.
	- Earnings	n.a.

Government	- Deficit/surplus	1983
	- Financing	1983
	- Debt	1983
Monetary accounts	- Central Bank	September 1985
	- Deposit money banks	September 1985
	- Other financial institutions	September 1985
External sector	- Merchandise trade: Values	October 1985
	Unit values	August 1985
	- Balance of payments	1984
	- International reserves	November 1985
	- Exchange rates	November 1985

