

# Basic Characteristics

# Economic

The economy of Cyprus can generally be characterised as small, open and dynamic, with services constituting its engine power. Since the accession of the country to the European Union on 1 May 2004, its economy has undergone significant economic and structural reforms that have transformed the economic landscape. Interest rates have been liberalised, while other wide-ranging structural reforms have been promoted, covering the areas of competition, the financial sector and the business sector. Following Cyprus' accession to the EU, the Government of the Republic of Cyprus also undertook the obligation to join the Economic and Monetary Union (EMU) and to adopt the euro as soon as the necessary preconditions (Maastricht Criteria) were fulfilled. Cyprus became a member of the euro area in 2008 and since then its monetary policy is dictated by the European Central Bank.

The tertiary sector (services) is the biggest contributor to GVA, accounting for about for about 87% in 2015. This development reflects the gradual restructuring of the Cypriot economy from an exporter of minerals and agricultural products in the period 1961-73 and an exporter of manufactured goods in the latter part of the 1970s and the early part of the 80s, to a tourist destination during the 1980s, and to an international business and services centre during the 1990s and the 2000s. The secondary sector (manufacturing) accounted for around 10.5% of GVA in 2015. The primary sector (agriculture and fishing) is continuously shrinking and only reached 2.4% of GVA in 2015.

On the one hand, the private sector, which is dominated by small and medium-sized enterprises, has a leading role in the production process. On the other hand, the Government's role is mainly to support the private sector and regulate the markets in order to maintain conditions of macroeconomic stability and a favourable business climate, via the creation of the necessary legal and institutional framework and secure conditions of fair competition.

Prior to the emergence of the global economic crisis, Cyprus had enjoyed a track record of satisfactory economic growth, low unemployment and relatively stable macroeconomic conditions. However, these good economic conditions were partly the result of excessive credit expansion and unsustainable consumption levels in the economy, which led to the creation of severe macroeconomic imbalances. In addition, the inadequate regulatory and supervisory framework of the financial sector and the significant exposure of the Cypriot banks to the Greek economy and to Greek sovereign bond holdings at the time, have contributed to the downfall of the financial sector and the Cyprus economy.

The result of these imbalances was the loss of access to the international capital markets in June 2011.

Consequently, the Republic of Cyprus submitted in June 2012 an official request to European Stability Mechanism and the International Monetary Fund for financial assistance.

The agreement reached on a Memorandum of Understanding in March 2013 safeguarding a financial assistance programme for a

three-year period contributed to the gradual stabilisation of the Cyprus economy and the steady recovery in confidence levels.

The business services sector has turned out to be much more resilient than anticipated. The resilience of the business sector, as well as, the better than anticipated performance in the tourist sector, contributed to the containment of the severity of the contraction of the economy. Economic activity contracted by 5.9% in 2013 compared to a forecast contraction of 8.7%, while in 2014, the recession was contained to approximately 2.5% compared with a projected contraction of 3.9%.

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In 2015 the Cyprus economy returned to positive growth rate territory, recording a growth rate of GDP of 1.7% following the recession in 2012-2014 which presented a cumulative GDP decline of around 10.6%. Economic activity is expected to gain further momentum in the following years.

Unemployment also fared better than expected as it peaked to around 16% in 2014, despite projections of more than 20% of the labour force. A concerning issue however is the high rate of youth unemployment, as well as the long-term unemployment. Youth unemployment has been on a declining path since 2014. In

2015, unemployment fell to 15% and is expected to continue on a downward trend.

As regards public finances, targets have been met with considerable margins both in 2013 and 2014 (-4.9% and -8.9% of GDP). In 2015, the budget deficit fell below the reference value of 3% of GDP at around 1%, one year ahead of the deadline set by the ECOFIN Council, allowing for the abrogation of the Excessive Deficit Procedure to commence.

In the context of the MOU, the Cypriot Banking Sector has been recapitalised and also went through significant restructuring. The supervisory framework has also been strengthened and enhanced while specific measures have been adopted in order to tackle the main challenge in this sector, that is the high level of Non-Performing Loans. These measures include, the new Foreclosure and Insolvency Laws, which introduce the right incentives for all stakeholders, including creditors and debtors, to negotiate a settlement of liabilities. They also create a safety net for vulnerable groups directly affected by the crisis.

Moreover, the following have been implemented:

- Centralized arrears management systems and dedicated recovery units have been implemented throughout the banking sector
- Additional legislation to facilitate loan securitisation and the swift transfer of title deeds to contribute towards the asset recovery process
- Establishment of the Financial Ombudsman for providing assistance to troubled borrowers facing difficulties repaying their loans

- Code of Conduct by Central Bank of Cyprus for Arrears Management in order to assist the loan restructuring procedure of the banks
- Title deeds (effective tackling of legacy issues)
- Tax reforms for removing impediments to loan restructurings

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It is also noted that the recent explorations for hydrocarbon reserves that have taken place in the Exclusive Economic Zone of Cyprus have revealed rich reserves in natural gas, which will have significant revenue implications for Cyprus in the medium to long-term. The Government is in the process of exploring options of best conduct regarding economic policy surrounding the exploration, discovery and exploitation of natural gas in Cyprus.