Cyprus enjoyed its third consecutive year of growth in 2017, outperforming most of the euro area. Cypriot public finances improved, supported by fiscal prudence and better-than-expected economic developments. But despite ongoing deleveraging, banks remain burdened by NPLs. Reform momentum should not lag, as the reforms are key to underpinning economic strength and enhancing resilience to external shocks.

The Cypriot economy was one of the fastest growing in the euro area in 2017. Annualised GDP grew at 3.9%, mainly led by private consumption and gross fixed capital formation. Investment was volatile, influenced by acquisitions in shipping equipment, but it contributed positively to growth mainly because of large construction projects. Service exports were particularly strong, as Cyprus experienced a record-high tourism season. The Cypriot economy remains dependent on demand from the UK and Russia, in particular in tourism and business services. Economic growth helped to increase the labour force and boost employment. The unemployment rate, however, remains above the euro area average, although it declined to 11.1% in December 2017 from 12.8% in December 2016. A large current account deficit and high private-sector indebtedness are clouding the economic outlook. Consumer price growth turned positive in 2017, after a deflationary period from 2013 to 2016.

Fiscal performance showed impressive improvement. The primary surplus rose to 5.0% of GDP in 2017 from 3.0% in 2016, corresponding to an overall fiscal surplus of 1.8% of GDP in 2017. A favourable economy and prudent fiscal policies drove the better performance. The debt-to-GDP ratio dropped below 100% in 2017 from 107.4% in 2016. To accelerate this decline, the government started to make early repayments on parts of its loans from the IMF and the Central Bank of Cyprus, exploiting beneficial market conditions. The ESM's monitoring of Cyprus' ability to repay, under the Early Warning System, showed that the positive fiscal and economic situation improved the country's ability to meet its scheduled loan service payments. The pace of reforms has, however, slowed, in particular those related to the public and justice administrations.

While NPLs declined further, the banking sector remained vulnerable to shocks. The ample liquidity and the relatively high capital ratios were certainly important mitigating factors, but risks stemming from weak profitability, the high NPL ratio of 43%, and the coverage of 47% that is still slightly below the euro area average could quickly destabilise the system. Although the necessary legal frameworks aiming at reducing NPLs are now in place, they are still inefficient and little used. Instead, banks are more and more in favour of offloading impaired assets from their balance sheets, mostly via debt-to-asset swaps, which deliver NPL reduction in the short-run but leave banks with significant exposure to the real estate sector. Furthermore, new regulatory requirements challenge the banks' outlook.

Positive economic conditions and fiscal consolidation contributed to favourable financial market terms, and the funding costs for the Cypriot government declined further. For instance, the yield on Cyprus' 7-year bond declined by 195 basis points in the year to December 2017. Cyprus was actively involved in lowering its interest payments and smoothing its maturity profile further. The strong economic performance bettered Cyprus' weak credit profile in 2017, reflected in positive outlooks from the rating agencies. Looking forward, any further upgrade will depend on additional improvements in the banking sector, continued solid economic growth, a reduction in the current account deficit, and a decline in the government debt burden.

Cyprus has achieved a solid recovery over the past few years. To boost economic resilience, the country needs to consolidate public finances by further reducing public debt and counteracting the concentration of economic activities by diversifying from the tourism and construction sectors. Despite successive reforms, Cyprus must regain reform momentum to enhance the efficiency of the public sector and judiciary, while supporting fiscal sustainability. The high level of NPLs remains a key vulnerability for banks, which suggests the need for a reform of the insolvency and foreclosure framework, and poses a risk for the economy going forward.