The Cypriot economy maintained strong momentum in 2016, the year it successfully concluded its ESM financial assistance programme, with growth mainly driven by domestic demand. Favourable economic conditions and advances in other key areas, such as on the fiscal side, helped it to also exit the EU's Excessive Deficit Procedure (EDP). The banking sector's performance continued to improve, albeit at a slower pace. The persistently high level of NPLs is still weighing on banks' outlook.

Cyprus experienced solid economic growth in 2016. GDP grew at 2.8%, better than the most recent forecasts had expected. This positive surprise stemmed largely from domestic demand growth of 3.9%. The labour market also extended its recovery. The unemployment rate declined to 13.3% in December 2016 from 16.6% in December 2014 but it still exceeded the 9.6% euro area average in December 2016. Although youth unemployment fell steadily, it remains too high. Low oil prices helped keep inflation negative.

Fiscal performance improved in 2016. The Cypriot primary surplus climbed close to 3% of GDP from 1.7% in 2015, leading to a balanced headline general government position compared to a deficit of 1.1% of GDP in 2015. Cyprus therefore exited the EDP, and re-entered the preventive arm of the EU stability and growth pact. The high government debt-to-GDP ratio slightly increased to 107.8% in 2016 from 107.5% in 2015. Some reforms have been postponed again, however, in particular those related to privatisation.

The banks are well capitalised and the liquidity position is improving. Modest internal capital generation in 2016 slightly strengthened capitalisation further, while the very high level of NPLs still weighed on profitability and outlook. Despite the high stock, NPLs fell and are expected to continue trending lower. The necessary legal framework to reduce NPLs has now been put in place, however, actual restructurings slowed over the year. The gradual improvement in economic performance combined with the recovery of the banking sector, means the privatisation process of the currently state-owned bank could start in mid-2017, following the full completion of the listing requirements. Despite the promising developments, new regulatory requirements pose a challenge to banks' outlook.

Robust economic growth and continuing fiscal consolidation contributed to sovereign financial market access and allowed Cyprus to exit the ESM programme in 2016 without a follow-up financial arrangement. The funding costs of the Cypriot government edged lower. For instance, despite the widespread bond sell-off in the euro area sovereign market, the yield of the Cyprus 10-year bond declined to 3.5% at the end of 2016 from 3.8% a year earlier. Over the programme period, Cyprus also built safe cash buffers and achieved a very sound maturity profile. While its credit ratings remain below investment grade, credit rating agencies' outlooks were universally positive. Looking forward, Cyprus's complete and successful return to financial markets will hinge largely on its determination to maintain its prudent fiscal policy, bank restructuring, and structural reforms.

Cyprus is bearing the fruit of reforms introduced over recent years. The country needs, however, to restart the structural reform momentum, consolidate improvements, and promote Cyprus's international competitiveness to attract investment. Prudent fiscal policies are particularly important now as the economy recovers. Further improving public sector efficiency and ensuring labour market flexibility will strengthen Cyprus's long-term growth potential and its attractiveness as an investment destination. Reunification of the country would also benefit investment and growth.