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Cyprus

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In-Depth Review 2024

Cyprus



European
Commission

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This in-depth review presents the main findings of the Commission's staff assessment of macroeconomic vulnerabilities for Cyprus for the purposes of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances. It provides technical input to the Commission for the Communication "European Semester – 2024 Spring Package" that will set out the Commission's assessment as to the existence of imbalances or excessive imbalances in Cyprus. That Communication will be published in June 2024. The current version has been presented and discussed with the Member States in the Economic and Political Committee of the Council.

This publication reproduces staff working document SWD(2024) 81 final, that was discussed with Member States in the Economic and Political Committee of the Council on 20 March 2024."

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1. INTRODUCTION

This in-depth review analyses the evolution of Cyprus's vulnerabilities related to high private, government and external debt, and possibly newly emerging risks. This year's IDR, which follows the 2024 Alert Mechanism Report (AMR) published in November 2023, assesses the persistence or unwinding of the vulnerabilities identified in previous years, potential emerging risks, and relevant policy progress and policy options that could be considered for the future ⁽¹⁾.

Solid economic growth, combined with declining inflation, are helping to put the Cypriot economy on a sound footing ⁽²⁾. The GDP growth rate moderated to 2.4% in 2023 from a very buoyant 5.1% in 2022. This slowdown in growth was mainly due to weaker external demand for financial and business services, affected by Russia's war of aggression against Ukraine. According to the Commission's winter 2024 interim forecast, in 2024 and 2025, economic growth is expected to pick up again to reach around 3%. This acceleration in growth is expected to be helped by sizeable planned investments in the areas of energy, education, healthcare and tourism, in part supported by the Recovery and Resilience Facility. Headline inflation started to moderate in 2023, dropping to 3.9% with core inflation slightly higher at 4.4%, down from 8.1% and 5.3% respectively in 2022. In 2024 and 2025, inflation is expected to continue declining. The Cypriot labour market remains robust, with employment continuing to increase and unemployment expected to fall below 6% by 2025, its lowest level in over a decade. At the same time, real wages are forecast to grow only moderately over 2024-2025, as in 2023, after having declined substantially in 2022. The fiscal position remains strong with a sizeable surplus in 2023, which is expected to be maintained in 2024 and 2025. The risks to the economic outlook are broadly balanced.

High integration with EU and non-EU economies makes Cyprus prone to spillovers resulting from economic developments in these economies ⁽³⁾. The Cypriot economy is highly dependent on Greek and Italian goods and services, while Greece and the UK are significant export partners. On external demand, the largest shares of total value added in the Cypriot economy are generated to satisfy domestic demand in Germany, the US and China, while Cypriot domestic demand is mostly satisfied by value added generated in the UK, Greece and Germany ⁽⁴⁾. Because Cyprus has high exposure, both direct and indirect, to non-EU partners, geopolitical and trade tensions appear to pose a non-negligible risk to its economy.

⁽¹⁾ [European Commission \(2023\), Alert Mechanism Report 2024, COM\(2023\) 902 final](#); and [European Commission \(2023\), Alert Mechanism Report 2024, SWD\(2023\) 901 final](#).

⁽²⁾ Forecast figures for GDP growth and inflation come from the Commission Winter 2024 interim Forecast (European Economy, Institutional Paper 268). All other forecast data used in the IDR come from the Commission autumn 2023 forecast (European Economy, Institutional Paper 258), unless stated otherwise, and all calculations are carried out using these data to ensure the coherence of their various components. The cut-off date for the data for the preparation of this IDR was 20 February 2024. Actual outturn data that have become available after the Autumn and Winter interim forecasts, and before the cut-off date for the IDR, are used and supersede figures from those forecasts.

⁽³⁾ In the context of the multiple disrupting shocks that affected the world economy and the EU in the past few years, Commission Services have run an exercise to estimate the spillovers and the degree of exposures of Member States' economies to various partners and industries, in terms of nominal trade, value-added trade, inflation and financial assets. See European Commission Institutional Paper 2024 (forthcoming) - Economic spillovers and exposures in the EU.

⁽⁴⁾ Greece and Italy account for 15.5% and 4.7% of Cyprus's imports, while US and Russia for 11.7% and 9.7% of Cyprus's exports.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

The Cypriot economy has been characterised by high private, government and external debt levels which have been declining in recent years. Private-sector debt, of both household and non-financial corporations, has long been one of the major concerns for Cyprus's financial stability, in particular after the financial crisis of 2013. Despite the decreasing debt burden in these areas, the rise in interest rates is increasing pressure on some households. However, both these stocks of private debt have fallen in recent years. The public-debt-to-GDP ratio has also fallen rapidly in recent years, with risks to fiscal sustainability assessed as medium in the medium term. Nevertheless, the current account deficit has been sizeable in recent years, raising concerns about Cyprus's import dependency, although the country's net international investment position (NIIP) has improved as a share of GDP mainly due to strong nominal growth in recent years. The concerns typically associated with high levels of private and external debt are mitigated by the sizeable share of this debt that is held by special purpose entities (SPEs) whose lenders are located outside Cyprus, thus alleviating the risk for the domestic financial system.

Assessment of the gravity, evolution and prospects of macroeconomic vulnerabilities

Private-sector debt

Private-sector debt has fallen significantly in recent years and continued to decline in 2023. The decline in private debt, particularly notable since 2020, has been due to the deleveraging of both households and domestic corporations in the aftermath of the financial crisis of 2013. The decline in private debt also reflects high nominal economic growth. Much of the private debt is owed by foreign companies set up as SPEs (see Box 1), whose lenders are located outside Cyprus, thus alleviating the risk for the domestic financial system. Including SPEs, private debt in Cyprus exceeded 300% of GDP for most of the previous decade, but declined to 210% of GDP by Q2 2023, continuing the declining trend recorded over the last decade (see Graph 2.3e). Excluding SPEs from the measure, private debt in Cyprus stood at 157% of GDP in Q2 2023, still high but closer to the MIP threshold of 133% of GDP. The reduction of debt in 2023 was driven by both a denominator effect consisting of real GDP growth (2.2%) and inflation (HICP 2.5%). But it was also driven by negative credit flows that contributed to active deleveraging (see Graph 2.3f). If credit flows continue on the same path in the future, the private-debt-to-GDP ratio is expected to decrease further, supported in part by nominal GDP growth (see Box 2).

Non-financial corporations (NFCs) account for the largest share of Cyprus's private debt, but their indebtedness has been slowly declining. The debt of the corporate sector slightly decreased to 140.5% of GDP in Q2 2023, down from 141.6% of GDP at the end of 2022. This level is above the fundamental benchmark and prudential threshold (see Table 2.2). The corporate-debt-to-GDP ratio excluding SPEs slightly decreased from 89% at the end of 2022 to 88% in Q2 2023. The NFC sector as a whole deleveraged in 2022, as net credit flows turned negative (falling by -2.6 pps) and continued this trend in 2023 with credit flows of -4.4 pps (see Graph 2.3f). The NFC debt to GDP ratio is expected to remain high in the future, but it is also forecast to decline continuously in 2024-2025, supported also by nominal GDP growth.

Households have deleveraged more than NFCs. The decline in household debt in 2023 was more marked than the decline in NFC debt. Household debt fell to 69% of GDP in 2023 from 72% of GDP in 2022. The household debt ratio is below its fundamental benchmark, estimated at 90% of GDP, but above the prudential threshold of 30% of GDP (see Table 2.2). If credit flows continue the trend observed over the last 5 years into the future, deleveraging is set to continue (see Box 1 below).

Despite the decreasing debt burden, the rise in interest rates is likely to increase pressure on borrowers, and in particular on vulnerable households. Roughly half of all households in Cyprus are indebted, which is close to the euro area average (which was 55% in Q2 2023). However, the debt-service-to-income ratio stands at 20.5% and is the highest in the euro area (average 12.8% in Q2 2023). This ratio is even higher for debtor households in the bottom quintile of the income distribution, who make up around 11% of all Cypriot households. For new mortgage loans, interest rates rose from 2% at the end of 2021 to 5% in November 2023. For outstanding mortgage loans, average interest rates rose from 2.5% in 2022 to 4.6% in November 2023. Rising interest rates create debt-servicing challenges for highly indebted households. By mid-2023, almost 70% of new loans carried variable interest rates. However, the Cypriot banking sector has (i) ample liquidity (a liquidity ratio of 327%, among the highest in the euro area); (ii) improving profitability (return on equity of 16.6% in Q3 2023); and (iii) sufficient capital to withstand shocks. To further strengthen the resilience of the banking sector, the Central Bank of Cyprus increased the countercyclical buffer rate from 0% to 0.5% in November 2023, and has already announced a further increase to 1.0% effective from 2 June 2024. Banks remain vigilant and have early warning systems in place to detect credit deterioration.

The stock of non-performing loans (NPLs) in the banking sector has declined significantly since its peak in 2014 but is still a concern for the economy. A significant proportion of NPLs left the banking system at the time of the resolution of the former Cyprus Cooperative Bank in 2018, when the performing assets were sold to Hellenic Bank and the NPLs were transferred to KEDIPEs, the fully government-owned asset-management company (EUR 6 billion, 22% of GDP exposure in December 2022). In addition, since 2018, other banks have also made significant progress in reducing NPLs, mainly by outright sales to credit-acquiring companies (CACs). With the NPL transfers to the CACs in 2018-2021, the latter now hold most of the bad loans in the Cypriot economy (roughly 90% of the total amount outstanding). Furthermore, in recent years the decline in the stock of NPLs held by banks was also the result of write-offs, cash repayments, debt-to-asset swaps and ‘curings’ (migration of non-performing loans into performing categories). The improvement continued in 2023, with the NPL ratio in the banking sector decreasing from 5.2% in 2022 to 4% in Q3 2023 (1.8% euro area average in Q3 2023), down from the peak of 50.5% in 2014 (see Graph 2.3d). Concerns about new NPLs remain subdued, even though the migration rate from stage 1 to stage 2 loans has increased ⁽⁵⁾. Nonetheless, legacy NPLs continue to affect the real economy by limiting lending, particularly by less-significant institutions, which continue to record higher ratios of NPLs than the systemic banks. This is attributed to less-significant institutions’ smaller and more diverse portfolios, which present challenges for the deleveraging process ⁽⁶⁾.

⁽⁵⁾ Stage 1 assets are financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk. Stage 2 assets are financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit-loss event. Stage 3 loans are considered to be credit-impaired (i.e. a credit loss has occurred). Credit-impaired is usually a wider definition than ‘90 days past due’.

⁽⁶⁾ ECB data on interest rates for outstanding amounts of loans to, and deposits from, euro area residents: <https://data.ecb.europa.eu/publications/financial-markets-and-interest-rates/3030667>.

Public debt

The public-debt-to-GDP ratio has decreased rapidly in recent years. The general-government-debt-to-GDP ratio has declined by more than 35 percentage points since its recent peak at the end of 2020 and was estimated at 78.4% of GDP at the end of 2023. The reduction in public debt was driven by strong nominal economic growth, budget surpluses, and the use of accumulated cash reserves ⁽⁷⁾. In addition, the budget position significantly improved last year. This improvement was the result of reduced government spending, especially following the withdrawal of both: (i) the support measures taken in the context of the COVID-19 pandemic; and (ii) most of the measures taken to mitigate the energy crisis. Moreover, tax revenues are growing strongly, and even more strongly than corporate and labour income and consumption, suggesting some improvement in tax collection. So far, the impact of higher borrowing costs on debt has been offset by lower nominal debt levels. Repayment capacity in the short term is strong, as the government maintains a large cash buffer. For 2024 and 2025, Cyprus's government debt is forecast to continue declining, to 71.5% and 66.2% of GDP respectively, as the fiscal position is expected to remain strong with forecasts for continued government surpluses.

Risks to fiscal sustainability are low overall in the short term, medium in the medium term, and low in the long term according to the Commission's debt-sustainability analysis ⁽⁸⁾. Government gross financing needs are expected to decrease to just over 4% of GDP on average over 2024 and 2025, from 4.9% in 2023, reflecting the projected sizeable budgetary surpluses and relatively low redemptions. Financial markets' perceptions of Cyprus are favourable, as its debt rating was upgraded again in 2023. The four main credit-rating agencies now rate Cyprus's sovereign debt two notches within the investment grade category. Under the baseline scenario of the debt-sustainability analysis, the government debt to GDP ratio is expected to decline substantially over the next decade (see Box 2 for more on the medium-term risks to fiscal sustainability). Over the long term, the very favourable initial budgetary position is only slightly diminished by a projected increase in ageing-related costs. At the same time, several additional risk factors need to be considered. These risk factors are related to: (i) the recent increase in interest rates; (ii) the negative NIIP; (iii) elevated yields; and (iv) risks to the budget balance from the potential continuation of recent fiscal support measures. Risk-mitigating factors include Cyprus's extension of debt maturities in recent years, its relatively stable financing sources and its diversified investor base. In addition, the full implementation of the structural reforms in the recovery and resilience plan under the RRF is expected to further benefit GDP growth in the coming years, and therefore help mitigate debt-sustainability risks.

External sector

Cyprus is a small, open economy that is highly dependent on imported goods, leading to large current account deficits. Cyprus's economy has been running a current account deficit for at least 20 years. Over the last 10 years, the deficit has been gradually increasing, and since 2018 it has remained above the threshold of 4% of GDP (3-year average) set under the MIP. Although

⁽⁷⁾ Cash reserves at the end of 2022 stood at EUR 2.6 billion – up from EUR 3.6 billion in 2020 – enough to cover financing needs for more than 12 months. See Public Debt Management Office, Annual Report on Public Debt Management 2022 (in Greek), April 2023.

⁽⁸⁾ The results presented here are based on the debt-sustainability analysis included in the post-programme surveillance report published in December 2023 (European Commission, Institutional Paper 265), which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast. See post-programme surveillance report. Cyprus, autumn 2023 (European Commission, Institutional Paper 265).

Cyprus had been running deficits in the area of 4–5% for most of the previous decade, the current account deficit climbed to 8% of GDP in 2022 and is expected to have reached 9.7% in 2023. This rapid increase in the country’s current account deficit is due to both structural and temporary factors. Cyprus’s reliance on energy imports, alongside imports of raw materials and consumer goods, have contributed to the widening trade-in-goods deficit. Moreover, in 2023, the widening of the trade deficit reflected a large transfer of economic ownership of transport equipment, mainly ships, which is registered as imports of goods (see Box 1). The deficit in the trade in goods of 21.5% in 2022 widened to 23.2% in Q3 2023 (on a four-quarter-sum basis (see Graph 2.3.a)). Turning to trade in services, the tourism sector and foreign-owned companies contributed to a surplus of 21.8% in 2022 and 22.8% in Q3 2023. However, the repatriation of profits by foreign-owned companies is impacting primary income, which is also affecting the current account. As a result, the negative current account deficit is driven by both primary income outflows due to foreign-owned companies and the imports of goods (see Thematic Chapter).

An improvement is expected in the overall current account performance but this improvement will still leave the current account worse than desired. The outlook suggests that growth in domestic demand will moderate somewhat, falling to 2.3% in 2024 and 2025, while the current account deficit is forecast to narrow to -8.8% of GDP in 2024 and -7.5% in 2025. Even at these reduced levels, this deficit would remain significantly larger than the fundamental benchmark (around 1.5%) and the prudential benchmark (around 0%). Just to stabilise the NIIP above the threshold of -35% over a period of 20 years, an annual current account deficit of below 0.7% of GDP would be needed.

Despite the negative developments in the current account deficit, the NIIP has been improving in recent years. The NIIP of Cyprus improved from -104% in 2021 to -96.2% of GDP in 2022, mainly due to strong nominal growth in GDP and, to a lesser extent, valuation effects (see Graph 2.3.b). This improvement marks the continuation of a positive trend over the last decade, in which the overall NIIP has improved from over -160% of GDP a decade ago. Although this improvement is noteworthy, the NIIP remains beyond the MIP scoreboard threshold of -35% of GDP, and the prudential NIIP benchmark of -62% for Cyprus. It is also estimated to have slightly widened to -97% in 2023. However, the SPEs, in particular the ship-owning companies, inflate the country’s NIIP (See Box 1). Excluding the SPEs, the NIIP would be close to the scoreboard threshold and within the prudential NIIP benchmark for Cyprus. Looking ahead, medium-term projections are for a deterioration in the NIIP, driven by continued large current account deficits, in particular the primary income deficit (see Box 2).

Box 1: The impact of SPEs on the Cypriot economy

Cyprus hosts SPEs the assets and liabilities of which exceed the country’s GDP by several times, distorting the external statistics of the country and making them more difficult to interpret. SPEs are legal entities, registered or incorporated in the host country, with little or no physical presence and employment, and limited or no production, and controlled directly or indirectly by non-residents ⁽⁹⁾. The major types of SPEs registered in Cyprus include both financial SPEs and NFCs. Financial SPEs are mainly: (i) financing and holding companies, which channel funds within a global group of entities on behalf of a non-resident parent company; (ii) factoring/invoicing companies, which invoice the sales of a group with global operations on behalf of the parent; and (iii) licensing and royalty companies that transact entirely with other group entities. Non-financial SPEs are mainly ship-owning companies. Setting up SPEs in Cyprus currently makes it possible for companies to benefit from relatively low taxation (including a special tonnage-tax regime for shipping companies) and a local pool of specialised expertise, mainly accountants, lawyers and ship-management companies ⁽¹⁰⁾.

⁽⁹⁾ IMF Task Force definition – October 2018.

⁽¹⁰⁾ Country Report Cyprus 2018, Including an in-depth review on the prevention and correction of macroeconomic imbalances COM (2018) 120 final.

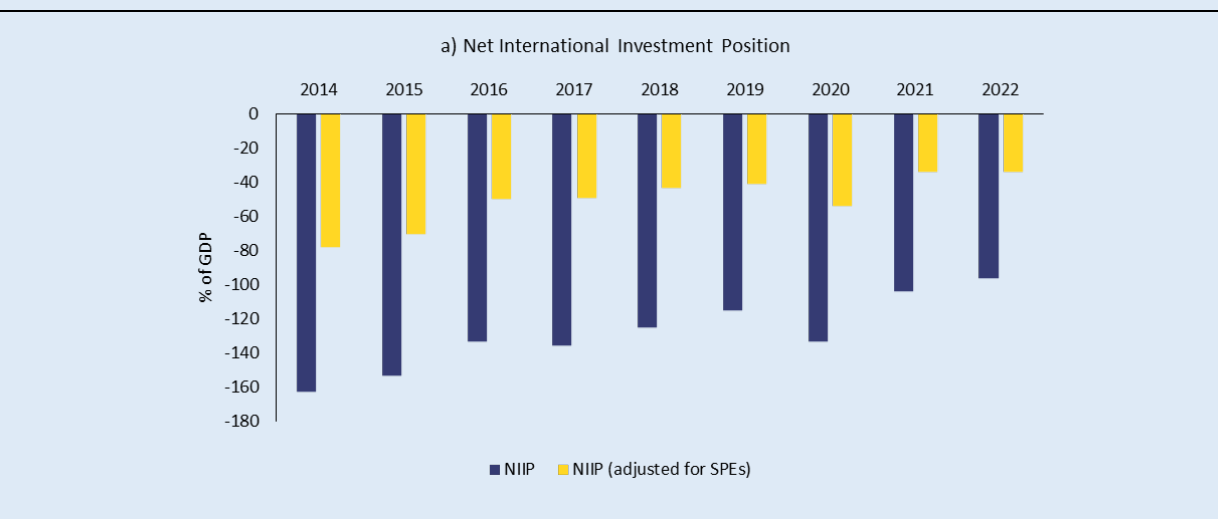
The NIIP is particularly affected by the debt of ship-owning SPEs which carries only limited financial risks for Cyprus. Unlike financial SPEs (the liabilities and assets of which are registered in the external financial accounts thus having limited impact on the NIIP) non-financial SPEs such as ship-owning SPEs are treated differently and have a large negative impact on NIIP calculations (see Graph 2.1.a). More precisely, ship-owning SPEs usually have large financial liabilities towards foreign creditors which are included in the NIIP, whereas their corresponding assets, mainly ships, are tangibles that are by definition excluded from the NIIP assets. However, the risks implied by these financial liabilities for the real domestic economy are limited, as ship-owning SPEs are currently overwhelmingly funded by foreign financial institutions or other related non-resident entities and own assets located outside Cyprus.

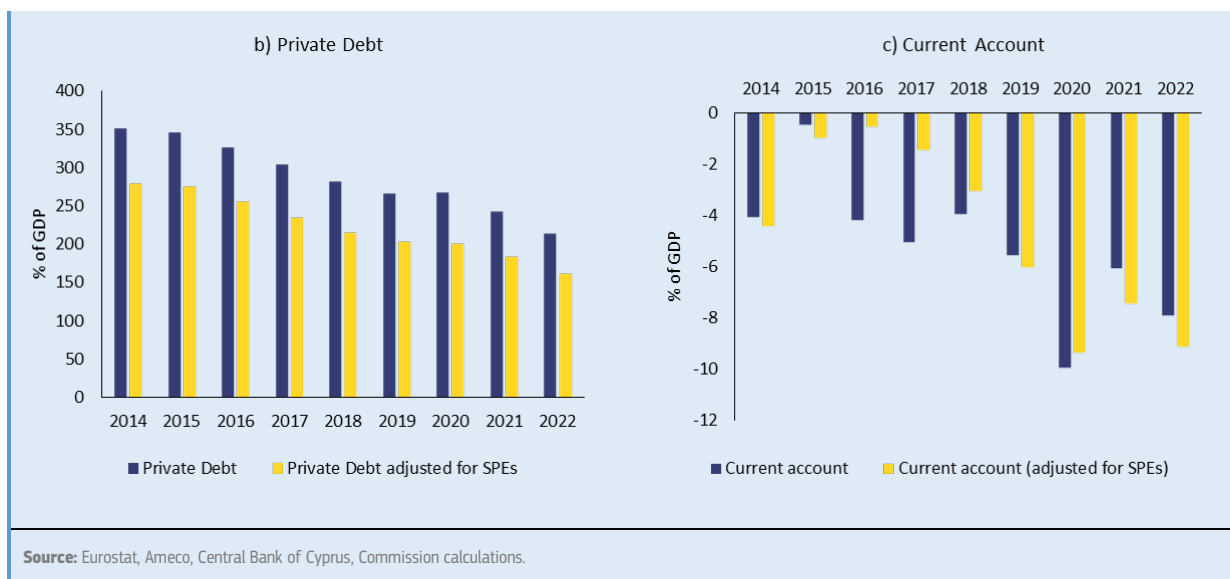
Similarly, measures of private debt in Cyprus are inflated by the debt of SPEs. A high share of the private debt comes from the operations of non-financial (mostly ship-owning) SPEs (see Graph 2.1.b). Their debt is overwhelmingly funded by foreign banks or other non-resident entities, posing minimal risks to the Cypriot banking sector and the real economy. As a share of GDP, SPEs' debt stood at 53% in mid-2023, inflating total private debt to about 210%. Excluding SPEs' debt, private debt is reduced to 157% of GDP, mitigating the risks from the still-high but continuously declining debt held by NFCs. A high share of cross-border intracompany borrowing attributed to SPEs limits Cyprus's NFC debt vulnerabilities.

The impact of SPEs on the current account is limited to around +/-1% of GDP each year. SPEs influence the goods and services balance through: (i) the registration (import) and deregistration (export) of ships; (ii) exports of sea transport and financial services; and (iii) imports of insurance and other auxiliary services (see Graph 2.1.c). Their impact on the primary income account (which in gross terms reaches 90%) mainly derives from interest on loans and deposits and the distribution of profits to the non-resident owners.

SPEs have had only a limited impact on the real economy so far. Despite their large financial flows and their impact on external-sector statistics (and especially their impact on the NIIP), the SPEs have only limited links with the domestic economy in Cyprus. These limited links are mainly to professional services, such as accountants and lawyers and some providers of financial services. For example, the closing down of some investment funds operating as SPEs due to Russia's war of aggression against Ukraine may in part explain a drop in the value added of professional services by 1% (1% in employment) and of the financial sector by 0.4% (2.2% in employment) in the first three quarters of 2023 (CYSTAT). The ship-management sector, consisting of mostly foreign-owned companies with a presence in Cyprus, accounts for around 2% of GDP and employment, and is only partly related to the ship-owning SPEs registered in Cyprus. The ship-owning sector (consisting only of SPEs) also has limited direct impact on GDP of about 2%. Overall, the share of the shipping sector in GDP is declining, while other sectors, such as the information and communications technology sector, are expanding rapidly.

Graph 2.1: **The impact of SPEs on macroeconomic indicators**





Box 2: Cyprus – External, private, and government debt projections for the medium term

This Box summarises projections for external debt to GDP and internal debt to GDP for Cyprus over the next decade, based on scenario analysis. It covers scenarios to take into account: (i) different underlying assumptions for stocks of external, corporate and household debt; and (ii) the outcomes of the latest government debt-sustainability analysis conducted by the Commission.

Cyprus's NIIP is projected to worsen in a range of scenarios, based on different underlying assumptions. In the baseline projections, which take the autumn 2023 forecasts for 2025 as a starting point, the NIIP gradually worsens to around -130% of GDP in 2033 (Graph 2.2 a). The deeply negative balance of primary income, which is also affected by the assumed increase in interest rates, is a key factor behind this deterioration, as the trade and capital account balances are comparatively negligible. Rising interest rates add to the accumulation of net liabilities. In a 'downside' scenario (Scenario 2), lower economic growth and a trade balance compounded by higher interest rates on liabilities drive the NIIP to around -170% of GDP in 2033. By contrast, in an 'upside' scenario (Scenario 1), where economic growth and the trade balance pick up and interest rates on liabilities decrease, the NIIP would stay broadly unchanged over the projection horizon. Excluding the impact of SPEs, the NIIP deteriorates in the baseline scenario as well as in the two alternative scenarios. Risks to the country's external position are mitigated by the favourable NIIP structure, as the NENDI (NIIP net of non-defaultable instruments) turned positive in 2022.

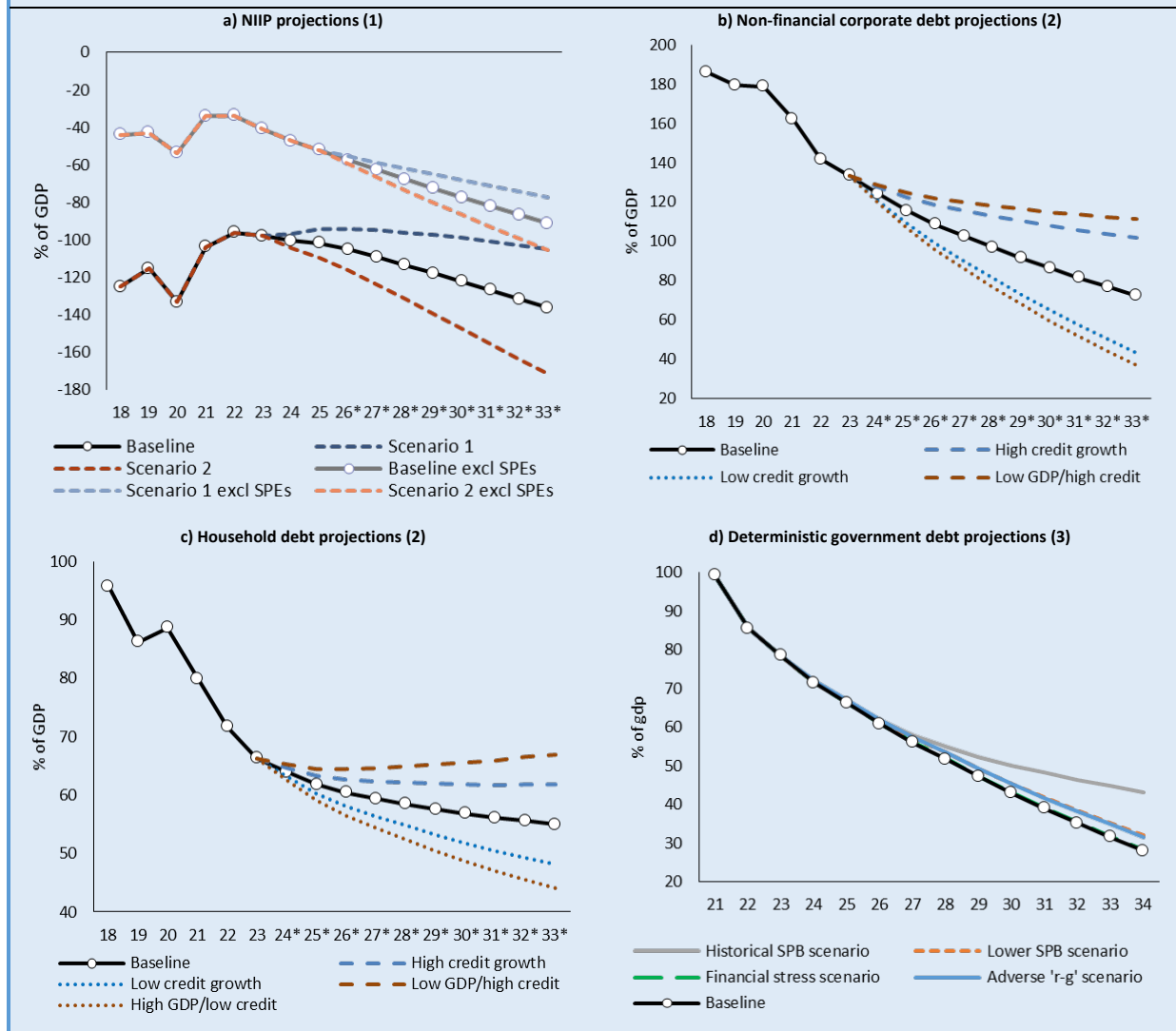
The corporate-debt-to-GDP ratio is projected to decrease under the baseline scenario by 61 percentage points by 2033, to 72%. The baseline scenario takes 2023 as a starting point and forecasts average real GDP growth of 1.8%, in line with Commission projections, and credit flows of -1.7% of GDP until 2033 (Graph 2.2 b). In this scenario, credit flows would be well below the 5.7% credit-to-GDP ratio needed to stabilise NFC debt over the projection horizon. Under an adverse scenario where credit flows are 3.5% of GDP higher – corresponding to half the intertercile range of the annualised quarterly credit-flow-to-GDP ratio over 2018-2023 – the NFC-debt-to-GDP ratio would be 29 percentage points higher in 2033. A permanent negative 1% GDP growth shock would increase the NFC-debt-to-GDP ratio by another 9 percentage points.

The household-debt-to-GDP ratio is projected to decrease over the next decade under the baseline scenario. The baseline scenario takes the 2023 forecast of 66% as a starting point and assumes as determining parameters average real GDP growth of 1.8% and credit flows of 1.4% of GDP for the period 2024-2033. It projects that the household debt ratio will continue to decline gradually (Graph 2.2 c). In this scenario, annual credit flows remain more than 1 pp. below the credit-to-GDP ratio that would stabilise household debt over the projection horizon. Depending on how interest rates and other economic conditions develop, credit flows could also behave differently. Graph 2.2 c considers alternative scenarios on credit flows. These alternative scenarios account for observed country-specific variability in credit flows since 2018 and permanent GDP shocks of 1 pp. above or below the baseline scenario. Under the most adverse scenario considered (high credit flows and low GDP growth), the household debt ratio would rise to 67% of GDP by 2033, still solidly below the pre-pandemic level (86%).

In Cyprus, medium-term risks to fiscal sustainability are medium overall. The debt-sustainability analysis for Cyprus shows that, under the baseline scenario, the government-debt-to-GDP ratio is expected to decline substantially over the medium term to reach 47.2% of GDP in 2029 and 28% of GDP in 2034 (Graph 2.2 d). The assumed structural primary balance – a sizeable structural primary surplus of 3.4% of GDP as of 2024 – appears ambitious compared with past

performance. At the same time, the baseline projections also benefit from a still-favourable but declining snowball effect of around 1% of GDP annually on average over 2025-2034, which is supported by the impact of Next Generation EU (NGEU) funding, and with average annual real GDP growth at around 0.9% over 2025-2034. Government gross financing needs are expected to decrease over that period and to become nil a decade from now. The baseline projections are stress-tested against four alternative scenarios to assess the impact of changes in key assumptions. For Cyprus, most of those scenarios would lead to worse results as compared with the baseline, with particularly adverse developments under the 'historical structural primary balance (SPB)' scenario ⁽¹¹⁾.

Graph 2.2: External, private, and government debt projections, based on scenario analysis for Cyprus



⁽¹¹⁾ The results presented here are based on the debt-sustainability analysis published in the post-programme surveillance report of December 2023 (European Commission, Institutional Paper 265), which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast. See notes to Graph 2.2 for more details on the four scenarios used.

(1) The baseline NIIP projections are based on the Commission's medium-term forecasts for GDP and interest rates. Additionally, assumptions are made about the drawdown of NGEU and MFF funds, and the median value of the last 3 years is used for non-investment income. Scenario 1 assumes higher GDP growth (+1 pp.) and a higher trade balance (+1 pp.) than in the baseline from 2024 onwards. Compared to the baseline scenario, Scenario 2 assumes lower GDP growth (-1 pp.) and a lower trade balance (-1 pp.), while the interest spread between liabilities and assets is higher by 0.3 pps in each year after 2023.

(2) For the NFC and household debt projections, the baseline refers to the country-specific, median, annual credit-flow-to-GDP ratio over 2018-2023. The high/low credit scenario assumes a higher/lower credit-flow-to-GDP ratio, with the difference to the baseline calculated as half the intertercile range of the annualised quarterly credit-flow-to-GDP ratio between Q1 2018 and Q3 2023. The latter is based on the moving sum of quarterly GDP. The high (low) GDP shock scenario reflects a permanent 1 percentage point increase (decrease) in GDP growth.

(3) 'Historical structural primary balance (SPB) scenario': the SPB returns to its historical 15-year average of -1.3% of GDP; 'Lower structural primary balance (SPB) scenario': the projected cumulative improvement in the SPB over 2023-2024 is halved; 'Financial stress scenario': the interest rates temporarily increase by 2.1 pps compared with the baseline; 'Adverse interest-growth rate differential (r-g) scenario': the interest-growth rate differential is 1 pp. lower compared with the baseline.

Source: Eurostat, Ameco, Commission calculations.

Assessment of MIP-relevant policies

Private debt

In December 2023, a legislative package was adopted to facilitate the implementation of the foreclosure framework and the subsequent NPL resolution. These legislative changes expand the scope of the existing competence of the Financial Ombudsman and promote out-of-court resolution. They introduce a right for eligible borrowers to appeal to the Financial Ombudsman's office for mediation regarding disputed amounts with their creditors. Furthermore, the package introduced a provision that allows appointing judges to adjudicate NPL cases secured by the primary residence (up to EUR 350 000). This should expedite the judicial resolution of NPLs. The legislative changes also improve transparency, by making it possible for two surveyors to be appointed to evaluate the mortgaged property, one from the lender's side and one from the borrower's side. The changes adopted are expected to alleviate concerns and enable the effective implementation of the foreclosure framework. Due to its recent entry into force, the impact of this policy on NPL resolution will have to be assessed over the next period.

The mortgage-to-rent scheme, in operation since December 2023, is also designed to address NPLs, while protecting eligible vulnerable borrowers in default from being evicted, by offering them a rent subsidy and a property buy-back option. The mortgage-to-rent scheme, which offers eligible vulnerable borrowers in default a rent-subsidy and a property buy-back option, was approved by the Cypriot Council of Ministers in July 2023 and came into effect in December. Participation is subject to strict eligibility criteria and targets NPLs collateralised by a primary residence with a value up to EUR 250 000 ⁽¹²⁾. The government estimates that up to 2 500 economically vulnerable households (of which 1 250 have mortgages that are held within the KEDIPEs NPL portfolio) could benefit from the scheme, with a baseline expectation for 800 homes (half of which have mortgages within KEDIPEs). KEDIPEs is tasked with the implementation of the scheme and has set aside a cash reserve of EUR 60 million to fund the acquisition of the properties from the participating institutions. The fiscal impact of this scheme is estimated at around EUR 100 million (approximately 0.4% of GDP) per year for the first 2 years. The measure's impact on the overall reduction of legacy NPLs for vulnerable households is expected to be minimal, as it is predominantly a social scheme aimed at protecting vulnerable households. The successful

⁽¹²⁾ Under the scheme, the eligible borrower hands the property to their mortgage lender, and KEDIPEs buys the property from the lender, paying 65% of the market value. The borrower is able to continue living in the property for 14 years, while the state covers the rent payments which are to be set at 65% of the going market rate. During those 14 years of residence, the borrower has the option to buy back the property at a discounted price.

implementation of the scheme is tightly linked to a well-functioning foreclosure framework. Due to its recent entry into force, the impact of the scheme will be assessed in the upcoming period.

Progress has also been made on the development of a liability-monitoring register, which will serve as tool for prudent policy making related to private indebtedness. In 2023, the register's action plan was finalised and approved. Once fully operational at the end of 2024, the liability-monitoring register will improve private-debt sustainability and prudence by providing the authorities with the appropriate tools to prevent and manage private indebtedness.

The insolvency framework has been strengthened, facilitating private debt management. The newly created Department of Insolvency is now fully operational and should ensure the effective and efficient application of insolvency procedures and preventive restructuring frameworks. Insolvency schemes, such as preventive restructuring solutions and early warning tools, can detect circumstances that could increase the likelihood of insolvency. They can therefore be used to provide early-stage restructuring and help avoid insolvency. The digitalisation of insolvency procedures, including the digitalisation and modernisation of the Department of Insolvency's operations, is expected to be implemented by 2025. The digitalisation of insolvency procedures should facilitate debt-workouts by increasing borrowers' participation in insolvency proceedings.

Improving the system for transferring title deeds, especially from lenders with a prior mortgage right to buyers, is supporting NPL resolution. In the past, many purchases of immovable properties were not accompanied by a transfer of the rights of the property (title deeds), creating disincentives for buyers to continue servicing their loans. This ultimately contributed to the creation of NPLs and hindered their resolution. As part of the RRF, the Sale of Property Law was amended to include two main changes. Under the first change, the buyer must be told at the time of the signing of the contract whether there is an encumbrance on the property on sale which may hinder the transfer of the title deed. Under the second change, in cases where there is a mortgage on the property on sale, a mechanism was introduced to ensure that the transfer of the title deed to the buyer is executed as soon as the buyer fulfils their contractual obligations.

Public debt

Public-debt reduction is expected to continue to be supported by sound fiscal policy. The fiscal strategy of Cyprus for 2024–2026 is to maintain general government budget surpluses above 2% of GDP. The main policy measure supporting fiscal targets on the expenditure side is the complete withdrawal of the energy-support measures. Other expenditure increases, in particular on health, wages and pensions, are set to be almost entirely offset by increases in revenue. Revenue collection is improving in all revenue categories. Income taxes are benefiting from higher wages and profits. As of January 2024, social security contributions have been increased. The Cypriot recovery and resilience plan includes reforms to further improve tax collection and the sustainability of the healthcare system, while taxes on interest, dividends and royalties are being introduced for certain types of transactions to address the issue of aggressive tax planning.

External sustainability

The full and timely implementation of RRP measures to diversify the economy will improve competitiveness and sustainability. Component 3.1 of the Cypriot RRP ('New growth model and diversification of the economy') includes several measures to strengthen competitiveness, productivity and investment in sectors such as agriculture, manufacturing (including green and agriculture technology), tourism (including agritourism), health and wellness. The measure also aims

to expand exports of halloumi cheese, which is one of Cyprus’s best-known exports. The RRP also provides grants for innovation programmes for start-ups, innovative companies and SMEs, and includes a reform of the existing licensing system for strategic investments in the country. The cohesion policy programme for Cyprus strengthens research and innovation capabilities, and contains policy measures to bolster digitalisation, competitiveness, diversification, and SME development.

The green transition is essential for reducing Cyprus’s very significant dependence on oil and reducing its current account deficit. An important reform was recently completed by creating digital ‘one-stop shops’ to both: (i) streamline permitting procedures for renewable energy projects; and (ii) facilitate energy-efficiency renovation in buildings. Progress has also been made in energy-efficiency renovations of public buildings. To further alleviate over-reliance on oil imports, more efforts are needed. Cyprus’s RRP also includes measures to expand energy production from renewable energy resources, install smart meters, and make transport more sustainable. EU cohesion policy is significantly helping to: (i) improve the energy efficiency of buildings and businesses; (ii) develop renewable energy; (iii) improve energy transmission and distribution systems; and (iv) develop energy-storage solutions.

Policy approach

Swift implementation of adopted legislation addressing private debt and green-transition measures can reduce long-standing vulnerabilities. The current account deficit reflects a long-term trend of low domestic savings and robust domestic demand. High levels of private debt have been declining recently but remain a concern. Effective foreclosure and insolvency frameworks are key to: (i) encouraging borrowers to participate in loan restructuring; (ii) increasing payment discipline; and (iii) helping reduce private indebtedness. To that end, the swift implementation of the adopted measures could lead to tangible results in the reduction of private debt in the short term. In the medium term, a comprehensive evaluation could be used to decide on whether additional policy measures will be required to facilitate the reduction of NPLs and private debt. The implementation of existing commitments in the RRP to diversify the economy, and additional steps where possible, are expected to support export growth and the green transition, reducing Cyprus’s high dependency on oil imports. On public debt, maintaining sound fiscal policies and improving tax collection remain crucial for sustained debt reduction.

Table 2.1: **MIP-relevant policy progress in Cyprus:**

Vulnerability	Policies enacted since January 2023	Policies in progress since January 2023
Private debt	In December 2023, the adoption of a legislative package aimed at increasing NPL resolution introduced provisions allowing a greater number of borrowers to seek loan restructuring through the Financial Ombudsman’s office.	Since the approval and adoption of the action plan in 2023, there has been progress in the development of a liability-monitoring register which, once fully operational at the end of 2024, will help ensure private-debt sustainability and prudence. In 2023, the government finished the recruitment, and training of staff (as well as customer-service and communication plans) for the Department of Insolvency.
Public debt	Phasing out of energy-support measures.	Cyprus’s fiscal strategy for 2024-2026 is to maintain budgetary surpluses above 2% of GDP.

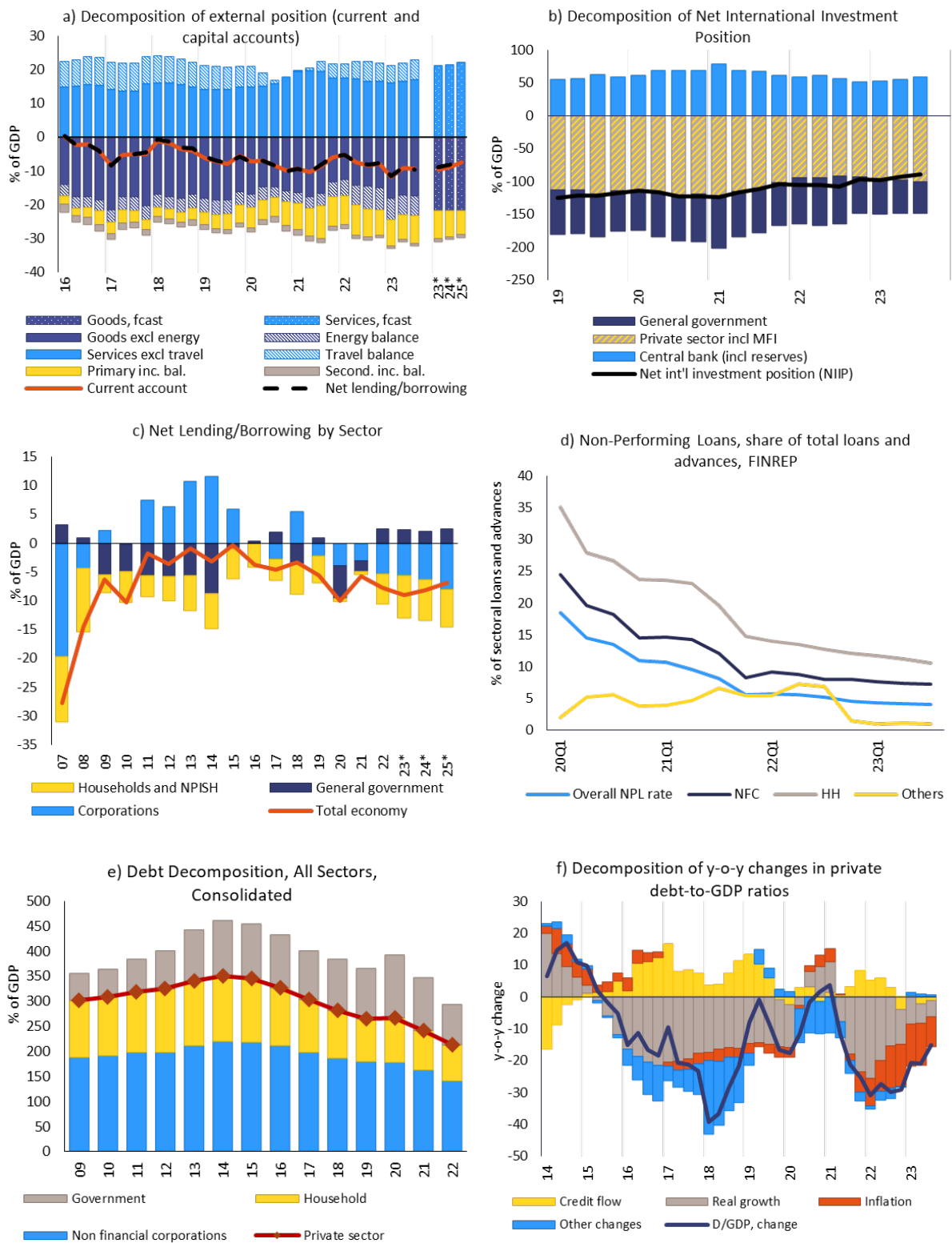
	The rate of social-security contributions increased as of January 2024.	RRP measures to improve tax collection, address aggressive tax-planning practices, and bolster the sustainability of healthcare systems.
Current account sustainability	Digital 'one-stop-shop' for licensing renewable energy and energy-storage projects. Adoption of a law to facilitate strategic development projects (including renewable energy and energy-storage projects).	The REPowerEU chapter was included in Cyprus's RRP and the implementation of measures to support the green transition in the country is ongoing. Measures in the RRP to diversify the economy and improve exports.

Conclusion

In Cyprus, vulnerabilities relating to private, public and external debt remain, but continue to recede and figures are heavily influenced by SPEs. Debt-to-GDP ratios for both households and NFCs continued to fall in 2023 but remain high. However, corporate debt is inflated by the debt of SPEs, which pose limited risks to the economy. In spite of the decreasing overall debt burden, rising interest rates are likely to increase pressure on some households and companies in the future. The decline in the stock of NPLs held by banks in recent years has been significant. This decline has been due to NPL sales, write-offs, cash repayments, 'curing', and debt-to-asset swaps. NPL resolution by the CACs is expected to support further reductions in private debt, as past transfers of NPLs out of the banking system and onto the balance sheets of the CACs still burden the economy. Mitigating factors that reduce those vulnerabilities include continued economic growth and limited credit expansion due to increasing interest rates. The government-debt-to-GDP ratio is decreasing rapidly and Cyprus is forecast to sustain budgetary surpluses for 2024 and 2025, which will lead to further reductions in the debt ratio. The current account deficit remained high in 2023 due to continued robust domestic demand and additional temporary factors, such as energy prices and the registration of ships. The current account deficit is expected to improve only slightly this year and next. The highly negative NIIP is set to deteriorate over the medium term unless the current account improves markedly.

Cyprus is making progress on the policy side to address its vulnerabilities. Cyprus has taken several measures to facilitate the resolution of NPLs. A legislative package that was recently adopted introduces provisions that: (i) allow eligible borrowers to seek loan restructuring through the Financial Ombudsman's office; (ii) enable borrowers to request Ombudsman confirmation of debt size; and (iii) enable the appointment of special judges for the expedited adjudication of NPL cases. The full and timely implementation of the RRP and measures to diversify the economy and promote the green transition are expected to further expand exports and alleviate the county's over-reliance on oil imports. Swift implementation of the adopted measures to reduce private debt and NPLs will be instrumental for successful NPL resolution. Nevertheless, additional efforts seem to be needed to create investment opportunities in sectors that would increase Cyprus's growth potential.

Graph 2.3: Selected graphs, Cyprus



Source: Eurostat, Ameco, ECB and European Commission calculations.

Table 2.2: **Selected economic and financial indicators (Part 1), Cyprus**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast	
								2024	2025
Real GDP	4.5	0.1	4.1	-3.4	9.9	5.1	2.2	2.6	2.9
<i>p.m.: Real GDP (Winter 2024 interim Forecast)</i>							2.4	2.8	3.0
Contribution to GDP growth:									
Domestic demand	6.0	-1.1	4.1	-1.7	4.9	6.9	4.3	2.3	2.3
Inventories	-0.2	0.4	0.4	-1.0	0.2	1.6	0.0	0.0	0.0
Net exports	-1.4	0.6	-0.4	-0.7	4.9	-3.4	-2.1	0.3	0.6
Output gap (2)	3.1	0.3	-1.8	-3.2	2.7	3.7	2.1	1.3	1.0
Unemployment rate	4.6	7.0	11.8	7.6	7.5	6.8	6.4	6.1	5.9
Hammonised index of consumer prices (HICP)	2.5	2.7	-0.2	-1.1	2.3	8.1	3.9	3.0	2.2
<i>p.m.: HICP (Winter 2024 interim Forecast)</i>								2.4	2.1
HICP excluding energy and unprocessed food (y-o-y)	1.4	1.7	0.0	-0.6	1.0	5.3	4.4	3.5	2.8
GDP deflator	3.5	2.0	-0.2	-1.4	2.7	6.1	5.8	3.3	2.8
External position									
Current account balance (% of GDP), balance of payments	-6.2	-7.7	-3.9	-10.0	-6.1	-7.9	-9.7	-8.8	-7.5
Trade balance (% of GDP), balance of payments	-2.2	-6.4	1.2	-1.4	4.0	0.3	.	.	.
Primary income balance (% of GDP)	-4.7	-0.3	-3.2	-7.0	-8.8	-7.5	.	.	.
Secondary income balance (% of GDP)	0.7	-0.9	-1.9	-1.6	-1.3	-0.7	.	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.6	-2.5	-1.6	-1.7	-1.9	-1.8	-1.6	-1.6	-1.4
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	0.3	2.8	-1.4	-1.9	-1.5	-0.9	-0.6	-0.3	0.0
Capital account balance (% of GDP)	0.1	0.3	0.3	-0.1	0.3	0.2	.	.	.
Net international investment position (% of GDP)	-68.2	-123.4	-137.7	-133.4	-104.0	-96.2	.	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	.	-69.0	-206.0	-110.4	-2.2	39.9	.	.	.
Net FDI flows (% of GDP)	.	9.0	16.2	-33.7	-31.1	-30.4	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	3.6	2.8	-2.6	1.8	-2.1	-0.9	4.5	3.0	1.3
Nominal compensation per employee	4.5	2.8	0.2	-0.5	4.3	1.1	5.0	4.0	2.6
Labour productivity (real, hours worked)	1.6	0.2	0.9	3.1	1.9	0.9	-0.4	0.2	0.3
Real effective exchange rate (ULC)	1.6	0.5	-3.6	-2.6	-2.0	-4.2	-1.8	-1.0	-1.2
Real effective exchange rate (HICP)	1.3	0.2	-0.9	-0.3	0.2	-1.8	.	.	.
Export performance vs. advanced countries (% change over 5 years)	.	-4.9	8.0	39.0	38.2	25.3	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	247.1	308.0	312.3	267.2	242.1	213.4	199.6	.	.
Household debt, consolidated (% of GDP)	84.7	116.9	110.0	88.6	79.9	71.7	66.3	.	.
Household debt, fundamental benchmark (% of GDP) (6)	69.0	78.6	95.9	97.0	93.1	91.1	90.3	.	.
Household debt, prudential threshold (% of GDP) (6)	41.7	41.6	41.7	44.7	43.9	40.7	30.3	.	.
Non-financial corporate debt, consolidated (% of GDP)	162.5	191.1	202.3	178.6	162.2	141.6	133.3	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	159.8	141.3	153.1	145.7	137.2	132.0	128.6	.	.
Corporate debt, prudential threshold (% of GDP) (6)	65.3	65.3	65.0	68.9	68.2	64.3	46.6	.	.
Private credit flow, consolidated (% of GDP)	22.6	18.7	5.7	-1.4	6.5	-3.9	-5.7e	.	.
Household credit flow, consolidated (% of credit stock)	11.5	6.8	0.1	3.4	2.9	-1.8	.	.	.
Non-financial corporate credit flow, consolidated (% of credit stock)	17.9	15.3	6.0	-4.5	4.5	-2.8	.	.	.
Net savings rate of households (% of net disposable income)	0.7	-0.5	-5.1	6.6	7.9	0.4	.	.	.

(e) Estimate based on ECB quarterly data.

(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.

(2) Deviation of actual output from potential output as % of potential GDP.

(3) Current accounts in line with fundamentals ('current account norms') are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), 'Methodologies for the assessment of current account benchmarks', European Economy, Discussion Paper 86/2018, for details.

(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of the Commission's T+10 projections.

(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.

(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crises and that of false alerts. The methodology to compute the fundamentals-based benchmarks and the prudential benchmarks is based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, pp. 1-42.

Source: Eurostat and ECB as of 2.20.2024, where available; European Commission for forecast figures (Autumn Forecast 2023).

Table 2.2: **Selected economic and financial indicators (Part 2), Cyprus**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast	
								2024	2025
Housing market									
House price index, nominal	8.2	-2.4	0.8	-0.2	-3.4	2.7	.	.	.
House price index, deflated	5.2	-4.9	1.2	0.8	-4.2	-3.6	.	.	.
Overvaluation gap (%) (7)	5.4	7.1	-1.8	-5.3	-13.3	-15.6	-14.2	.	.
Price-to-income overvaluation gap (%) (8)	9.1	3.9	-2.5	-8.5	-17.9	-20.2	-20.6	.	.
Residential investment (% of GDP)	10.3	8.2	5.2	8.0	8.3	8.6	.	.	.
Government debt									
General government balance (% of GDP)	-1.9	-4.1	-1.7	-5.7	-1.9	2.4	2.3	2.1	2.5
General government gross debt (% of GDP)	61.1	60.4	100.7	114.9	99.3	85.6	78.4	71.5	66.3
Banking sector									
Return on equity (%)	.	-48.2	-2.9	-3.2	1.4	3.5	.	.	.
Common Equity Tier 1 ratio	.	7.7	15.6	18.4	18.9	18.7	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	.	8.9	27.6	9.1	4.7	3.8	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	29.9	11.0	5.6	4.5	4.0	.	.
Cost of borrowing for corporations (%)	.	6.7	4.2	3.2	2.9	3.9	5.7	.	.
Cost of borrowing for households for house purchase (%)	.	5.3	2.9	2.2	2.2	3.4	5.1	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philipponnet, N., Turrini, A. (2017), 'Assessing House Price Developments in the EU', European Economy - Discussion Papers 2015 - 048, Directorate-General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation from the long-term average (from 1995 to the latest available year).

(8) Price-to-income overvaluation gap measured as the deviation from the long-term average (from 1995 to the latest available year).

(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 20.2.2024, where available; European Commission for forecast figures (Autumn Forecast 2023).

3. THEMATIC CHAPTER: EXTERNAL-SECTOR DEVELOPMENTS

Cyprus's current account deficit has continued to increase in recent years. While some structural factors might explain the persistency of the current account deficit, the continued expansion over the past few years could be due to other reasons ⁽¹³⁾. As outlined in Chapter 2, Cyprus had a persistent current account deficit of 4-5% of GDP pre-pandemic, which exceeded the level that fundamentals suggested (estimated at slightly over 1.5% of GDP). The presence of SPEs has little bearing on the current account although it does lead to a bloated NIIP (see Box 1). After 2019, the current account deficit averaged more than 8% of GDP. The dynamics in the repatriation of profits by foreign investors has contributed markedly to the deterioration. In addition, domestic demand has remained robust amid high inflation weighing on real incomes. In understanding the role of domestic demand and the repatriation of profits, analysing the large FDI (excluding SPEs) holdings in Cyprus is key.

Cyprus has shown remarkable resilience in domestic demand despite substantial shocks, but this resilience has also had a negative impact on the current account. Cyprus's economic performance is underscored by robust real GDP growth, which eased to 2.5% in 2023, following a 5.1% increase in 2022, but clearly surpassing the EU and euro area average of 0.5% ⁽¹⁴⁾. Unlike the euro area, real domestic demand in Cyprus was also noticeably resilient in 2023 (see Graph 3.3a, 3.3b), remaining a pivotal force behind GDP growth and contributing a substantial 4.3 pps to the overall growth rate. The resilience of domestic demand can be seen in the widening current account deficit, reflecting both domestic demand that exceeds potential output and the country's dependency on imported goods. The outlook suggests that domestic demand will moderate somewhat to 2.3% in 2024 and 2015, while the current account deficit is forecast to narrow in 2024 (-8.8%) and 2025 (-7.5%).

Vigorous investment activity also reflects strong demand in the construction sector, partly driven by non-residents. Between 2019 and 2022, growth in nominal private consumption and gross capital formation in Cyprus significantly outpaced that in the euro area. While the cumulative rate of growth in domestic demand in the euro area was nearly 14%, it was 21% in Cyprus in this period. Total investment has been at around 20% of GDP since 2017, largely driven by corporations and households. In Cyprus, investment activity has been mainly concentrated in the construction sector (see Graph 3.3.c), reflecting the strong demand for housing and the concentration of FDI in real estate. Real estate FDI liabilities accounted for 50% of GDP in 2022, which amounts to about a quarter of total FDI liabilities adjusted for SPEs. In nominal terms, the real estate FDI increased from EUR 11.8 billion in 2021 to around EUR 14.2 billion in 2022 due to inward flows of around EUR 2.3 billion, close to twice the average between 2018 and 2021.

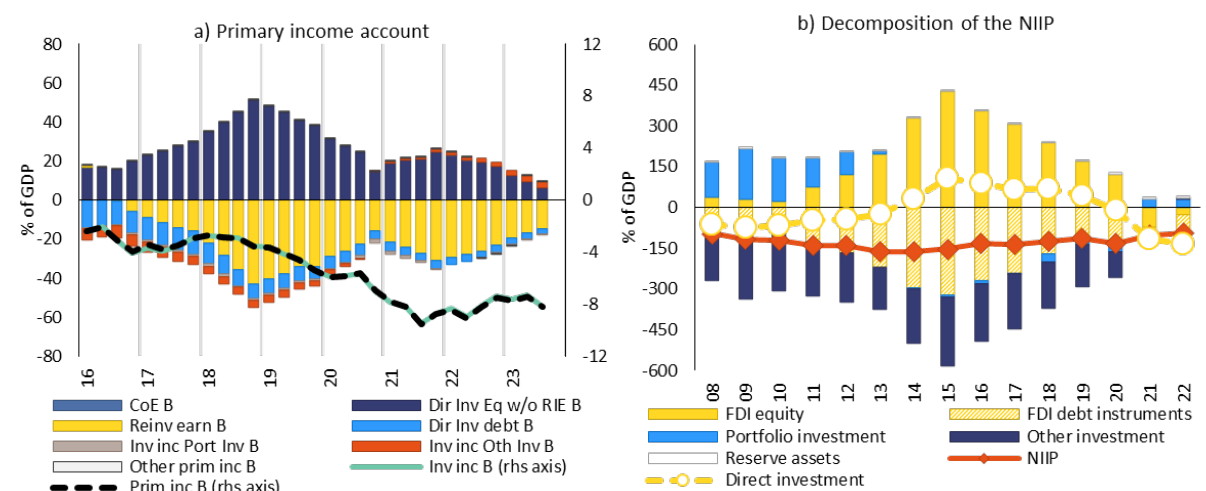
From the saving-investment perspective, the current account deficit reflects persistently low domestic savings in the household sector, and more recently low saving among corporates. The current account gives a picture of the disparity between an economy's savings and its investments, and a distinctive attribute of the Cypriot economy has long been its historically low savings rate (see Graph 3.3d). In particular, the household sector invests significantly more than it

⁽¹³⁾ The balance is below the levels explained by current account norms, i.e., current accounts in line with fundamentals, which are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), 'Methodologies for the assessment of current account benchmarks', European Economy, Discussion Paper 86/2018.

⁽¹⁴⁾ Based on the CYPSTAT Flash Estimate of 14 February 2024.

saves, owing mainly to its high investment in housing, financed by both borrowing and reducing financial assets ⁽¹⁵⁾. After a short period of elevated savings during the pandemic, households returned to their usual high consumption pattern in 2022 and increased their net borrowing from 0.5% of GDP in 2021 to 5.4% of GDP in 2022 (above the pre-pandemic average), and to an estimated 7.3% in 2023 (see Graph 2.3.c). In addition, the corporate sector, which had alternated between surpluses and deficits over the years, has become a net borrower since 2019 with a particularly large negative net position in 2022. The net borrowing position is forecast to widen in the coming years, continuing the strong reduction in the gross savings rate of the previous years. The government sector has been a net-lender since 2016, except in 2018 due to the support extended to the banking sector, and 2020/2021 due to the pandemic-related support measures.

Graph 3.1: **Primary income and NIIP decomposition, Cyprus**



Source: Eurostat, Ameco, ECB and European Commission calculations.

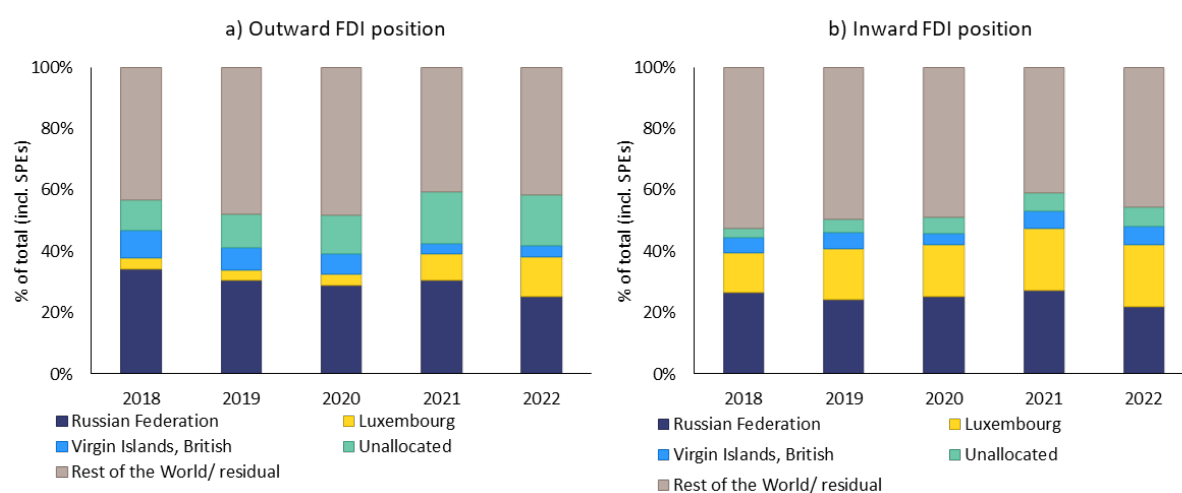
The repatriation of profits by foreign-owned companies seems to be another key driver of the current account deficit. Although foreign-owned companies significantly boost service exports in Cyprus, the persistent repatriation of their profits is a primary driver behind the growing primary income deficits (see Graph 3.1.a). The primary income balance has continued to deteriorate since 2017, during which time it has also shifted in composition. Up until 2018, the primary driver of the negative balance was other investment income, mainly from interest on loans. During this period, received dividends balanced out the negative impact of reinvested earnings from FDI. However, since 2019, the positive contribution of dividends has waned, while reinvested earnings continue to remain negative. Potential reasons for the stronger outflow of FDI income could be the generation of profits in the economy, the passthrough of income, and/or the complexity of measuring investment income. Despite a temporary narrowing from 8.8% in 2021 to 7.5% in 2022, the primary income deficit expanded again in Q3 2023 by 8.2%. Key sectors driving the primary income deficit, such as ICT and financial and insurance activities, align with those contributing to service exports. Furthermore, the increasing influence of foreign-owned CACs since 2018, along with their profit repatriation and foreign-debt interest payments, also negatively impact the current account. This effect extends to

⁽¹⁵⁾ See thematic chapter in the 'In-depth review of Cyprus' 2023 – Institutional Paper 215, May 2023. Brussels. [In-Depth Review 2023 - Cyprus - European Commission \(europa.eu\)](https://ec.europa.eu/economy_finance/in-depth-review-2023-cyprus).

the foreign-owned companies in the retail sector, where imported products and repatriated profits contribute to the trade-in-goods deficit and the primary income deficit.

The current account deficit mirrors the external financing via FDI in Cyprus. The current account reflects flows from exports and imports of goods, services, and generated income from and to the rest of the world. And the mirroring financial account displays the cross-border acquisition/disposal of financial assets and liabilities. Hence, the financial account measures how the current account deficit is financed when analysing the net financial flows ⁽¹⁶⁾. In Cyprus, FDI has been the determining force in the financing of the current account deficit since 2016 (see Graph 3.3.e). In 2022, the financial account deficit widened to 7.2% of GDP due to disinvestments, aligning with the current account deficit of 7.9% but remaining higher than the pre-pandemic average deficit of 2.7%. The disinvestments, which were last recorded in 2020 and 2018, resulted from more net-disposals of financial assets (-31.9% of GDP), mainly in intracompany debt, than the net-reduction of liabilities (-24.7% of GDP), mainly in loan liabilities of the private sector. This development reflects the halt in FDI flows to and from Russia following Russia’s war of aggression against Ukraine. As of September 2023, financial investments on a four-quarter-sum basis turned positive again, and net direct investments into Cyprus (-10.9% of GDP) remain the source of external financing, partly offset by the net acquisition of – mainly long-term – foreign-debt securities by residents in Cyprus (+5.2%).

Graph 3.2: **Outward and inward FDI, Cyprus**



Source: Eurostat, Ameco, ECB and European Commission calculations.

There has been a shift in the regional allocation of direct investment in and from Cyprus.

In general, direct investments are a long-term investment ⁽¹⁷⁾. The direction of investment determines the type of analysis, with outward FDI referring to the assets of the resident investor and inward FDI referring to the liabilities of the resident affiliates. Over the past 5 years, Cyprus has experienced a shift in the regional allocation of FDI positions, characterised by diminished ties with Russia and greater engagement with Luxembourg (see Graph 3.2.a, 3.2.b). The share of outward FDI to Russia reduced by around 9 percentage points to 25% between 2018 and 2022, while the share of inward FDI from Russia reduced by 5 percentage points to 22%. At the same time, the relevance of

⁽¹⁶⁾ See IMF, The sixth edition of the Balance of Payments and International Investment Position Manual (BPM6).

⁽¹⁷⁾ See OECD Benchmark Definition of Foreign Direct Investment – 4th Edition.

Luxembourg for outward FDI increased by around 9 percentage points to 13% between 2018 and 2022, and for inward FDI by 7 percentage points to 20% between 2018 and 2022.

FDI is marked by the prevalence of SPEs, which have liabilities equivalent to roughly 14 times the GDP of Cyprus. The high amounts of SPEs and the shifts between equity and debt instruments may reflect the allure of Cyprus for tax-planning models, although the exact reasons remain uncertain ⁽¹⁸⁾. In Q3 2023, foreign investment liabilities were equivalent to around 14 times the GDP of Cyprus while assets were equivalent to around 13 times GDP, highlighting the significance of FDI for the international investment position of Cyprus. SPEs account for most of these substantial FDI stocks, which are 11 times greater than Cyprus's GDP. The main purpose of SPEs is usually to channel capital between entities and isolate financial risks (see Box 1). Over the period spanning from 2016 to 2019, FDI assets were on average 20 times greater than GDP, with liabilities standing at 19 times greater. These volumes were primarily facilitated through SPEs. Between 2010 and 2020, the difference between the FDI net equity position and debt instruments is remarkable. At the peak in 2015, equity reached around 400% of GDP and debt instruments accounted for around -300% of GDP (see Graph 3.1.b). However, there has been a shift in composition and regional allocation of FDI since then. Until 2020, positive net equity positions were mainly attributable to claims outside the euro area. Since 2021 however, these net-claims have significantly decreased, resulting in a negative net equity position ⁽¹⁹⁾. More regional information is available for the net positions of debt instruments. Resulting net liabilities were mainly recorded towards Russia and offshore financial centres ⁽²⁰⁾. Since 2021, net liabilities from debt instruments towards offshore financial centres have continued to significantly increase. At the same time, claims vis-à-vis the EU, particularly from the Netherlands and Luxembourg, have turned positive ⁽²¹⁾. The reasons behind these shifts remain unclear, although the availability of new data might lead to a reinterpretation.

The NIIP is bloated by SPEs, while the NENDI has turned positive for the first time in 15 years. Although the highly negative NIIP (including SPEs) has narrowed in recent years despite the current account deficit, it remains considerable at almost -100% of GDP. If SPEs are excluded, the resulting NIIP shows activities of the 'truly domestic' Cypriot economy of -37.3% in the first half of 2023 (see SPE box). There has also been a clear shift in the composition of NIIP (including SPEs), as described in the previous paragraph. The net FDI position turned negative in 2020 with financial liabilities exceeding assets. This was due to SPEs which had ceased business. In 2022, other investment assets, mainly deposits including currency and loans, exceeded liabilities for the first time in more than 15 years. At the same time, portfolio investments continued to contribute positively to the NIIP for the second year in a row, due to the net acquisition of foreign equity and debt securities. This shift also affected the NIIP excluding non-defaultable instruments (NENDI), which turned positive for the first time since 2007, reaching 40% in 2022 (see Graph 3.3.f) and is forecast to remain at this level in 2023, reducing concerns related to the external position ⁽²²⁾.

⁽¹⁸⁾ See European Commission (2017), 'Aggressive Tax Planning Indicators. Final Report', Taxation Papers, Working Paper 71/2017.

⁽¹⁹⁾ In Cyprus, aggregate FDI (the net-investment into Cyprus in terms of financial transactions) exceeds investments from Cyprus, mainly reflecting external financing via FDI. However, the development of the positions is also impacted by other changes, e.g., valuation effects.

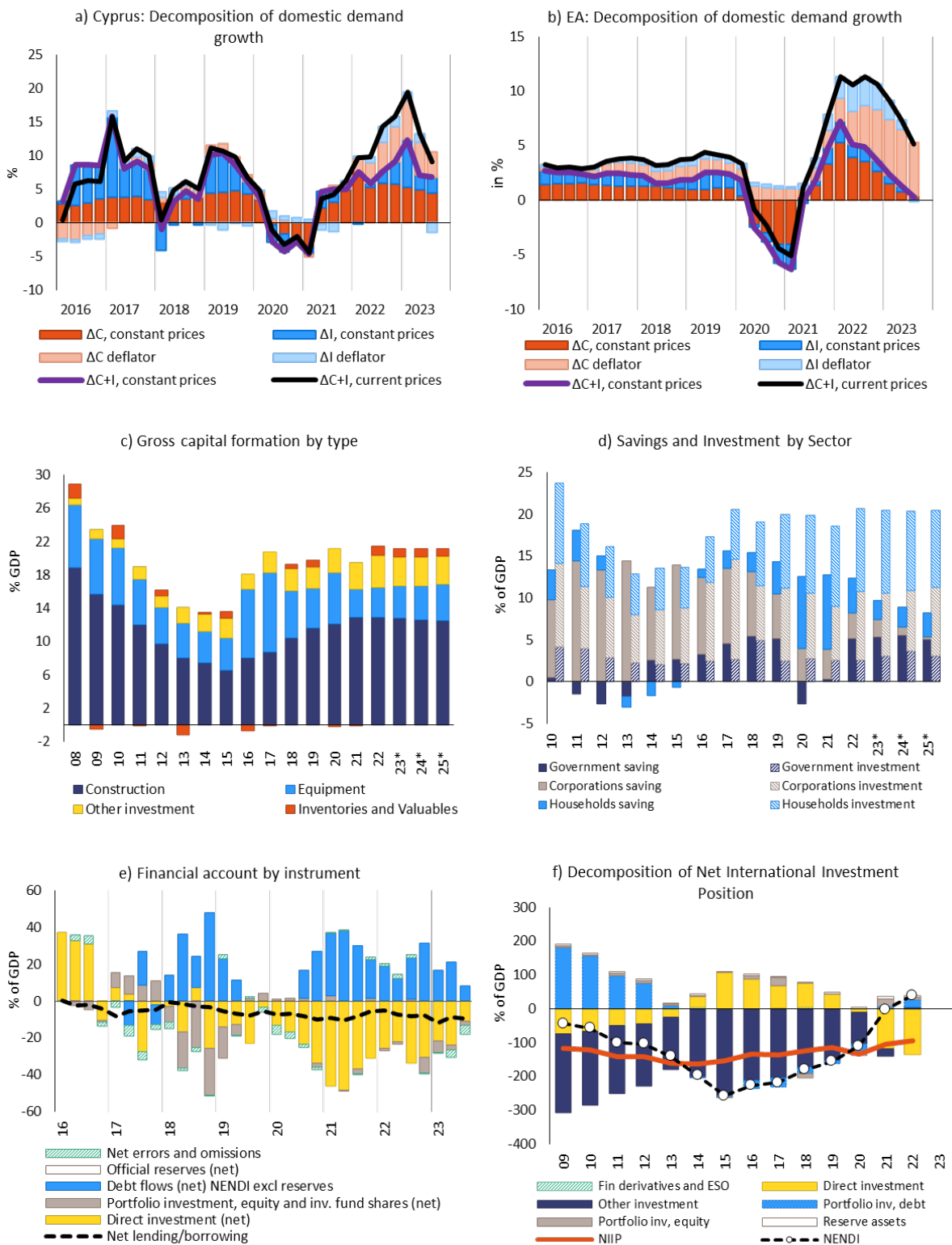
⁽²⁰⁾ According to the definition by Eurostat (e.g., British Virgin Islands, Cayman Islands).

⁽²¹⁾ Information on net debt instruments vis-à-vis Luxembourg are flagged as confidential up to Q4 2022.

⁽²²⁾ NENDI is defined as NIIP excluding FDI and equity in portfolio investment.

In conclusion, the widening current account deficit reflects both vigorous domestic demand and the repatriation of profits, which requires continued vigilance. The current account deficit is currently twice the size of pre-pandemic levels and exceeds the current account norm by several percentage points. However, it remains unclear to what extent the pre-pandemic 'departure level' of the current account deficit should be a cause of concern, or which statistical factors might contribute to it. A strong part of the current account deficit can be attributed to shifting patterns of FDI dividend payouts, robust domestic demand, and low domestic savings. Moreover, since 2020, substantial shifts in trading partners and the overall structure of the Cypriot balance of payments, especially in FDI, might have contributed. These changes underline the evolving dynamics of the economic landscape, and their contributing factors require continued careful observation.

Graph 3.3: External-sector selected graphs, Cyprus



Source: Eurostat, Ameco, ECB and European Commission calculations.

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