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Cyprus, Autumn 2023

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The report was prepared in liaison with staff from the ECB ([2]). Staff from the European Stability Mechanism (ESM) also provided comments.

This report reflects information available and policy developments that have taken place until 31 October 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with a cut-off date of 31 October 2023).

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([1]) The executive summary of this report was adopted as Commission Communication C(2023) 9804 on 19 December 2023. The rest of the report reflects the findings of the staff working document SWD(2023) 984 accompanying that communication.

([2]) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

EXECUTIVE SUMMARY

The 15th post-programme surveillance mission to Cyprus took place from 25 to 29 September 2023. This mission involved European Commission staff in liaison with European Central Bank (ECB) staff. European Stability Mechanism (ESM) staff participated on aspects relating to the ESM's Early Warning System.

Economic growth in Cyprus is set to slow down over the coming years following a strong recovery post-COVID-19. Real GDP growth is expected to slow to 2.2% in 2023 from 5.1% in 2022. Domestic demand and tourism continue their strong growth performance, but external demand for financial and business services is being negatively affected by global developments such as the ongoing Russia's war of aggression against Ukraine. Growth is expected to continue on a moderate path in 2024 and 2025 at around 3%. This will mainly be driven by sizeable investments in the areas of energy, education, health and tourism, in part supported by the RRF. The Cypriot labour market remains robust, with employment continuing to increase and unemployment expected to fall to its lowest level in over a decade, below 6% by 2025. Inflation is set to decelerate markedly to 4.1% in 2023 after reaching a peak in 2022 at 8.1% and is set to further decelerate over the coming years. However, core inflation is projected to remain elevated, partly due to the automatic wage-indexation system pushing up prices. The current account deficit widened in 2023 as external demand for non-tourism services is moderating. The deficit is expected to only gradually narrow in the following years.

The fiscal position remains strong. The general government balance posted a sizeable surplus of 2.4% of GDP in 2022. In 2023, revenues have remained buoyant, while expenditure has also increased, albeit to a lesser degree. According to the Commission's autumn 2023 forecast, the general government surplus is expected to decrease somewhat before increasing again over the coming years. There are some potential risks to the fiscal outlook, such as possible new or extended measures, notably in case of a new surge of energy prices, and the contingent risks from the banking sector.

Cypriot banks recorded strong profits in the first half of 2023, benefitting from higher policy rates and the sector's capital position remains solid. The bulk of the income gains derived from the banks' excess liquidity placed with the ECB and to a lesser extent from a swift passthrough of the higher interest rates on variable-rate loans and a slower passthrough to deposit rates. As a result, Cypriot banks benefit from interest margins that are much wider compared to the rest of the euro area. The banking sector's capital position remains solid, comfortably surpassing minimum requirements. Asset quality has improved, mostly because of Non-Performing Loans' (NPL) sales achieved over the last few years by the systemic banks. Further progress depends also on the ability of the smaller banks to deleverage. The past transfers of NPLs out of the banking system to the balance sheets of the credit acquiring companies (CACs) still burden the economy through private indebtedness. Macroeconomic risks have increased moderately for Cypriot banks as higher interest rates and rising living costs weaken borrowers' capacity to service their loans.

Further progress in the management of NPLs requires an effective foreclosure framework ([3]). This is important for legal certainty and to maintain payment discipline as it provides lenders leverage over uncooperative borrowers. Repeated suspensions of the foreclosure framework have hampered its efficacy. This can impact the efforts to reduce NPLs and as a result the robustness of the Cypriot banking sector. The effective implementation of the foreclosure tool is also important for the success of schemes like the mortgage-to-rent scheme, designed to protect the primary homes of vulnerable households.

Cyprus retains the capacity to service its debt. Despite a number of challenges, the economic, fiscal and financial situation in Cyprus is sound overall. According to the debt sustainability analysis, Cyprus faces low risks in the short and long terms, while medium-term risks appear to be medium. The government's gross financing needs for 2023 and 2024 are low thanks to significant projected primary

([3]) On 8 December 2023, the Cypriot Parliament adopted legislation related to the foreclosure framework and the NPL resolution, which could not yet be analysed for the purpose of this report.

surpluses. Repayments of the principal on ESM loans will start in 2025 and will conclude in 2031. Cyprus has a very large cash buffer and continues to enjoy favourable market perception. Its sovereign debt rating was upgraded by three rating agencies in 2023, now being at least two notches within investment grade area by all four main rating agencies.

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1. INTRODUCTION

Following a request by Cyprus on 25 June 2012, a three-year economic adjustment programme was agreed between the Cypriot authorities and the European Commission, the ECB and the IMF on 2 April 2013. Cyprus exited its Economic Adjustment Programme in March 2016. The programme included an ambitious reform agenda and measures designed to decisively address the financial, fiscal, and structural challenges facing the Cypriot economy so as to return to a sustainable growth path. It provided financial assistance of up to EUR 10 billion (the ESM providing up to EUR 9 billion and the IMF contributing around EUR 1 billion). Cyprus eventually used EUR 7.3 billion (EUR 6.3 billion from the ESM and EUR 1 billion from the IMF). Cyprus fully repaid its IMF loan in February 2020.

Staff from the European Commission, in liaison with staff from the ECB, undertook from 25 to 29 September 2023 the fifteenth post programme surveillance (PPS) mission to Cyprus. Staff from the European Stability Mechanism (ESM) participated in these meetings on aspects related to the ESM's Early Warning System and staff from the IMF also participated. Under PPS, the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS mission is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt. ([4])

This report reflects information available on, and policy developments until, 31 October 2023. The macroeconomic and budgetary projections (including those underlying the debt sustainability analysis) are in line with the Commission's autumn 2023 forecast released on 15 November 2023 (with a cut-off date of 31 October 2023).

([4]) Under Regulation (EU) No 472/2013, PPS will continue until at least 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, PPS will last until 2030.

2. MACROECONOMIC DEVELOPMENTS

In 2023, real GDP growth in Cyprus began to moderate after a period of strong recovery following the COVID-19 crisis. Based on the Commission's autumn 2023 forecast, economic growth is set to slow to 2.2% in 2023, from 5.1% in 2022 and 9.9% in 2021. Domestic demand continued its strong performance during the year. However, external demand for services, especially financial and business, was negatively affected by global developments such as the ongoing Russia's war of aggression against Ukraine. A successful diversification strategy led to tourism revenues exceeding their pre-COVID-19 levels and arrivals almost reaching levels set in record year of 2019. Private consumption benefited from dynamic employment growth and automatic wage indexation, which partly compensated for the loss of purchasing power of disposable income ([5]). Housing construction was supported by the extension of the interest subsidy scheme for mortgages, which was originally introduced by the government in 2020 as a compensatory measure for the COVID-19 crisis. The buoyant inflow of foreign companies created additional demand for residential and commercial property demand.

Economic growth is set to continue on a path of moderate growth, with real GDP expected to expand by 2.6% in 2024 and by 2.9% in 2025. Investment in Cyprus is projected to benefit from sizeable infrastructure projects in the areas of energy, education, health and tourism as well as investments financed under the Recovery and Resilience Plan (RRP). This will be partially offset by an expected slowdown in residential construction activity following the robust expansion in recent years and increased interest rates. Household disposable income is set to rise, partly reflecting the impact of the increased wage indexation agreement. This is expected to uphold growth in private consumption, albeit at a lower pace than recent years. Based on bookings so far, the expansion of tourism is expected to slow down after its full recovery from the COVID-19 crisis. External demand for non-tourism services is also expected to moderate over the forecast horizon following the dynamic expansion of the years 2020-2022. Housing prices in Cyprus increased by 4.6% in the first half of 2023, driven by robust domestic and external demand and in line with increases elsewhere in the euro area so far. However, developments in the real-estate sector warrant close monitoring as the exposure of the banking sector and credit-acquiring companies to real-estate remains high.

The outlook is subject to downside risks, in particular due to the uncertainty in the oil price developments. Furthermore, rising interest rates, in the context of very high private indebtedness pose a risk to the overall quality of loan portfolios, in particular in critical sectors for the economy such as tourism, trade and construction.

Continuous economic growth is reflected in the labour market. Employment increased by 1.8% in the first half of 2023, and total hours worked increased by 2%, with especially strong growth in services, in particular ICT. The unemployment rate decreased to 5.9% in the second quarter of 2023, down from 6.7% in the same period of 2022. Shortages of labour and skills are becoming more prevalent in some sectors (notably tourism) and are being addressed by Ukrainian refugees and by granting temporary work permits for non-EU nationals, including students. The expected ongoing expansion of economic activity is set to further support the labour market. Employment is expected to increase by around 1.6% in 2024 and 2025. The unemployment rate will decrease in 2024 to 6.1% and further fall to 5.9% in 2025.

Inflation in Cyprus is decelerating amid declining energy prices, but core inflation remains elevated. The harmonised index of consumer prices decelerated markedly from a peak of 8.1% in 2022 to 4.4% in the period January-September 2023 due to a decrease in energy and food prices. However, core inflation (excluding energy and food prices) remained higher at 5% in January-September 2023 due to the pass-through

([5]) Cyprus has an automatic cost-of-living allowance indexation with wages in place (COLA). Under the scheme, the wages and salaries of employees of the broader public sector and the private sector covered by collective agreements (about 30% of private-sector employees) are adjusted every January as of 2024 by 66.7% (from 50% previously, following a renewed agreement in May 2023 among the social partners) of the year-on-year percentage change (only if positive) in the consumer price index (CPI), excluding any increases in consumption taxes, and only if GDP rose during the second and third quarters of the previous year. In 2023, wages increased by 5.3% through COLA adjustment (50% of the 2022 Consumer Price Index on January and additionally 16.7% on June) for around 45% of employees.

of previous increases in energy prices to the prices of services. The wage indexation has also pushed prices up as nominal wages increased by 7.1% in the first two quarters of 2023. Assuming energy prices are declining, inflation is expected to further slow to 3% in 2024 and 2.2% in 2025. Upside risks to the inflation outlook increased due to the uncertainty in the global energy markets, in particular for oil.

The current account deficit increased significantly and is expected to remain high in the coming years. In 2023, the current account deficit is expected to increase to 9.6% of GDP from 7.9% in 2022. The deterioration results to a large extent from the decrease in exports of business and professional services due to the ongoing Russia's war of aggression against Ukraine. The deficit in trade of goods in 2023 is expected to deteriorate due to increased registration of ships in the first half of the year and buoyant domestic demand. In 2024, the current account is expected to improve only slightly to 8.8% of GDP as exports of non-tourism services are set to slow. In 2025, a more pronounced improvement is projected with current account deficit of 7.5% of GDP in line with the anticipated improvement of the global economy and external demand as well as the expected further decline in energy and commodity prices.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE

The public finances recorded a sizeable improvement in 2022. After a deficit of 1.9% of GDP in 2021, the general government balance improved to a surplus of 2.4% of GDP in 2022. In 2023, the general government balance of Cyprus is expected to remain in surplus thanks to buoyant revenues offsetting most of the expenditure increases. Overall, a surplus of 2.3% of GDP is expected in 2023.

Revenue increases in Cyprus continued to be strong and broad-based. In January-August 2023, VAT revenue continued its strong performance, up by 20% over the same period last year as it was boosted by inflation and strong nominal wage increases. In 2023, revenue-decreasing energy-related measures that were introduced in response to the energy crisis continued to impact revenue (0.1% of GDP), although this impact is set to be less than half that of the year before. Taxes on income and wealth also grew significantly in January-August 2023 (by 15%) compared to the same period in 2022. This reflected wage increases and sustained employment growth as well as tax buoyancy ([6]), in particular for corporate income tax. The continued growth in revenues from taxes on income and wealth can partly be linked to improved tax collection by the tax administration, including by reducing the backlog of tax declarations. However, the effects of these improvements are expected to dissipate over the forecast horizon.

Expenditure also grew significantly in the first 8 months of 2023 (by 9.3% year-on-year), mainly due to wages and pensions. In contrast with the year before, the public wage bill in Cyprus is projected to increase significantly in 2023, by 11.6%, partly due to automatic indexation. Expenditure by the country's National Health System (NHS) and on pensions led to a sharp increase in social payments in 2023. Energy-related measures that were introduced in response to the energy crisis are expected to continue to impact expenditure (by 0.4% of GDP in 2023). Moreover, on 19 October 2023, the government adopted an additional package of predominantly temporary measures including against high energy prices that will take effect in the last quarter of 2023. The government has also put in place a government-subsidised mortgage-to-rent scheme for vulnerable households offered through KEDIPES ([7]) and a number of other housing policy measures. The total impact of this mortgage-to-rent scheme and other housing-policy measures is estimated at around 0.8% of GDP in 2024 ([8]). Growth in public investment expenditure benefitted from the implementation of the Cyprus' recovery and resilience plan. Interest payments fell in the first 8 months of 2023, as the reduction in public debt more than offset the increase in borrowing costs.

3.2. FISCAL OUTLOOK

The budget balance is expected to remain in surplus over the coming years. According to the Commission's autumn 2023 forecast, the general government surplus in Cyprus is expected to slightly decrease to 2.1% of GDP in 2024 and then increase again to 2.5% in 2025. The main drivers of these fiscal surpluses are the expected phasing out of the measures against high energy prices by spring 2024 and an increase in the rate of social security contributions as of January 2024.

The debt-to-GDP ratio is forecast to continue declining over the coming years. From a peak of 114.9% in 2020, the debt-to-GDP ratio is expected to drop to 71.5% in 2024, on the back of expected growth in nominal GDP and significant primary surpluses, notwithstanding pressures from higher costs of funding for the State (see Section 5 on sovereign financing and the debt sustainability analysis in Annex 2).

The fiscal outlook faces mostly downside risks. A new surge in prices for energy would pose a risk because it may trigger the continuation of recently

([6]) This means that revenues increased faster than the corresponding macroeconomic tax base (i.e., gross operating surplus of enterprises for corporate income tax).

([7]) The scheme transfers assets from the private sector (banks and credit-acquiring companies) to the state-owned asset management company KEDIPES, which in turn offers rent subsidies to the eligible households. For a more detailed description of the scheme, see in Subsection 4.2 text on *The Cyprus Asset Management Company Ltd (KEDIPES)*.

([8]) The fiscal impact estimate of the mortgage-to-rent scheme may turn out lower, depending on the take-up of the scheme.

reintroduced support measures. Uncertainty on the oil price developments is also a downside risk. There are also contingent fiscal risks from the financial sector which are related to the foreclosure framework ([9]). This may affect public finances, as KEDIPES and the Housing Finance Corporation, both of which hold a lot of NPLs, are State-owned companies. Potential positive developments are mainly likely to come from a continuation of stronger-than-expected buoyancy in tax revenues linked to the inflow of foreign direct investment. Further improvements to the fiscal picture may come from the application of a domestic minimum top-up tax (increasing the effective tax rate to 15%) for all Pillar 2 ([10]) companies, mainly large multinational enterprises. A related draft bill was submitted in Parliament by the government, to be applied as from 1 January 2024. It has not yet been adopted.

([9]) On 8 December 2023, the Cypriot Parliament adopted legislation related to the foreclosure framework and the NPL resolution, which could not yet be analysed for the purpose of this report.

([10]) Under an OECD Inclusive framework, more than 140 countries agreed to enact a two-pillar solution to address the challenges arising from the digitalisation of the economy. Pillar 2 introduces a global minimum effective tax rate (ETR) where multinational groups with consolidated revenue over EUR 750 million are subject to a minimum ETR of 15% on income arising in low-tax jurisdictions. Pillar 2 is enshrined legislatively in an EU directive (Council Directive 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union).

4. FINANCIAL SECTOR DEVELOPMENTS

4.1. BANKING SECTOR DEVELOPMENTS

Profitability

The banking sector recorded strong profits in the first half of 2023, driven mainly by an increase in net interest income (NII). During the first half of the year, Cypriot banks reported aggregate profits of EUR 612 million, corresponding to an exceptionally high return on equity of 25% ([11]), compared with EUR 172 million for the whole of 2022. Cypriot banks' NII benefitted from higher policy rates and a slow pass-through of interest rate hikes to deposits. In this respect, the bulk of the income gains originated from the banks' excess liquidity placed with the European Central Bank (ECB), and to a lesser extent from higher interest rates on variable-rate loans. Interest expense rose less than interest income in the first half of 2023 as banks have not significantly raised their deposit rates so far. The improvement in NII was partially offset by the increased interest paid on issued debt securities. Banks' fee and commission income remained solid, at similar levels as for the same period of 2022, which was the highest since the Cypriot banking crisis in 2012-2013. Impairments declined as asset quality improved, while staff and other administrative costs were lower than in previous years due to voluntary exit schemes executed by a few banks the years before and a reduction in the number of branches. The cost-to-income ratio improved significantly to 36% in Q2 2023 from 71% in Q4 2022 mainly thanks to growth in interest income, but also supported by cost savings. Despite the efficiency gains seen in recent years, there is still room for further savings, mainly through digitalisation of operations.

The pass-through of policy-rate hikes was faster to lending rates than to deposit rates. Supported by a large share of variable-rate loans, lending rates charged by Cypriot banks adjusted quickly to the higher rate environment, while a stable deposit base allowed the banks to delay the lifting of deposit rates. Loans linked to Euribor or the ECB's main refinancing rate benefited from the higher interest rates ([12]), albeit with some time lag, while loans linked to banks' base rates adjusted more slowly ([13]). In August 2023, the average interest rate for mortgages was 4.20%, up from 2.56% a year earlier. For loans to non-financial corporations (NFCs) of up to EUR 1 million the average interest rate was 5.56% in August 2023, rising from 3.85% a year earlier. The increase was even more pronounced for larger loans, where the interest rate increased to 6.10% in August 2023 from 3.11% a year earlier. On the deposits side, the interest rate for household term deposits with a maturity of up to 1 year was 0.88%, rising from 0.06% a year earlier. The corresponding rate for NFCs' deposits was 1.78% compared with 0.13% a year before ([14]). While the pass-through of higher interest rates to deposits is expected to accelerate, it will likely remain much lower than the levels of pass-through on credit facilities because banks have little incentive to attract additional deposits while liquidity is abundant. As a result, Cypriot banks enjoy wider interest margins than the rest of the euro area.

The recent upgrade of Cyprus' sovereign debt to investment grade by all main credit-rating agencies was followed by Moody's upgrade of the ratings of the two largest banks to investment grade. In October 2023, Bank of Cyprus and Hellenic Bank saw their long-term deposits rating upgraded to Baa3 from Ba1 and their Baseline Credit Assessments (BCA) and Adjusted BCAs upgraded to ba2 from ba3. The improved credit ratings, coupled with strong profitability and improved asset quality should enable the banks to secure funding at lower cost on the capital markets. Bank of Cyprus paid dividends for the first time since 2011, which should also result in improved market access.

([11]) Annualised

([12]) On average, the Euribor pass-through share to new loans to NFCs over the last 12 months was 86% and for new household loans it was 58%.

([13]) Approximately 21% of NFCs' loans and 49% of households' loans are linked to banks' underlying base rates, which uses a methodology that considers the cost of deposits and thus the pass through is lower.

([14]) On average, the Euribor pass-through share to new deposits by NFCs, over the last 12 months was 44% and for new households' deposits was 22%.

Solvency

Cyprus' credit institutions maintain a robust capital position, comfortably exceeding minimum requirements. In June 2023, the CET1 ratio in the banking sector increased to 18.9% from 17.8% in December 2022, driven by improved profitability that bolstered retained earnings, with only a slight uptick in risk-weighted assets. The total-own-funds ratio reached 23.3% in June 2023 (as compared with 21.3% in December 2022) which is a record high. Critically, this total-own-funds ratio is comprised of high-quality capital. The sector's capital buffer surpasses Pillar-2 guidance (P2G) by 6.2 pp. Total banking sector assets amount to EUR 64 billion, a similar level to December 2022 and with no significant change in the distribution of assets across the asset classes since then. The aggregate leverage ratio rose to 7.1% in June 2023 (from 6.8% in December 2022), well above the minimum requirement of 3% and the EU average of 5.6%. The largest banks, Bank of Cyprus and Hellenic Bank reported a CET1 ratio of 15.6% and 20.8%, respectively (up from 15.2% and 18.3%, respectively, at the end of 2022). Both banks are in compliance with their 2025 final minimum requirement for own funds and eligible liabilities (MREL) target, following successful issuances of MREL-eligible securities in 2023.

Deposits and liquidity

Cypriot banks benefit from a strong and stable deposit base, helping them to exceed their liquidity requirements by a wide margin. Despite the slow pass-through of interest rate hikes to savers, deposits from households (EUR 31.4 billion) and NFCs (EUR 12.2 billion) in June 2023 remained largely unchanged from their levels in December 2022. Total deposits grew modestly by 0.27% to EUR 52.3 billion in the 6 months to June 2023 providing a stable and abundant base of liquidity. In June 2023, the liquidity coverage ratio of the banking sector was 327%, comfortably surpassing the minimum requirement and nearly double the euro-area average, while the net stable funding ratio remained high at 187% (these ratios stood at 310% and 178% respectively in December 2022). This substantial liquidity cushion amidst subdued lending activity results in a rather modest loan-to-deposit ratio of below 50% as of June 2023. This low ratio explains the gradual adjustment of deposit rates, while the predominance of domestic over foreign deposits explains why deposits are stable. In particular, liquidity ratios are set to remain at comfortable levels even after the repayment of the targeted longer-term refinancing operations.

Assets quality and challenges

Cypriot banks made further progress in reducing their legacy NPLs, but at a slower pace than in previous years. The stock of NPLs fell from EUR 2.3 billion (9.4% NPL ratio) at the end of 2022 to EUR 2.1 billion in June 2023, representing an NPL ratio of 8.7% ([15]). In the absence of NPL sales since January 2022, the reduction was mainly driven by organic actions such as loan repayments, cures (NPLs turning performing) and write-offs. Household NPLs amounted to EUR 1.2 billion in June 2023 (11.2% of all loans to households, down from 12.1% in December 2022), whereas the NFC segment saw NPLs of EUR 0.9 billion (7.3% of all loans to NFCs, down from 7.9% in December 2022). The modest resolution of legacy NPLs can be attributed to the lack of progress achieved by the less-significant institutions (LSIs), the NPL ratios of which persistently exceed those of systemic banks. LSIs' smaller portfolios and limited loss-absorption capacity pose challenges for portfolio sales. To keep the aggregate NPL ratio on a decreasing path, LSIs must also make significant progress. In the meantime, the Central Bank of Cyprus (CBC) is exploring potential initiatives, such as a securitisation scheme, to reduce further the stock of NPLs in the banking system.

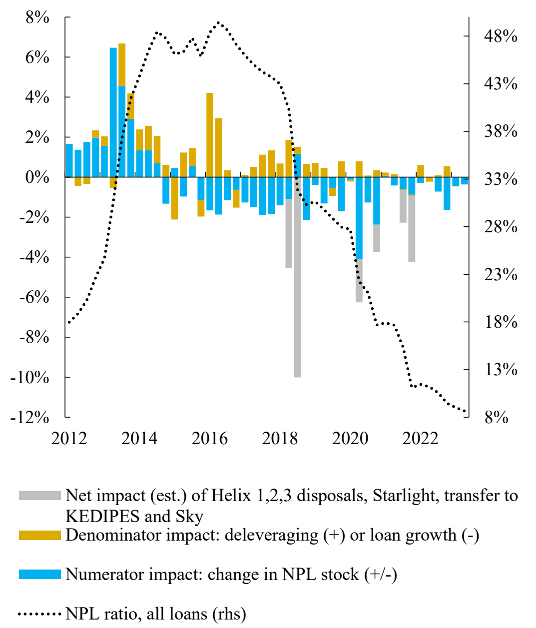
The NPL coverage ratio has increased and now exceeds the EU average. Loans to households had a coverage ratio of 37% in June 2023, while loans to NFCs had a coverage ratio of 66%. On aggregate, the NPL coverage ratio of the banking sector increased by 2.7 pp since last December to

([15]) The NPL ratios referred to in this report are based on the CBC's data and concern local operations. In particular, the NPL ratio is here calculated as the amount of NPLs as a proportion of the total amount of loans and advances, excluding loans and advances to central banks and credit institutions. This ratio differs from the NPL ratio referred to in the 2023 Cyprus Country Report, which uses ECB's data that incude, in the denominator, loans and advances to central banks and credit institutions. Using ECB's data, the NPL ratio in June 2023 was 4.3%.

50.4% in June 2023, and is now above the EU average of 44%. This translates to EUR 1.06 billion of provisions for impairments. The level of non-provided NPLs in Cyprus is at the lowest level ever observed.

The share of Stage 2 loans has remained relatively stable, although recently migration rates from Stage 1 to Stage 2 seem to have slightly increased. The staging of loans [16] provides some insights into how the banking sector perceives the forward-looking riskiness of the loan book. In June 2023, loans of EUR 2.7 billion are classified as Stage 2, representing 11% of all loans and advances, compared with EUR 2.9 billion or 12% of all loans in December 2022. The share of Stage 2 loans is higher for the NFC sector than for households. It stands at 14% of all loans to NFCs in June 2023 (compared with 17% in December 2022), whereas 8% of household loans are classified as Stage 2 (at similar level as in December 2022). Coverage of Stage 2 exposures increased to 2.7% from 2.3% in December 2022, but remains below the EU average (3.8%). Cyprus remains one of the EU countries with the highest proportion of Stage 2 and Stage 3 exposures, together comprising 18% of the loan portfolio of its banks [17]. However, current levels of Stage 2 and Stage 3 exposures are well below the pandemic peak of EUR 4.6 billion in December 2020. While the Stage 2 ratio was still declining by June 2023, in the second quarter of the year a small increase in the migration rates from Stage 1 to Stage 2 was observed, which could point to some distress in the future. The riskier sectors are transport, professional services and construction, where NPL ratios stood at 18%, 16% and 10% respectively in June 2023.

Graph 4.1: **NPL ratio and breakdown of changes**



Source: Central Bank of Cyprus

The Cypriot banking sector weathered the pandemic and the energy crisis well and has not seen a significant deterioration in asset quality, although challenges have emerged. Notwithstanding the cost-of-living scheme that is in place in Cyprus and partially compensates the loss of purchasing power, inflation remains above its long-term average and erodes households' disposable income. Corporates are also facing increasing operating costs and declining turnover. By facing, in addition, higher debt-servicing costs due to the higher interest rates, the default risk of borrowers is also increasing. Rising interest rates are therefore a 'double-edged sword' for the banks. On the one hand they boost profit, but on the other hand, they create debt-servicing challenges for households and corporates and thus pose risks for banks' asset quality. Banks remain vigilant and have early warning systems in place to detect credit deterioration to avoid new NPL inflows. The rising interest rates in 2023 have prompted a wave of requests for renegotiation of variable-rate loans across all the client base of most Cypriot credit institutions and renegotiations as a share of total loan books are larger in Cyprus than in other euro area countries. While these renegotiations appear to be linked to competition forces and borrowers' attempt to obtain better contract conditions, they need to be closely monitored as some of them may

(16) 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'.

(17) This number excludes 2% of loans which are recorded as POCI (purchased or credit-impaired at origination) and are reported outside the staging system.

be a sign of impending financial difficulties for the clients.

The overall operating environment remains challenging for Cypriot banks. The levels of household and corporate indebtedness imply restricted lending prospects in the future. Internal competition is fierce, so there are fewer opportunities to expand lending except by increasing market share. Therefore, banks will need to continue to seek alternative investments to generate profit once the margins from higher interest rates contract.

Lending

Buoyant new lending in Cyprus in the first six months of 2023 is expected to slow down amid higher borrowing costs. New lending ([18]) excluding renegotiations, for the first 6 months of 2023 reached EUR 1.73 billion (approximately half of the total new lending for all of 2022), which is significant considering the prevailing higher interest rates. Of this new lending, EUR 1.1 billion were in new loans to NFCs and the remaining were new loans to households. The wholesale and retail trade sectors borrowed most in the first 6 months of 2023, followed by construction and real estate. Many households have been deterred by higher interest rates and have reduced their demand for loans while several NFCs requested additional credit lines to cover working capital needs. Current economic headwinds, higher borrowing costs and overall high levels of private indebtedness are likely to constrain the expansion of credit this year.

Macroprudential oversight and systemic risks

The macro-financial environment remains stable but high indebtedness continues to burden the Cypriot private sector. The non-financial private sector remains highly indebted with a debt-to-GDP ratio of 163% in March 2023, down from 187% at the end of 2021. The burden of debt service has been increasing recently, both for households and companies given the high share of variable-rate loans. Rising living costs and increased interest rates make it more difficult for households and companies to meet their debt-servicing obligations. On the positive side, the private sector in particular increased its savings during the pandemic and built up a financial cushion. The most indebted economic sectors in Cyprus are (i) construction and real estate; (ii) wholesale and retail trade; and (iii) hospitality. In this context it is worth noting that past transfers of NPLs out of the banking system and onto the balance sheets of the CACs still burden the economy through private indebtedness.

Cypriot banks are heavily exposed to the property sector, where risks are still contained by modest -but increasing- valuations. In Cyprus, 87% of all household loans and 68% of all NFC loans are collateralised by real estate. As in other countries, the commercial real estate (CRE) sector has come into focus for both structural reasons (such as the trends for working from home and online shopping) and cyclical developments, in particular supply shortages and higher construction costs. In June 2023, Cypriot banks had CRE exposures amounting to 143% ([19]) of their Tier1 capital. In the EU, this level of exposure is only exceeded by Estonia. These risks are mitigated by several factors. Firstly, the property market, including for commercial property, does not seem to be overvalued in Cyprus ([20]). Commercial property prices have been increasing even in the most recent months as overseas companies continued to demand office space in Cyprus. Secondly, the loan-to-value (LTV) ratios of outstanding loans for CRE have been conservative at 57%. Moreover, a large share of CRE exposures is to the hotel sector, which has been enjoying a post-pandemic boom. The risk also appears to be limited in the residential property market. The residential property market has seen more transactions in 2022 and 2023 compared with the years of the pandemic, buoyed by demand from foreign buyers. Underwriting standards have tightened, with LTV ratios for new loans hovering between 39% and 49% since end-2021 and LTVs of outstanding loans at 48.5%. The debt-service-to-income ratio was 27.6% ([21]) in December 2022, down from 31.5% a year earlier.

([18]) New Lending data are based on the Monetary Financial Statistics (MFS - Regulation (EU) No 1072/2013) the scope of which are Euro denominated loans.

([19]) EBA Risk Dashboard

([20]) ESRB risk dashboard, September 2023 (Issue 45)

([21]) The definitions are based on the ESRB's recommendation on closing real estate data gaps.

Table 4.1: **Soundness indicators for the banking sector in Cyprus**

	2016	2017	2018	2019	2020	2021	2022				2023					
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
NPLs*, all loans (EUR billions)	23,8	20,6	10,3	9,0	5,1	3,0	2,9	2,9	2,7	2,3	2,3	2,3	2,2	2,2	2,2	2,1
NPLs*, all loans (% of total)	47,2	43,7	30,3	27,9	17,7	11,0	11,4	11,2	10,6	9,5	9,5	9,3	9,0	9,0	9,0	8,7
NPLs*, loans to NFCs (% of total)	56,4	50,3	33,2	24,5	14,5	8,1	9,1	8,7	8,0	8,0	8,1	7,8	7,6	7,7	7,7	7,3
Restructured non-performing (% of total)	25,8	22,8	14,4	10,8	6,4	4,0	4,3	4,2	3,9	3,9	3,9	3,9	4,0	4,0	4,0	3,9
Restructured performing (% of total)	9,4	8,6	6,8	4,5	3,1	10,7	11,9	11,4	11,3	11,4	11,4	11,1	9,5	9,1	8,4	6,5
NPLs*, loans to households (% of total)	56,0	53,9	37,6	35,2	23,7	14,7	14,0	13,4	12,7	12,1	12,1	11,9	11,7	11,6	11,5	11,2
Restructured non-performing (% of total)	20,1	19,7	17,1	15,7	10,4	6,2	5,9	5,6	5,2	4,7	4,6	4,6	4,5	4,4	4,3	4,2
Restructured performing (% of total)	7,7	8,3	7,1	4,8	4,6	3,7	3,3	3,0	2,9	2,9	2,8	2,7	2,6	2,5	2,5	2,5
Coverage rate (Impairments / NPLs)*	40,3	45,9	49,6	55,2	46,2	42,7	45,7	46,2	47,0	47,5	47,2	48,4	48,8	49,4	50,0	50,4
Cost-to-income ratio	52,6	53,6	62,5	72,3	63,7	71,9	75,7	71,7	82,7	68,7	..		37,0	..	..	36,0
Lending margin on new loans	2,0	1,9	2,6	2,8	2,8	2,7	2,7	2,7	3,4	3,2	4,2	3,8	4,7	4,7	4,7	3,8
Common Equity Tier 1 ratio	15,9	14,9	15,1	17,4	17,6	17,6	17,2	17,5	18,0	17,7	..	..	17,3	..	..	18,9
Return on equity (annualised)	1,7	-11,2	6,1	3,5	-3,9	0,4	5,9	0,2	4,4	5,2	..	..	25,0	..	..	25,1

(1) The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis. Figures exclude exposures to central banks and credit institutions.
Source: Central Bank of Cyprus, ECB

The stock of immovable property held by banks and CACs remains substantial. A general improvement in the real estate market since 2020 has helped banks to continue with their disposals of real estate assets, while supervisors are urging them to dispose of their properties. The stock of immovable property held by banks declined slightly to EUR 1.3 billion (corresponding to 4 984 properties) in June 2023, but the average period held increased to 5.3 years from 4.7 a year earlier. In the first half of 2023 banks sold 615 properties (mainly residential property and farmland), compared with 725 properties sold in the same period of the previous year.

The CBC is one of the five central banks in the euro area that target a positive value for the countercyclical capital buffer (CCyB) in a neutral risk environment. The CBC has specified that during a standard or neutral risk environment, when cyclical financial systemic risks are neither particularly elevated not subdued, the CCyB should be set at a minimum of 0.5%. The CBC announced last year that the CCyB would be raised from 0% to 0.5% with effect as from 30 November 2023 and recently announced a further increase to 1.0% with effect as from 2 June 2024.

4.2. OTHER FINANCIAL SECTOR ISSUES

Foreclosure developments

The effectiveness of the foreclosure framework has been hampered by repeated suspensions and continued political deliberations. Efforts to resolve NPLs through consensual recovery options, such as cash collections, loan restructurings and debt-for-assets swaps have faltered with non-cooperative borrowers and strategic defaulters. Initiatives to aid vulnerable borrowers (such as the ESTIA and OIKIA schemes) did not achieve the anticipated take-up. The ongoing discussion in the Cypriot Parliament about diluting the foreclosure framework is undermining the efforts of banks and CACs to agree consensual solutions with non-cooperative borrowers and strategic defaulters. Foreclosures were intermittently suspended several times during the pandemic, between March 2020 and January 2023 ([22]). These suspensions were either legislatively imposed or voluntarily applied by banks and CACs. Foreclosures resumed in February 2023. However, the debate resurfaced again in March, when the Parliament voted narrowly against renewing the suspension. In July 2023, two bills directly impacting the foreclosure

([22]) The perimeter of the last legislative suspension concerned primary residences with a value of up to EUR 350 000; agricultural land with a value of up to EUR 100 000; and professional premises of business with annual turnover of less than EUR 750 000.

process were tabled for discussion in Parliament, one of which was adopted [23]. The adopted legislation will improve transparency but it is likely to result in a more cumbersome, costlier, and lengthier process. Meanwhile, the government announced a package of measures to improve the framework for NPL resolution without impeding the existing foreclosures framework. This includes the mortgage-to-rent scheme and amending proposals to the Courts law to allow special jurisdiction within District Courts to adjudicate on NPL-related matters. In the meantime, credit institutions and CACs announced in July that they would voluntarily suspend foreclosures of residential properties valued at up to EUR 350 000 until the end of October 2023, in order to facilitate the legislative process.

Any attempts to dilute the functionality of the foreclosures framework jeopardises efforts to reduce NPLs and sends a negative signal on the robustness of the Cypriot banking sector. Amendments to the existing framework resulting in its de facto suspension would effectively render the framework ineffective and would reverse previous progress on this front. A diluted framework both (i) deprives the lenders of much-needed leverage over uncooperative borrowers and strategic defaulters; and (ii) eliminates the option of legal recourse for debt recovery. Consequently, the borrowers have little incentive to agree to any consensual solution. A potent foreclosure framework is pivotal to ensure legal certainty, uphold payment discipline, encourage borrowers to participate in loan restructuring and reduce moral hazard. In addition, the foreclosure tool iskey to the viability and implementation of the recently approved mortgage-to-rent scheme, which aims to protect the primary homes of vulnerable households.

The Cyprus Asset Management Company Ltd (KEDIPES)

Overall, the performance of KEDIPES was satisfactory in the first half of 2023 despite headwinds. Since its inception in 2018, KEDIPES has made cash repayments of EUR 1.08 billion of state aid, of which EUR 200 million were paid in the first half of 2023. During the first 6 months of 2023, cash inflows amounted to EUR 217 million (a 6% decrease compared with the same period of 2022, attributed partly to the impact of the continuous suspensions of foreclosures). On cash inflows, the current performance of KEDIPES exceeds that forecast in its business plan by EUR 266 million [24]. In the meantime, in March 2023, KEDIPES signed a collective labour agreement for 2019-2023 that reaffirms the restoration of pay cuts from mid-2020.

KEDIPES is close to achieving an important milestone by disposing of a performing loan portfolio. The perimeter of the sale of project Ledra [25] has been agreed with the bidder. Albeit reduced compared with the initially announced perimeter, the completion of the transaction will mark a milestone for KEDIPES, as it signals its commitment for future sales.

KEDIPES offers an interest-rate subsidy for 2023 on restructured variable-rate performing loans which are linked to ECB and Euribor rates. Under this initiative, announced in March, interest rates have been capped at 3.5% for loans collateralised by residential real estate and at 4% for other loans. The initiative helped EUR 79 million of loans that were in arrears at the start of 2023 to turn performing by 30 June. Some further restructuring products have been announced premised on the introduction of a fixed interest rate to provide certainty on future payments and thus foster the long-term viability of restructurings.

The planned mortgage-to-rent scheme offers eligible vulnerable borrowers in default a rent subsidy and a property buy-back option. Following the European Commission's approval of the amendments to the 2018 Commission Decision on liquidation aid to Cyprus Cooperative Bank, the mortgage-to-rent scheme was approved by the Cypriot Council of Minister on 12 July 2023 and

(23) The adopted legislation provides that the warning letter sent by lenders to borrowers prior to the initiation of the foreclosure process must include additional standardised information of which, in certain cases, the amount due would need to be attested by an auditor.

(24) KEDIPES's business plan targets the full repayment of the state aid granted (including properties to be transferred to the state).

(25) The sale of a performing loan portfolio amounting to around EUR 465 million (project Ledra) by KEDIPES was originally envisaged in H1 2022. The autumn 2022 Post-Programme Surveillance Report for Cyprus provides more details.

will be implemented by KEDIPES. It targets NPLs collateralised by a primary residence with a market value of up to EUR 250 000 and for participation there are eligibility criteria ([26]). The government estimates that up to 2 500 homeowners (of which 1 250 within KEDIPES) could benefit from the scheme, with a baseline expectation for 800 homes (of which half within KEDIPES). KEDIPES has already set aside a cash reserve of EUR 60 million to fund the acquisition of the properties from the participating institutions. The Cypriot authorities expect that the scheme will decrease banks' NPLs and have only a small adverse fiscal impact of less than EUR 200 million (approximately 0.6% of GDP).

An effective foreclosure framework is seen as a necessary condition for the mortgage-to-rent scheme to be successful. A key parameter for the success of the scheme is the number of eligible borrowers that will opt to participate and are ready to voluntarily relinquish ownership of their property. This will only happen if the right incentive structure is in place for which an effective foreclosure framework is a key element.

([26]) Eligible borrowers shall be individuals that receive certain social and welfare benefits or had been rejected under ESTIA and OIKIA schemes, as non-viable borrowers. According to the MTR scheme, the borrower hands the property to their mortgage lender, and KEDIPES buys the property from the lender, paying 65% of the market value. The borrower shall be able to continue living in the property for 14 years while the state shall cover the rent payments which are to be set at 65% of the going market rate. Following 5 years of rental residence and up to the 14th year, the borrower has the option to buy back the property at a discounted price.

5. SOVEREIGN FINANCING AND ABILITY TO REPAY

The general government debt-to-GDP ratio continued decreasing in the first 8 months of 2023 and is projected to continue on a steep downward trajectory over the coming years. The general government debt-to-GDP ratio declined by about 30 percentage points over the past 2 years to 85.6% at the end of 2022 ([27]) and is projected to decline further to 71.5% by 2024. The decline was driven by strong nominal growth, primary surpluses and the use of cash reserves which were accumulated at the beginning of the COVID-19 crisis. The debt ratio is projected to continue decreasing beyond 2025 (see the Commission's debt sustainability analysis (DSA) annex).

Gross financing needs for 2023-2025 are low, reflecting low redemptions and significant fiscal surpluses. Excluding Treasury bills (T-bills), gross financing needs (GFN) for 2023 are estimated at around EUR 0.9 billion or 2.9% of GDP. A share of the gross financing needs concerns the recent buy back of a EUR 300 million domestic bond, maturing in 2024, leading to a further reduction of the debt ratio by 1% and a small reduction of EUR 3 million in the interest paid. For 2024 and 2025, GFN are estimated at about EUR 1.1 bn or some 3.3% of GDP and EUR 0.9 bn or some 2.0% of GDP, respectively.

Cyprus' cash buffer remains large and hence risks to state financing are low in the short term. The current cash buffer remains significant and the authorities intend to maintain it at levels that cover the country's financing needs for the following 9-12 months. Cyprus also benefits from the disbursements of RRF grants and loans. Disbursements of grants (including pre-financing) to Cyprus under the RRF have amounted to EUR 216 million, and disbursements of loans (consisting of pre-financing) under the RRF have amounted to EUR 26 million, by the cut-off date of this report.

The maturity profile of public debt for the coming years is balanced. Debt redemptions range between EUR 1.7 bn and EUR 2.1 bn over 2023-2025. The average annual debt redemption in 2026-2030 is about EUR 2.2 billion, with 2028 showing the highest public debt repayments at about EUR 2.8 bn. As of August 2023, the average remaining maturity of debt was at 7.5 years. In August 2023, the share of debt maturing within 1 year decreased to 5.9% (from 6.7% in August 2022), while the share of debt falling due within 5 years decreased to 40.1% (from 45.6% in August 2022). These indicators compare very well with euro area averages. On the distribution of the debt, 70% of the debt has fixed interest rates and the remaining 30% has a floating rate, which is well above the euro area average where only 9.6% of public debt is floating rate on average. However, 90% of floating rate debt consists of ESM loans, which bear a relatively low interest rate ([28]). Cyprus' debt is issued in euro and thus there is no foreign currency risk.

The cost of debt has been declining in recent years, as the increases in borrowing costs were offset by a decreasing debt level. Cyprus' borrowing costs on the primary markets have increased, but the impact of these higher costs on the weighted average cost of debt has been limited, increasing from 1.8% in 2022 to 2% in July 2023. Interest payments as a share of government revenue declined from 9.2% in 2012 to 3.6% in 2022, and as a percentage of GDP they declined from 3.3% in 2012 to 1.5% in 2022. In 2023, it is yet projected to decline to 1.4% of GDP. The main underlying drivers are the low-cost of the new issuances replacing existing debt that carried higher interest rates (reflecting the improvements of the sovereign credit ratings, see below), decreasing debt level and the denominator effect (higher government revenues and GDP).

The cost of refinancing has increased. Since February 2022, the yields on Cyprus' bonds have been increasing, in line with those of its EU peers against the background of a volatile global geopolitical situation, increasing inflation, tightening of monetary policy. At the end of October 2023, the yield of the 10-year bond issued in April 2023 stood at around 4.1% and the 10-year spread on the German Bund was 1.3%, on a slightly decreasing trend since the previous month. Yields on Cypriot T-bills also increased after an extended period of negative interest rates. They

([27]) During the COVID-19 pandemic, the debt-to-GDP ratio increased by 23.0 percentage points from 90.8% in 2019 to 113.8% at the end of 2020.

([28]) The ESM interest payments on the floating-rate debt rely on a blended interest rate, calculated based on the funding and operational costs of the ESM.

turned positive in June 2022 and have continued to increase, reaching 4.05% at the T-bill auction in October 2023 (reflecting changes in the ECB's monetary policy).

Cyprus has benefited from improving assessments by credit-rating agencies. The main credit-rating agencies rate Cyprus' sovereign debt at investment grade. On 29 September 2023, Moody's upgraded the credit rating for Cyprus by two notches, to Baa2 from Ba1, with the country now rated as investment grade by all major agencies after 11 years spent without investment-grade status. This upgrade was driven by the broad-based, continuous improvements in its credit profile due to ongoing economic, fiscal and banking reforms. At the same time, DBRS upgraded Cyprus' rating by one notch in September. The S&P and Fitch credit ratings for Cyprus stand at BBB. Hence, Moody's credit rating upgrade has brought Cyprus to investment-grade level according to all major credit rating agencies. All the major credit-rating agencies rank Cyprus two notches up from the highest non-investment grade, with the exception of the DBRS agency which rates the country only a notch higher (BBB high). The credit outlook is stable according to Fitch, DBRS and Moody's, while S&P has a positive outlook.

Cyprus will repay its debt to the ESM in 2025-2031. The country's total outstanding debt to the ESM is EUR 6.3 bn, or about 21% of GDP. ESM debt constitutes about 27% of the country's total public debt and about 90% of its floating-rate debt. Cyprus will start repaying its loan to the ESM in 2025, with the first repayment amounting to EUR 0.35 bn. In the following years, repayments will reach EUR 0.9-1.05 bn for each year (on average EUR 0.99 bn per year). Repayment is planned to be completed in 2031.

Cyprus retains the capacity to service its debt. According to the DSA, Cyprus faces low fiscal sustainability risks in the short term and in the long term, while in the medium term, risks appear to be medium. Cyprus is facing increased funding costs when tapping the markets and is also facing an interest-rate risk because a high share (about 30%) of its public debt is subject to a variable interest rate. There are risk-mitigating factors, however. The floating-rate debt is expected to be maintained at similar levels in the coming years but to start declining from 2025 due to the repayment of the variable-rate ESM loans. As a result, within the following five years, it is expected that the share of floating-rate debt will fall to the euro area average (9% of outstanding debt). Cyprus also has a large cash buffer and is projected to have increasing primary surpluses in 2023-2025.

ANNEX 1
Main macroeconomic indicators

Table A1.1:

	2019	2020	2021	2022	2023	2024	2025
Real economy			*(percent change)*				
Real GDP	5,5	-3,4	9,9	5,1	2,2	2,6	2,9
Domestic demand incl. inventories	6,1	-2,8	5,0	8,9	4,3	2,3	2,3
Private consumption expenditure	3,9	-6,8	5,6	8,5	4,1	2,0	2,2
Government consumption expenditure	12,4	10,6	7,9	2,7	5,7	3,0	1,7
Gross fixed capital formation	6,9	4,7	-0,1	7,8	4,1	2,7	3,5
Exports of goods and services	8,7	2,2	21,6	13,6	-0,8	3,0	3,6
Imports of goods and services	9,5	3,1	15,4	18,3	1,5	2,6	2,9
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	5,6	-1,7	4,9	6,9	4,3	2,3	2,3
Foreign trade	-0,5	-0,7	4,9	-3,4	-2,1	0,3	0,6
Changes in inventories	0,4	-1,0	0,2	1,6	0,0	0,0	0,0
Inflation			*(percent change)*				
GDP deflator	1,3	-1,4	2,7	6,1	5,8	3,3	2,8
HICP	0,5	-1,1	2,3	8,1	4,1	3,0	2,2
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	7,1	7,6	7,5	6,8	6,4	6,1	5,9
Employment	3,8	-1,2	3,2	3,0	1,8	1,6	1,6
Compensation per employee	4,4	-0,5	4,3	1,1	5,0	4,0	2,6
Labour productivity	1,7	-2,2	6,5	2,0	0,5	1,0	1,3
Unit labour costs	2,7	1,8	-2,1	-0,9	4,5	3,0	1,3
Public finance			*(percent of GDP)*				
General government balance	0,9	-5,7	-1,9	2,4	2,3	2,1	2,5
Total revenue	39,4	38,5	40,0	41,2	42,4	43,3	43,0
Total expenditure	38,5	44,2	41,9	38,8	40,1	41,2	40,6
General government primary balance	3,1	-3,6	-0,1	3,9	3,7	3,5	3,9
Gross debt	93,0	114,9	99,3	85,6	78,4	71,5	66,3
Balance of payments			*(percent of GDP)*				
Current external balance	-5,5	-10,0	-6,1	-7,9	-9,6	-8,8	-7,5
Ext. bal. of goods and services	1,0	-1,4	4,0	0,3	-0,5	-0,2	0,4
Exports goods and services	76,5	80,7	89,4	95,0	88,4	88,0	88,2
Imports goods and services	75,5	82,0	85,5	94,7	88,9	88,2	87,8
Memorandum item			*(EUR bn)*				
Nominal GDP	23,2	22,1	24,9	27,8	30,0	31,9	33,7

Source: European Commission, European Economic Forecast Autumn 2023

ANNEX 2
Debt Sustainability Analysis

This annex assesses fiscal sustainability risks for Cyprus over the short, medium and long term. It follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast and including a technical change to anchor the fiscal variables to the structural primary balance of the first forecast year (t+1) as opposed to the second forecast year (t+2) in previous publications. This change aims to ensure a higher degree of stability and consistency with the ongoing work on the revision of the economic governance framework. This means that the debt and budget balance projections for t+2 (in this case 2025) can differ from the Commission 2023 autumn forecast. A more detailed description and explanation of this update will be published in the forthcoming Debt Sustainability Monitor 2023.

1 – Short-term risks to fiscal sustainability are low. The Commission's early-detection indicator (S0) does not point to major short-term fiscal risks (Table A2.2) ([29]). Government gross financing needs are expected to decrease to around 4% of GDP on average over 2023-2024 (Table A3.1, Table 1) ([30]). Financial markets' perceptions of Cyprus are favourable as its debt rating continued to be upgraded in 2023. The main four credit-rating agencies now rate Cyprus' sovereign debt at investment grade (two notches within the investment-grade area).

2 – Medium-term fiscal sustainability risks are medium.

The DSA baseline shows that the government debt ratio is expected to decline substantially to reach 28% of GDP in 2034 (Graph 1, Table 1) ([31]). The debt reduction is supported by the assumed sizeable structural primary surplus of 3.4% of GDP as of 2024. This appears ambitious compared with past performance, suggesting limited space for additional consolidation ([32]). The debt decline also benefits 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).

The baseline projections are stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions relative to the baseline (Graph 1). Under the *historical structural primary balance (SPB) scenario* (i.e. the SPB returns to its historical 15-year average of 1.4% of GDP) the debt ratio would be about 15 pps. of GDP higher than under the baseline in 2034. Under the *adverse interest-growth rate differential scenario* (i.e. the *interest-growth rate* deteriorates by 1 pp. compared with the baseline), the debt ratio would be higher than under the baseline by 3.5 pps. of GDP in 2034. Under the *financial stress scenario* (i.e. interest rates temporarily increase by 1 pp. compared with the baseline) government debt ratio would be almost unchanged compared with the baseline. Finally, under the *lower structural primary balance scenario* (i.e. the projected cumulative improvement in the SPB over 2023-2024 is halved) the debt ratio would be higher than under the baseline by about 4 pps. in 2034.

The stochastic projections indicate medium risk, pointing to the moderate sensitivity of these projections to plausible unforeseen events ([33]). These stochastic simulations indicate

([29]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of fiscal and financial-competitiveness indicators that have proven to be a good predictor of emerging fiscal stress in the past.

([30]) Gross financing needs are determined in line with the methodology described in the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast.

([31]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline include in particular: (i) a structural primary surplus, before ageing costs, of 3.4% of GDP from 2024 onwards; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 autumn forecast until 2025, followed by the EPC/OGWG 'T+10 methodology projections between T+3 and T+10 (average of 1.7%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor.

([32]) This assessment is based on the consolidation space indicator, which measures the frequency with which a tighter fiscal position than assumed in a given scenario has been observed in the past. Technically, this consists of looking at the percentile rank of the projected SPB within the distribution of SPBs observed in the past in the country, taking into account all available data from 1980 to 2022.

([33]) The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's budgetary position, economic growth, interest rates and a 4% probability that the debt ratio will be higher in 2028 than in 2023, implying limited risks. At the same time, the uncertainty surrounding the baseline debt projections is high: the difference between the 10th and 90th debt distribution percentiles points to an 80% probability that the debt ratio will lie in a large range of 36 pps. of GDP in five years' time (Graph 2).

3 – Long-term fiscal sustainability risks appear overall low. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and bring to 60% of GDP (S1 indicator) over the long-term ([34]). This assessment is driven by the very favourable initial budgetary position, only slightly mitigated by the projected increase in ageing costs. These results are conditional on the country maintaining a high structural primary surplus over the long term.

The S2 indicator points to low fiscal sustainability risks. The indicator shows that, relative to the baseline, the SPB would not need to improve to ensure debt stabilisation over the long term. This result is underpinned by a very favourable initial budgetary position (contribution of -3 pps. of GDP), which more than offsets the projected increase in ageing-related costs (contribution of 1 pp. of GDP). Ageing costs are primarily driven by the projected increase of public pension expenditure (+0.9 pp. of GDP) (Table A3.1, Table 2).

The S1 indicator also points to low fiscal sustainability risks. The S1 indicator signals that no consolidation effort is needed to bring debt to 60% of GDP by 2070. This result is driven by the very favourable initial budgetary position (contribution of -3.6 pps. of GDP), which is only partly offset by ageing costs (0.5 pp. of GDP) and the debt requirement (0.2 pp. of GDP) (Table A3.1, Table 2).

4 – Finally, several additional risk factors need to be considered in the assessment. Risk factors are related to the recent increase in interest rates, Cyprus' negative net international investment position, elevated yields and risks to the budget balance due to potential continuation of recent fiscal support measures. On the other hand, risk-mitigating factors include the lengthening of debt maturities in recent years, relatively stable financing sources, (with a diversified investor base), the currency denomination of debt, and the low share of short-term public debt. In addition, the structural reforms under the NGEU/RRF, if fully implemented, could have a further positive impact on GDP growth in the coming years, and therefore help to mitigate debt sustainability risks.

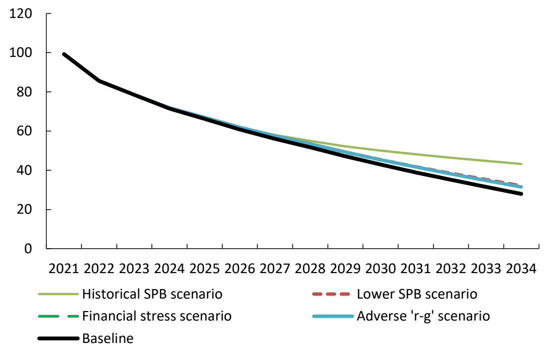
exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

([34]) The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2024 that would be required to stabilise public debt in the long term. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2024 to bring the debt ratio to 60% by 2070. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 % of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

Table A2.1: **Debt sustainability analysis - Cyprus**

Table 1. Baseline debt projections	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Gross debt ratio (% of GDP)	**99,3**	**85,6**	**78,4**	**71,5**	**66,2**	**60,8**	**56,0**	**51,7**	**47,2**	**42,9**	**38,9**	**35,2**	**31,6**	**28,0**
Changes in the ratio	-15,7	-13,7	-7,1	-7,0	-5,3	-5,4	-4,8	-4,3	-4,5	-4,2	-4,0	-3,8	-3,6	-3,6
of which														
Primary deficit	0,1	-3,9	-3,7	-3,5	-3,9	-3,7	-3,5	-3,3	-3,6	-3,4	-3,3	-3,2	-3,1	-3,0
Snowball effect	-11,4	-8,7	-5,1	-3,1	-2,6	-1,7	-1,3	-1,0	-1,0	-0,8	-0,7	-0,6	-0,5	-0,5
Stock-flow adjustments	-4,4	-1,1	1,7	-0,4	1,2	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Gross financing needs (% of GDP)	6,1	4,6	4,9	2,7	4,6	4,7	4,3	4,4	3,6	2,7	2,6	-0,1	-0,4	-0,6

Graph 1. Deterministic debt projections



Graph 2. Stochastic debt projections 2024-2028

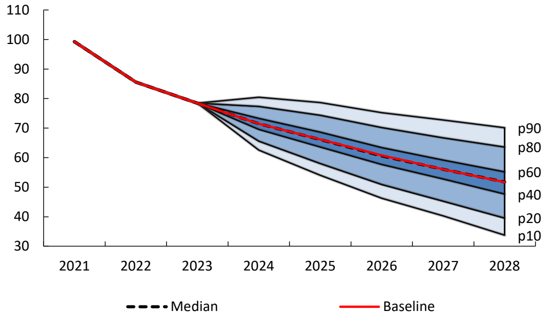


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

		S1	**S2**
Overall index (pps. of GDP)		**-2,9**	**-2,0**
of which			
Initial budgetary position		-3,6	-3,0
Debt requirement		0,2	
Ageing costs		0,5	1,0
of which	*Pensions*	0,6	0,9
	Health care	0,2	0,3
	Long-term care	0,1	0,2
	Others	-0,4	-0,4

Source: Commission services

Table A2.2: **Heat map of fiscal sustainability risks - Cyprus**

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
			Deterministic scenarios								
Overall (S0)	Overall		Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	S1	Overall (S1 + S2)
LOW	MEDIUM	Overall	LOW	LOW	LOW	LOW	LOW	MEDIUM	LOW	LOW	LOW
		Debt level (2034), % GDP	28,0	43,2	32,1	31,5	28,2				
		Debt peak year	2023	2023	2023	2023	2023				
		Fiscal consolidation space	24%	30%	26%	24%	24%				
		Probability of debt ratio exceeding in 2028 its 2023 level						4%			
		Difference between 90th and 10th percentiles (pps. GDP)						36,4			

(1) *Debt level* in 2034. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The *debt peak year* indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) *Fiscal consolidtation space* measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) *Probability of debt ratio exceeding in 2028 its 2023 level*. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the *difference between the 90th and 10th percentiles* measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Source : European Commission (for further details on the Commission's multidimensional approach, see the 2022 Debt Sustainability Monitor)

Source: Commission services

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