ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Cyprus, Spring 2023

INSTITUTIONAL PAPER 205 | MAY 2023

EUROPEAN ECONOMY

Economic and Financial Affairs

European Economy Institutional Papers are important reports analysing the economic situation and economic developments prepared by the European Commission's Directorate-General for Economic and Financial Affairs, which serve to underpin economic policy-making by the European Commission, the Council of the European Union and the European Parliament.

DISCLAIMER

The views expressed in unofficial documents do not necessarily represent the views of the European Commission.

LEGAL NOTICE

Neither the European Commission nor any person acting on behalf of the European Commission is responsible for the use that might be made of the information contained in this publication.

This paper exists in English only and can be downloaded from https://economy-finance.ec.europa.eu/ecfin-publications_en.

Luxembourg: Publications Office of the European Union, 2023

PDF ISBN 978-92-76-61654-2 ISSN 2443-8014 doi:10.2765/79391 KC-BC-23-012-EN-N

© European Union, 2023
Reuse is authorised provided the source is acknowledged. The reuse policy of European Commission documents is regulated by Decision 2011/833/EU (OJ L 330, 14.12.2011, p. 39). For any use or reproduction of material that is not under the EU copyright, permission must be sought directly from the copyright holders.

CREDIT
Cover photography: © iStock.com/benslimanhassan

European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2023

EUROPEAN ECONOMY

Institutional Paper 205

// ACKNOWLEDGEMENTS

This Post-Programme Surveillance assessment was prepared in the Directorate-General for Economic and Financial Affairs of the European Commission under the guidance of Declan Costello, Deputy Director General, Luc Tholoniat, Director, Maarten Masselink, Head of Unit for Cyprus, and Monika Sherwood, Deputy Head of Unit for Cyprus. ([1])

Contributors: Angela Droussiotou, Zivile Didziokaite, Anna Laudwein, Andreea-Alexandra Maerean, Marios Christodoulou, Angeliki Paritsi from the Directorate General Economic and Financial Affairs, and Anna Grochowska, Elena Pavlova, Marcus Sonntag from the Directorate General for Financial Stability, Financial Services, and Capital Markets. Editorial assistance was provided by Jakob Abou Zeid and Patricia Bernardos Schepers.

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 28 April 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 spring forecast released on 15 May 2023 (with a cut-off date of 28 April 2023).

Comments on the report would be gratefully received and should be sent, by mail or email, to:

Maarten Masselink
European Commission
Directorate-General for Economic and Financial Affairs
Head of Unit responsible for Cyprus
B-1049 Brussels
E-mail: ECFIN-F1-PPS-CYPRUS@ec.europa.eu

([1]) The executive summary of this report was adopted as Commission Communication C(2023) 4005 on 22 May 2023. The rest of the report reflects the findings of the staff working document SWD(2023) 654 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 14th post-programme surveillance mission to Cyprus took place from 20 to 22 March 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 activity continued to be robust in 2022 but signs point to a slowdown over the coming years. Real GDP growth reached 5.6% in 2022 but is expected to slow to 2.3% in 2023 and 2.7% in 2024 as the global economy loses momentum, high inflation dampens households' disposable income and rising interest rates adversely affect investment. Growth is expected to be driven by domestic demand and exports in services due to both a rebound in tourism and an influx of ICT companies. The implementation of the Recovery and Resilience Plan (RRP) is also having a positive impact on real GDP. The labour market has performed well, with strong employment growth and unemployment falling back below the levels preceding the COVID-19 pandemic. The outlook points to the labour market improving further as labour-intensive services continue to expand, albeit at a slower pace. Inflation reached its peak in 2022 at 8.1% and is set to decelerate to 3.8% and 2.5% in 2023 and 2024, respectively, due to declining energy prices. However, core inflation remains high, partly due to the wage indexation system, which pushes prices up. The current account deficit widened in 2022 due the increase in energy prices and is expected to only gradually narrow in the following years, although this is mostly linked to foreign direct investment.

The fiscal position improved significantly in 2022, but downside risks remain. The general government balance posted a surplus of 2.1% of GDP in 2022, reflecting buoyant revenues and limited expenditure increases that are partly due to the withdrawal of COVID-19 support measures. The measures to counteract high energy prices have had a moderate fiscal impact so far. According to the Commission's spring 2023 forecast, the general government balance is expected to remain in surplus (1.8% and 2.1% of GDP in 2023 and 2024, respectively). The fiscal outlook faces downside risks, such as possible new or extended measures to counter the high energy prices. Furthermore, the planned expansion of the State-owned asset management company KEDIPES could negatively affect public finances in the near term.

The banking sector is adequately capitalised, has ample liquidity and became profitable in 2022, while non-performing loans (NPLs) continue to decline. At the aggregate level, banks had a common equity tier 1 (CET1) ratio of 17.7% in December 2022 (the highest capital buffer since 2017). Nevertheless, this ratio is commensurate with the still-meaningful credit risk on the balance sheet of Cypriot banks. Deposits from households continued to grow throughout 2022 while deposits from non-financial corporations (NFCs) peaked in October 2022. In December 2022, the liquidity coverage ratio stood at 310%. Excess liquidity used to be a drag on profitability, but this is now changing and becoming a source of profits as interest rates are increasing. After 2 years of losses, the banking sector made a sizeable profit in 2022, driven by improvements in net interest income, higher net fee and commission income, and by a decline in provisions and impairments. New lending to the domestic economy for 2022 exceeded the levels of previous years - with all major segments registering higher volumes. Yet, amid rising interest rates, a deceleration in credit growth is expected in the future. Asset quality has remained stable. Banks made further progress in reducing their NPL exposures, although the system-wide NPL ratio remains the second highest in the EU. The decline was mainly driven by loan repayments, write-offs and cures because there were no NPL sales in 2022. A large part of the NPL reduction in preceding years was the result of transfers from the banking sector to credit-acquiring companies. These NPLs therefore still burden the economy through high private indebtedness and by reducing business opportunities for banks in the domestic market.

On the policy side, the authorities made progress with reforms to facilitate NPL management. Following several extensions since the start of the COVID-19 pandemic in March 2020, the restricted suspension of foreclosures came to an end in February 2023. The numerous extensions had both a direct impact on cases targeted for foreclosure and an indirect impact on consensual solutions, given the lenders' reduced leverage on uncooperative borrowers and the ensuing adverse payment discipline

implications. In addition, the foreclosure tool remains key to the viability and implementation of the recently announced mortgage-to-rent scheme, which aims to protect the primary homes of vulnerable households. In parallel, the State-owned asset management company KEDIPES has been making slow progress with the resolution of its residential portfolio due to the recurrent foreclosure suspensions, very low participation in the ESTIA scheme (the State-support scheme for NPLs backed with primary residences) and delays in launching the mortgage-to-rent scheme. KEDIPES also announced an interest-rate subsidy for 2023 on restructured performing loans with variable rates, providing for caps on interest charged. As regards the insolvency field, the transposition of Directive (EU) 2019/1023 on preventive restructuring into Cypriot law was completed in December 2022. Furthermore, the Department of Insolvency filled some positions in its organisational structure, including the new Director. Additional reforms are still ongoing, including on digitalisation of insolvency proceedings and improvements to address the scarce use of the current restructuring tools.

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 surpluses. Repayments of the principal on ESM loans will only start in 2025 and will conclude in 2031. In April 2023, the Cypriot government issued its first sustainable bond (worth EUR 1 billion) with a maturity of 10 years and a yield of 4.2%. Cyprus has a very large cash buffer and continues to enjoy favourable market perception as its sovereign debt rating was upgraded in 2023.

CONTENTS

1.	Introduction	1
2.	Macroeconomic developments	2
3.	Public finance developments	4
	3.1. Fiscal performance	4
	3.2. Fiscal outlook	4
4.	Financial sector developments	6
	4.1. Banking sector developments	6
	4.2. Other financial sector issues	10
5.	Sovereign financing and ability to repay	12
A1.	Soundness indicators for the banking sector in Cyprus	14
A2.	Main macroeconomic and financial indicators	15
A3.	Debt Sustainability Analysis	16

LIST OF TABLES

A2.1. Selected economic indicators	15
A3.1. Debt sustainability analysis – Cyprus	18
A3.2. Heat map of fiscal sustainability risks – Cyprus	18

LIST OF GRAPHS

4.1. NPL ratio and breakdown of changes	7

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, visited Nicosia from 20 to 22 March 2023 for the fourteenth post programme surveillance (PPS) mission to Cyprus. Staff from the 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 to the European Financial Stabilisation Mechanism (EFSM), the European Financial Stability Facility (EFSF) ([3]).

This report reflects information available on, and policy developments until, 28 April 2023. The macroeconomic and budgetary projections (including those underlying the debt sustainability analysis) are in line with the Commission's spring 2023 forecast released on 15 May 2023 (with a cut-off date of 28 April 2023).

([3]) 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 2022, the Cypriot economy continued to show robust and broad-based growth. Real GDP increased by 5.6% in 2022, following a 6.6% growth in 2021, on the back of domestic demand and dynamic growth in tourism and exports of business services. All sectors of economic activity grew – except for construction, which was hit by supply-side disruptions and high prices for building materials. Tourism performed well and reached about 90% and 80% of the pre-pandemic levels in revenues and arrivals respectively, thus indicating a successful market diversification strategy. Pent-up demand following COVID-19 related restrictions and increased employment and wages led to private consumption growing robustly by 7.7%. A buoyant inflow of foreign investment in residential and commercial property together with ongoing housing projects to meet domestic demand have pushed up construction investment. Investment in equipment was also boosted by a buoyant ICT sector.

Economic growth is set to slow down in 2023 and 2024 against the backdrop of elevated prices and tightening monetary policy. Based on the Commission's Spring 2023 Forecast, real GDP is projected to grow by 2.3% and 2.7% in 2023 and 2024, respectively. Some big infrastructure projects in the areas of energy, education, health and tourism are projected to continue, but increasing interest rates are expected to negatively affect corporate investment and residential construction for domestic demand. By contrast, foreign direct investment in real estate is on the rise. The RRP investment (particularly in the green and digital areas) will support small and medium-sized enterprises. Household disposable income has been affected by the sharp increase in consumer prices, which led to a decrease in real wages for the total economy by 1.8% in 2022, putting pressure on consumption. This was partly offset by wage indexation (an increase of 4.4% was implemented in January 2023 for around 45% of employees) and the full indexation of pensions ([4]). Based on bookings, tourism demand is expected to continue towards full recovery, most likely reaching 2019 levels this year. External demand for business ICT and financial services is also projected to expand, albeit at a slower pace in line with the weakening momentum of the global economy. Even though the economy has proven resilient to the fallout from Russia's invasion of Ukraine and the energy crisis, but downside risks are again on the rise mainly due to recent turbulence in the international financial markets. Furthermore, the erosion of purchasing power and rising interest rates in the context of very high private indebtedness entail a risk that NPLs will increase. The increase in housing prices (3.2% in 2022) ([5]) is largely explained by the high construction costs. Nonetheless, developments in the real estate sector warrant close monitoring because 65% of the loans in the banking sector are secured by real estate collateral and 85% of the acquisition value of loans in the credit-acquiring companies.

The labour market has shown resilience. Employment increased by 2.9% in 2022 and total hours worked by 4.1% on the back of robust economic growth. The unemployment rate decreased more than initially expected to 6.8% in 2022 (down from 7.5% in 2021). Labour and skills shortages are becoming more prevalent in some sectors (notably tourism) and are being addressed by loosening rules for non-EU nationals, including students and Ukrainian refugees. Going forward, the expected further expansion of labour-intensive services sectors is set to support the labour market. Employment growth is expected to slow to around 1.7% in 2023 and to somewhat accelerate by 1.9% in 2024 – in line with GDP growth. Unemployment will slightly increase in 2023 to 6.9% and fall to 6.4% in 2024 - below the pre-pandemic level but above the natural rate of unemployment which is estimated at around 5%.

Inflation is decelerating amid declining energy prices, but core inflation remains high. The harmonised index of consumer prices reached 8.1% in 2022 as a result of a sharp increase in

([4]) Cyprus has a cost-of-living allowance scheme in place. 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 by 50% of the year-on-year percentage change (only if positive) of the consumer price index, excluding any changes in consumption taxes (8.7% in 2023) if GDP rose during the second and third quarters of the previous year.

([5]) This is according to the Eurostat definition. The difference with the increase derived from the Central Bank of Cyprus house price index (5.2% in 2022) is due to methodological differences.

energy and food prices that was linked to the energy crisis and supply chain disruptions. This led to a pass-through to prices for services. As a result, core inflation (i.e. excluding oil and food prices) increased from 1% in 2021 to 5.3% in 2022. As energy prices are declining, inflation is expected to slow to 3.8% and 2.5% in 2023 and 2024 respectively. However, core inflation is expected to remain high at around 4.9% and 3.1% in 2023 and 2024 respectively. This is partly explained by second-round effects of the wage indexation system, which will accelerate nominal wage growth to around 6% in 2023. These increases, in combination with a delayed transmission of producer price increases, are expected to be passed through to consumer prices over the coming year. Upside risks to the inflation outlook remain due to the ongoing uncertainty in the global energy market.

The current account deficit increased significantly and is expected to remain high in the coming years. It rose from 6.8% of GDP in 2021 to 9.1% in 2022. The deterioration was mainly due to the balance of goods deficit resulting from robust demand for, and the very high cost of, imports of oil and other imported goods. The services balance only partly offset this. The fall in energy and commodity prices is expected to reduce the current account deficit to around 7.3% in 2023 and 6.9% in 2024. The financing of the external deficit comes mainly from foreign direct investment, which has so far been concentrated in the activities of holding companies in the financial sector and in real estate. This reduces risks regarding the sustainability of the current account but also seems to have only a very limited positive impact on potential output ([6]).

([6]) In-depth review for Cyprus 2023, Commission (2023) 635.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE

The public finances recorded a surplus in 2022. After a deficit of 2.0% of GDP in 2021, the general government balance improved to a surplus of 2.1% of GDP. The improvement was driven by the continuing economic recovery and buoyant tax revenues, in particular from VAT. Government expenditure was also contained due to the phasing-out of COVID-19 related measures.

Revenue increases were strong and broad-based. In 2022, VAT revenues continued increasing by 23% (a rate comparable with the previous year's) thanks to the continuing strong performance of private consumption (by contrast with 2021 when there were lock-downs related to the COVID-19 pandemic), the sharp increase in consumer prices and tax buoyancy ([7]). This is despite the energy-related measures on VAT and excise duties ([8]), which had a negative impact on revenue amounting to 0.3% of GDP in 2022. Taxes on income and wealth also grew significantly in 2022, reflecting a continuing improvement in the profitability of businesses combined with wage increases and sustained employment growth as well as tax buoyancy for corporate income tax.

Expenditure remained contained overall as expenditure decreased by 3.7 percentage points to 39.8% of GDP in 2022. Expenditure was reduced by the phasing-out of COVID-19 measures, which reduced expenditure by 2% of GDP. This was only partly offset by the introduction of energy-related measures to support businesses and households, which increased expenditure by 0.3% of GDP. Moreover, the increase in the public wage bill remained contained at 5.1%. This was significantly below the nominal increase in GDP (12.5%) because wage indexation lags by one year and takes only a share of the inflation rate into account. Interest payments also fell, mostly due to the reduction in public debt. However, expenditure on pharmaceuticals and water supply led to a sharp increase in intermediate consumption expenditure in 2022. The increase in public investment expenditure can be partly linked to the implementation of the RRP.

3.2. FISCAL OUTLOOK

The budget balance is expected to remain in surplus in 2023 and 2024, supporting a strong decline in the public debt ratio. In 2023, the headline balance is expected to remain in surplus, reaching 1.8% of GDP, as revenues and expenditure are forecast to grow broadly in line with nominal GDP, with the exception of compensation of public employees and public investment that are projected to grow more strongly. In 2024, the budget surplus is expected to grow to around 2.1% of GDP, mainly due to the projected phasing out of the measures to mitigate the impact of high energy prices.

The debt-to-GDP ratio is forecast to continue declining firmly over the coming years. It is expected to reach 72.5% in 2024 on the back of expected nominal GDP growth 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 3).

The fiscal outlook is subject to significant uncertainty and faces mostly downside risks.

1. Continuing high retail energy prices pose a risk because they may trigger additional fiscal measures or a prolongation of the existing ones.

2. There is also a risk of a weaker than expected collection of tax revenues (particularly from corporate income tax and VAT) specifically if domestic and global economic activity grows less strongly than projected.

3. A further downside risk comes from the government's plan to transfer assets from the private sector (banks and credit-acquiring companies) to the State-owned asset management company KEDIPES to offer a government-subsidised mortgage-to-rent

---

([7]) This means that revenues increased faster than the corresponding macroeconomic tax base (i.e., final consumption expenditure for VAT).

([8]) The 2023 Country Report for Cyprus includes a box that provides a comprehensive overview of the measures taken in response to the energy crisis, together with an assessment of whether they are targeted towards the most vulnerable and preserve the price signal, as well as the government's intentions for their withdrawal.

scheme to vulnerable households ([9]). The Cypriot authorities have estimated that the cost will be 0.4% of GDP in 2023 ([10]).

4. The fiscal projections for 2023 and 2024 will be affected negatively by the amendment of the cost-of-living allowance to compensate for two thirds of inflation as opposed to half of inflation previously, which has been agreed after the cut-off date of 28 April and could not be taken into account in the forecast. The impact is estimated at 0.1% and 0.3% of GDP in 2023 and 2024, respectively.

5. Potential cost overruns related to the healthcare system also constitute a downside risk of up to 0.3% of GDP per year when comparing budgeted expenditure with the actuarial projections of the International Labour Organization. However, the expenditure-constraining measures taken by the health insurance fund and public healthcare providers may achieve the projected savings.

6. The risks related to government guarantees remain contained.

7. Upside risks mainly come from stronger-than-expected buoyancy of tax revenues, linked to the inflow of foreign direct investment.

([9]) The scheme aims to protect the primary homes of vulnerable households by converting mortgage into rent payments at below market rates.
([10]) See Section 4 and Post-Programme Surveillance Report – Cyprus, autumn 2022, page 6.

4. FINANCIAL SECTOR DEVELOPMENTS

4.1. BANKING SECTOR DEVELOPMENTS

Assets quality

Banks have made further progress in reducing their NPLs, but the banking sector's NPL ratio remains one of the highest in the EU. Cypriot banks reduced their NPLs to EUR 2.3 billion in December 2022 from EUR 3.0 billion a year earlier (corresponding to a drop in the NPL ratio to 9.5% from 11.0% ([11])). The decline was driven mainly by loan repayments (EUR 390 million), write-offs (EUR 283 million) and cures (EUR 164 million). Unlike in previous years, there were no NPL sales in 2022. Most of the remaining stock of NPLs is held by smaller banks and contained in smaller portfolios and it is more difficult for these banks to arrange NPL sales. Cyprus still has the second highest share of NPLs in the banking system in the EU (after Greece) for both the household segment (12.1%) and NFCs (8.0%). The amount of unprovisioned NPLs is EUR 1.1 billion (the lowest amount since the financial crisis) and the coverage ratio rose to 47.5% in December 2022 from 43.6% a year earlier. The Single Supervisory Mechanism is working with the banks to ensure increasing provision coverage in line with supervisory expectations. A large part of the NPL reduction in preceding years was the result of transfers from the banking sector to credit-acquiring companies. These NPLs therefore still burden the economy through high private indebtedness and by reducing business opportunities for banks in the domestic market.

The current challenging circumstances have not led to a significant deterioration in asset quality so far. The Cypriot banking sector has survived the COVID-19 pandemic without any major impairment of its asset quality. The challenging economic circumstances slowing economic growth, high (albeit decelerating) inflation and higher debt-service costs – nevertheless pose new risks, although they have not yet led to an increase in the NPL level or to new NPL inflows. On the business side, the sectors most impacted by the current situation of high inflation and rising interest rates are hospitality, transport/storage and manufacturing. Indeed, these sectors saw a slight increase in NPL ratios in 2022 and restructuring activity may pick up as the repayment capacity of new borrowers comes under pressure.

The perceived riskiness of the loan portfolio subsided as strong policy support and activism on the part of banks ensured that the effects of the pandemic were less severe than initially feared. The staging of loans provides some insights into how the risks in the loan book have developed. At the start of the pandemic, banks moved large parts of their loan books (particularly loans to the tourism and construction sectors) into the stage 2 category ([12]). These loans were later reclassified back into stage 1 ([13]). In 2023, further loans may become eligible for reclassification from stage 2 to stage 1. The total amount of loans classified as stage 2 stood at EUR 2.9 billion in December 2022. This represents 12% of all loans and is still above their pre-pandemic level of 9% in December 2019, though down from 15% in June 2022. Their share is higher for the non-financial corporation sector at 17% than for households where only 8% are classified as increased risk. Coverage of these exposures is quite low (at 2.4%) when compared with the EU average (3.8%) but may improve when expected loan reclassifications from stage 2 to stage 1 take place. Cyprus remains among the EU countries with the highest proportion of stage 2 and stage 3 exposures, together comprising 20% of the loan portfolio ([14]) ([15]) ([16]).

([11]) The NPL ratios referred to in this report are based on the Central Bank of Cyprus's data and definition. They differ from the ratios referred to in the 2023 Cyprus Country Report, which are based on the ECB's Consolidated Banking Data. 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. See also Annex 1.

([12]) Stage 2 assets are (in the IFRS 9 context) financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit-loss event.

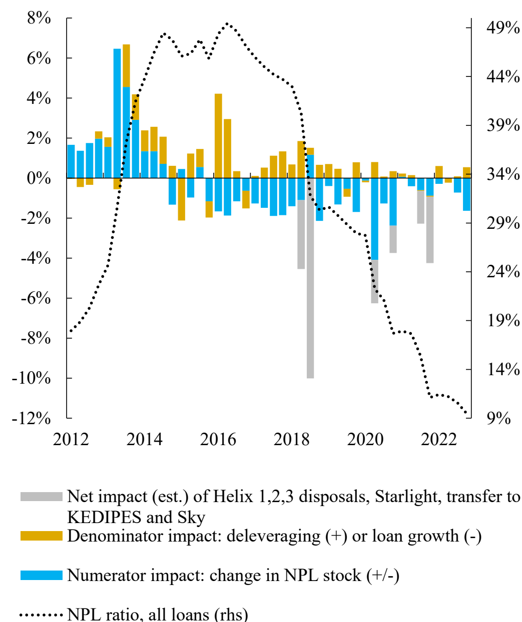
([13]) Stage 1 assets are (in the IFRS 9 context) financial instruments that either have not deteriorated significantly in credit quality since initial recognition or have low credit risk.

([14]) Stage 3 loans are considered to be credit-impaired (i.e. a credit loss has occurred). This is usually a wider definition than '90 days past due'.

([15]) Ireland, Austria and Romania have a similarly high share of stage 2 and stage 3 loans.

The repayment moratoria that banks offered during the pandemic have not led to major inflows into NPLs. In September 2022 there were EUR 8.8 billion of loans outstanding that had exited a moratorium scheme. The repayment schedule has not yet begun for a small fraction (3.7%). Of those with due payments, 2.9% experienced a default, 5.2% resulted in arrears and 16.8% were renegotiated. There was considerable variation between sectors. The default, arrears and renegotiation ratios were highest in the construction and accommodation sectors.

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



Source: Central Bank of Cyprus.

Lending and lending support schemes

New lending to households expanded slowly amid soft loan demand. New lending expanded at a moderate pace in 2022, with new loans to households and NFCs exceeding their 2021 levels by 1.5% and 17.6% respectively. Mortgage origination was EUR 1.2 billion in 2022 (EUR 57 million more than the previous year). Banks meanwhile extended EUR 1.8 billion of new loans to NFCs, thus exceeding the previous year's lending by EUR 272 million (albeit still falling slightly below the pre-pandemic level of EUR 2.0 billion in 2019). This strengthening of business lending occurred despite the phasing-out of the interest-rate subsidisation scheme at the end of 2021. The Cypriot government also offered a loan guarantee scheme in 2021 which did not meaningfully impact lending activity. The wholesale and retail trade sectors borrowed most, followed by construction and real estate. Outstanding loan balances declined overall as loan repayments and the reduction of non-performing exposures exceeded new lending. Current economic headwinds, higher borrowing costs and overall high levels of household and company indebtedness are likely to constrain the expansion of credit this year. Furthermore, the bank lending survey of January 2023 points to slowing loan demand during the coming months.

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

Profitability

The banking sector returned a sizeable profit in 2022 after 2 years of losses. The aggregate profit of banks operating in Cyprus amounted to EUR 178.1 million in 2022, after losses of EUR 149.6 million and EUR 79 million in 2020 and 2021 respectively. This favourable result was driven by improvements in net interest income (NII), higher net fee and commission income, and a decline in provisions and impairments. NII had been on a downward trend since 2012 and reached its lowest point in the first half of 2022. Positive policy rates are a change for the banks and have already boosted their income. The pass-through of rates to banks' profits has been rather quick in Cyprus and is mainly due to banks' excess liquidity and the large proportion of variable-rate loans. Banks' fee and commission income rose to EUR 363.5 million (up from EUR 323.9 million in 2021) – the highest level since the banking crisis in 2012-2013.

High staffing costs and limited lending opportunities are likely to remain a drag on the banks' profit opportunities. The overall operating environment remains challenging for Cypriot banks. The level of household and corporate indebtedness means that there are few opportunities to expand lending except by increasing market share. Competition is therefore

intense. Costs are increasing in the meantime, not least due to collective agreements that stipulate salary increases for bank staff that are often in the range of 4% to 6% over and above the increases required by the cost-of-living allowance (currently 4.36%). Banks are obliged to honour collective agreements even after their expiry date unless a new agreement is signed. In recent years, banks have therefore resorted to costly voluntary staff exit programmes in order to reduce headcount, thus at least temporarily slowing down the growth of staff costs. Bank of Cyprus and Hellenic Bank both offered voluntary redundancy programmes to their staff in 2022. By EU standards, Cyprus has a relatively high number of employees in the banking sector relative to its population. In 2022, personnel expenses were EUR 546.9 million (EUR 30.1 million more than in 2021), due in part to the cost of the exit schemes. Banks are working to improve their efficiency, including through digitalisation. Overall, gaining economies of scale is difficult given the small size of the Cypriot economy. The cost-income ratio stood at 70% in December 2022, compared with 73% a year earlier and the EU average of 61% in Q3 2022.

Capitalisation

Banks are solidly capitalised with capital buffers at their highest level since 2017. The CET1 ratio stood at 17.7% in December 2022 (unchanged from December 2021) as both capital and risk-weighted assets declined. Banks are thus exceeding their pillar 2 guidance by 4.6 percentage points in aggregate. The overall amount of assets contracted to EUR 63.8 billion in December 2022 (EUR 66.9 billion in 2021), chiefly due to declining loans and advances. The aggregate figures mask some variation between banks (Hellenic Bank featured a CET1 ratio of 18.3%, compared with Bank of Cyprus's 15.4%). The aggregate leverage ratio stood at 6.8% in December 2022, which is among the lowest levels ever recorded in Cyprus but still well above the minimum requirement of 3% and the EU average of 5.6%.

Deposits and liquidity

Cypriot banks benefit from a large and stable deposit base that provides them with ample liquidity. Deposits from households continued to grow throughout 2022 while deposits from NFCs peaked in October 2022. Overall, total deposits stood at EUR 52.1 billion in December 2022 (0.4% above the previous year's value). Banks exceed their net stable funding ratio (NSFR) and liquidity coverage ratio (LCR) requirements by a wide margin. The NSFR and the LCR were 178% and 310% respectively in December 2022. Excess liquidity used to be a drag on profitability, but this is now changing and becoming a source of profit as interest rates increase. Banks have started to gradually increase their deposit rates, but the pass-through is expected to be slow due to ample liquidity.

Macroprudential oversight and systemic risks

The private sector's indebtedness remains high when compared with the EU average but has improved in recent years. The non-financial private sector's overall indebtedness as a share of GDP declined in recent years to 169% in September 2022 (down from 187% at the end of 2021 but still above the EU average of 135%).

Banks have significant exposures to the real estate sector. Overall, 65% of all loans are collateralised by real estate and the banks are therefore exposed to revaluation risk. However, the risk of major price corrections seems low because properties in Cyprus are still considered to be undervalued. Moreover, conservative loan underwriting standards imposed by the central bank have contributed to an improvement of the private sector's debt fundamentals in recent years. The loan-to-value ratio (LTV) of new residential property loans was 42.6% in December 2022 (down from 45.5% a year earlier) and the debt-service to income (DSTI) ratio was 27.6% ([17]) in December 2022 (down from 31.5% a year earlier). These figures look benign, but debt-service costs are set to rise for households and the most vulnerable ones may find it difficult to service their debt. For commercial real estate, new loans had a higher average loan-to-value ratio (LTV) ratio of 84% ([17]) in December 2022, with outstanding loans registering an LTV of 57.3%.

The central bank has borrower-based measures in place to contain the build-up of risk in banks' lending portfolios. Property financing is limited

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

by an LTV cap of 70%. This cap is raised to 80% for mortgages for the borrower's primary permanent residence, but a more stringent cap of 50% applies to loans to real estate developers of luxury properties. Lending is further restricted by a maximum DSTI ratio of 80%. In this case, disposable income refers to the borrower's net income after cost-of-living expenses. Furthermore, in November 2022, the central bank announced the implementation of a new macroprudential policy framework that targets a positive countercyclical capital buffer (CCyB) rate when the risks in the financial system are neither high or low. In line with this new policy, the Central Bank of Cyprus (CBC) has introduced a CCyB rate of 0.5% which will be applicable after the usual one-year implementation period on 30 November 2023. No systemic risk buffer has been set.

Cyprus's banks are vulnerable to climate risk, but the cost of the transition is not expected to be a significant drag on the banking sector. The CBC has evaluated the banking sector's exposure to climate-transition risk. Only 25% of the banks' loan books relate to the top five carbon intensive sectors, while the remaining share corresponds to 'green' sectors. Furthermore, Cyprus is below but close to the EU average in terms of emissions per GDP and the economy's carbon intensity has declined in recent years. The central bank therefore does not expect the cost of the transition towards a more sustainable economy to be significant.

Foreclosure developments

Following several extensions since the start of the COVID-19 pandemic, the suspension of foreclosures recently came to an end. Over the past year, foreclosures of primary residences with an estimated value of up to EUR 350 000, agricultural land with a market value below EUR 100 000 and business premises of companies with up to EUR 750 000 in annual turnover were suspended again from August 2022 until the end of October 2022 and subsequently until the end of January 2023. In early March 2023, the Parliament voted narrowly against extending the suspension and the government is currently working on alternative ways to support vulnerable borrowers. The numerous suspensions had both a direct impact on cases targeted for foreclosure and an indirect impact on consensual solutions, given the lenders' reduced leverage on uncooperative borrowers and resulting moral hazard implications. With each suspension, the process needs to restart almost from the beginning and this leads to delays in the projected volume of foreclosure auctions and repossessions. An effective foreclosure framework therefore remains essential in order to ensure legal certainty, maintain payment discipline, support banks' efforts to reduce NPLs and encourage borrowers to participate in loan restructuring. In addition, the foreclosure tool remains key to the viability and implementation of the recently approved mortgage-to-rent (MTR) scheme which aims to protect the primary homes of vulnerable households.

The stock of immovable property held by banks remains substantial, amidst the relatively low success rates of e-auctions. A general improvement in the real estate market at the end of 2022 helped the stock of immovable property held by banks to decline slightly on an annual basis to EUR 1.4 billion (corresponding to 5 445 properties), but the average period held increased to 5 years (from 4.3 years at the end of 2021). The number of properties sold at e-auctions (currently the only method used by banks) remains quite low. In Q4 2022, 153 properties (mainly residential property and farmland) were sold (80 were sold in Q3 2022). 92% of these were bought by the mortgage lender – as in previous quarters. The total auction success rate for banks (measured by the number of properties successfully sold in an auction as a share of the number of properties sent to auction) was 14.8% in Q4 2022. Initiating a foreclosure procedure followed by the onboarding of the asset has thus become a way for banks to bring collateral assets onto their balance sheets.

Cyprus Asset Management Company (KEDIPES)

Overall, the performance of KEDIPES improved in 2022. Since its inception in 2018, KEDIPES has made cash repayments of EUR 940 million of State aid, with EUR 310 million in 2022 (including EUR 80 million in Q4 2022) and EUR 60 million in Q1 2023. In 2022, cash inflows amounted to EUR 439 million (a 9% increase on 2021). Overall, the actual performance was ahead of the business plan by EUR 221 million in terms of cash

inflows excluding portfolio sales ([18]). KEDIPES has been progressing slowly with the resolution of its residential portfolio, while recording an increase in property repossessions and a decline in consensual solutions (restructurings and debt-to-asset swaps). The recurrent foreclosure suspensions, very low participation in the ESTIA scheme and delays in launching the mortgage-to-rent (MTR) scheme have weighed on a substantial part of the loan portfolio.

Following the completion of several operational milestones, KEDIPES is embarking on new initiatives. After a lengthy process, the revised service loan agreement with the credit servicer Altamira that reduces servicing fees was finalised on 25 October 2022 (the terms came into effect retroactively from the beginning of 2020). In March 2023, KEDIPES signed a collective labour agreement for 2019-2023 that reaffirms the restoration of pay cuts from mid-2020. As regards the sale of a performing loan portfolio ('project Ledra' ([19])) that had previously been put on hold, KEDIPES has been examining the potential of a transaction with the preferred bidder for a limited part of the initial perimeter, excluding the sale of municipality/local council loans. However, the significant increase in interest rates is currently making it more difficult to evaluate viability and the expected re-default statistics of the performing loan perimeter. KEDIPES will also provide an interest-rate subsidy for 2023 on restructured variable-rate performing loans based on ECB and Euribor rates, envisaging caps on interest charged (3.5% for loans collateralised by residential real estate and 4% for other loans).

The new mortgage-to-rent (MTR) ([20]) scheme will contribute to a limited expansion of KEDIPES. The envisaged MTR scheme as approved by the authorities in February 2023 is a targeted scheme, which covers defaulted borrowers that receive social benefits and rejected, non-viable ESTIA applications ([21]). It provides a solution to vulnerable debtors by offering a rent subsidy and a property buy-back option. The eligible NPL perimeter includes loans collateralised by primary residences with a market value of up to EUR 250 000. KEDIPES will onboard the eligible properties from the participating banks and credit acquiring companies (CACs) at an agreed percentage of their market value. Overall, the Cypriot authorities envisage that the scheme will slightly decrease banks' NPLs and have a small adverse fiscal impact of less than EUR 100 million (approximately 0.4% of GDP per year).

4.2. OTHER FINANCIAL SECTOR ISSUES

Insolvency developments

The transposition of Directive (EU) 2019/1023 on preventive restructuring into Cypriot law was completed in December 2022. The legislative package included the adoption of amendments to the Department of Insolvency and related matters Act, the Bankruptcy Act and the Companies Act. Additional reforms are still underway, including adjustments to ensure the efficient digitalisation of insolvency proceedings and improvements to address the limited use of the current restructuring tools (e.g., *examinership* ([22])).

New actions within the national action plan for insolvency have just begun or will commence soon. The Ministry of Energy, Commerce and Industry launched a new 24-month project in February 2023 to create a digital archive or repository of insolvency files in order to enhance the organisation of the Department of Insolvency's filing system and the digitalisation of files. The Ministry will launch a new project for the automation of most services provided by the Department of Insolvency (the Cypriot Recovery and Resilience Plan includes a target of Q4 2025).

([18]) KEDIPES's business plan targets the full repayment of the State aid granted (including properties to be transferred to the State).

([19]) 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.

([20]) The implementation of the MTR scheme is still contingent on final notification by the Cypriot authorities and approval by the Commission's Directorate-General for Competition of the necessary amendments to the 2018 Commission Decision on liquidation aid to Cyprus Cooperative Bank in order to allow KEDIPES to manage a system-wide scheme.

([21]) The ESTIA scheme is a State-support scheme for NPLs backed with primary residences. For more details on the scheme and on the eligibility criteria, see the autumn 2018 Post-Programme Surveillance Report for Cyprus.

([22]) Examinership is a rescue procedure that gives companies facing insolvency a period of protection vis-à-vis its creditors in order to facilitate the survival of the debtor as a going concern.

The recruitment process to fill the vacancies within the organisational structure of the Department of Insolvency (DoI) has finally made some progress. The new director of the DoI has been appointed and took over in mid-April 2023. The appointment of seven managers will be completed in May/June 2023. The remaining officers (9 out of 15) will be appointed soon after. Continuing professional development and licensing for insolvency practitioners were implemented in Q1 2023. The training sessions for insolvency practitioners, in cooperation with the academy for public servants, are expected to start in 2023. Cyprus will appoint and train the DoI's personnel as one of its RRP reforms.

The digitalisation of insolvency proceedings in Cyprus is progressing on schedule. The digitalisation and modernisation of the DoI's operations is one of the RRP priorities and is expected to be completed by end of 2025. The DoI's current website (online since Q3 2021) will increase its capabilities in 2023 and adapt its layout to all official government websites (mainly the development of new e-tools). The plans to set up a customer service and a communication plan for insolvency have been delayed until all the DoI's officers have been appointed.

5. SOVEREIGN FINANCING AND ABILITY TO REPAY

The government debt-to-GDP ratio decreased significantly in the last 2 years and is projected to continue on a downward path over the coming decade. The general government debt-to-GDP ratio declined by 27.3 percentage points over the past 2 years to 86.5% at the end of 2022 ([23]). The decline was driven by strong nominal growth, primary surpluses and the use of cash reserves from the significant cash buffer which was accumulated at the beginning of the COVID-19 crisis. The public debt ratio is projected to decrease further in 2023 and 2024 to 80.4% and 72.5% of GDP respectively on the back of nominal GDP growth and fiscal primary surpluses. It is then projected to continue its downward path (see the Commission's debt sustainability analysis (DSA) annex).

In April 2023, the Cypriot government issued its first sustainable bond. On 4 April 2023, the government tapped the international markets with a EUR 1 billion sustainable 10-year bond with a coupon of 4.125% (and a primary yield of 4.219%). The bond attracted robust demand with a record order book of over EUR 12 billion. The bond's proceeds will be used to finance projects and activities that promote sustainability, climate and other environmental and social purposes within the meaning of eligible expenditures as defined in the Cyprus Sustainable Finance Framework (published in January 2023).

Gross financing needs for 2023-2024 are low, reflecting low redemptions and significant fiscal surpluses, while cash buffers remain large. Excluding Treasury bills (T-bills), gross financing needs (GFN) for 2023 are estimated at around EUR 0.99 billion or 3.4% of GDP. They consist of EUR 1.4 billion of debt redemption needs that are partly offset by an expected budget surplus of EUR 0.53 billion ([24]). For 2024, GFN are estimated at about EUR 1.6 billion or some 5.3% of GDP. The current cash buffer remains significant and covers the financing needs beyond the end of 2023. According to the 2023-2025 medium-term public debt management strategy, cash balances throughout this year will be maintained at levels that cover the financing needs for the following 6-9 months.

The public debt maturity profile is balanced. Capital repayments are low in 2023, amounting to EUR 1.4 billion (about 4.8% of GDP), while in 2024 they are expected to be higher, at about EUR 2.4 billion (approx. 7.8% of GDP). The average annual debt redemption for the coming decade is about EUR 1.9 billion. Public debt repayments will peak in 2028 at about EUR 2.7 billion, but the Public Debt Management Office plans to smooth the redemption schedule and keep the refinancing risk at low levels. In 2022, the average remaining maturity of debt decreased slightly to 7.3 years from 7.6 years in 2021 ([25]). Over the same period, the share of debt maturing within 1 year went down to 6.7% (from 9.3% in 2021), while the share of debt falling due within 5 years increased to 45.6% (from 42.5% in 2021). These indicators compare very well with the euro area averages.

The cost of debt has been declining in the last years, reaching low levels. Cyprus's borrowing costs when accessing the markets have increased, but the impact on the average cost of debt is expected to be limited in the short to medium term. The weighted average cost of debt has been falling from 4.2% in 2012 to 1.6% at the end of 2021, and slightly increased to 1.8% in 2022. Interest payments as a share of government revenue declined from 9.2% in 2012 to 3.6% in 2022, while interest payments as a percentage of GDP declined from 3.3% in 2012 to 1.5% in 2022. The drivers behind the decline were the low-cost of the new issuances replacing existing debt that carried higher interest rates (reflecting the improvements of the sovereign credit ratings), the low interest rates environment, and higher government revenues and GDP. Since February 2022, the yields on Cyprus's 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 and recent volatility in the capital markets. At the end of April 2023, 10-year bond

([23]) 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.

([24]) The figure for the fiscal surplus is derived from the Commission's spring 2023 forecast.

([25]) The average remaining maturity of marketable debt increased slightly in 2022 to 7.9 years (compared with 7.7 years in 2021). This was due to the 2022 issuance of the 10-year bond and the reduction in nominal public debt (denominator effect). The average remaining maturity is lower than the EU average (of 8.5 years).

yields stood at around 4.1% and the 10-year spread on the German Bund was 1.76%. Yields on T-bills also increased after an extended period of negative interest rates. They turned positive in June 2022 and have continued to increase, reaching 3.3% at the T-bills auction in April 2023 (reflecting changes in the ECB's monetary policy). To manage the impact of the increased cost, the government reduced the amount of 13-weeks T-bills issued ([26]). In this context, Cyprus is facing higher borrowing costs when accessing the markets. Nevertheless, the increase in the weighted average cost of the debt portfolio is expected to be limited due to the share of the new issuances and the fact that the new issuances carrying higher yields will be replacing old bonds of similar costs.

Cyprus has benefited from improving assessments by credit-rating agencies. The main credit-rating agencies (except Moody's) rate Cyprus's sovereign debt at investment grade. In March 2023 Fitch upgraded Cyprus's rating by one notch from BBB- to BBB (this is two notches within the investment-grade area). The upgrade was motivated by the strong fiscal performance, the declining government debt ratio, macroeconomic resilience to shocks and improving bank asset quality. The S&P and DBRS credit ratings for Cyprus both stand at BBB. The credit outlook is stable according to Fitch, S&P and DBRS, while Moody's 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 billion, or about 22% of GDP. ESM debt constitutes about 27% of the total public debt and about 90% of the floating-rate debt. Cyprus will start repaying its loan to the ESM in 2025, with the first repayment amounting to EUR 0.35 billion. In the following years, repayments will reach EUR 0.9-1.05 billion for each year (on average EUR 0.99 billion per year). Full 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 long term, while in the medium term, risks appear to be medium ([27]). 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 2023-2024.

([26]) T-bills are a complementary source of funding for Cyprus. T-bills usually amounted to around EUR 300 million per year, while the stock of outstanding T-bills was recently below EUR 150 million.

([27]) See Annex 3 on the DSA, which assesses fiscal sustainability risks over the short, medium and long terms.

ANNEX 1

Soundness indicators for the banking sector in Cyprus

Table A1.1: **Soundness indicators for the banking sector in Cyprus**

	2016	2017	2018	2019	2020	2021	2022		2022					
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec
NPLs*, all loans (EUR billions)	23.8	20.6	10.3	9.0	5.1	3.0	2.9	2.9	2.9	2.8	2.7	2.7	2.7	2.3
NPLs*, all loans (% of total)	47.2	43.7	30.3	27.9	17.7	11.0	11.4	11.2	11.0	10.9	10.6	10.5	10.5	9.5
NPLs*, loans to NFCs (% of total)	56.4	50.3	33.2	24.5	14.5	8.1	9.1	8.7	8.4	8.3	8.0	8.0	8.1	8.0
Restructured non-performing (% of total	25.8	22.8	14.4	10.8	6.4	4.0	4.3	4.2	4.3	4.3	3.9	3.9	4.0	3.9
Restructured performing (% of total)	9.4	8.6	6.8	4.5	3.1	10.7	11.9	11.4	11.5	11.5	11.3	11.4	11.3	11.4
NPLs*, loans to households (% of tota	56.0	53.9	37.6	35.2	23.7	14.7	14.0	13.4	13.3	13.3	12.7	12.7	12.5	12.1
Restructured non-performing (% of total	20.1	19.7	17.1	15.7	10.4	6.2	5.9	5.6	5.6	5.5	5.2	5.1	4.9	4.7
Restructured performing (% of total)	7.7	8.3	7.1	4.8	4.6	3.7	3.3	3.0	2.9	2.9	2.9	2.8	2.9	2.9
Coverage rate (Impairments / NPLs)*	40.3	45.9	49.6	55.2	46.2	42.7	45.7	46.2	46.5	46.7	47.0	46.8	47.4	47.5
Cost-to-income ratio	52.6	53.6	62.5	72.3	63.2	71.9	75.7	71.7	..		82.6	..	..	..
Lending margin	2.0	1.9	2.6	2.8	2.8	2.7	2.7	2.7	2.9	2.9	3.4	3.2	3.8	3.2
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
Return on assets (annualised)	-0.3	-1.1	0.3	0.3	-0.2	-0.1	0.1	0.2	..	..	-0.1	..	..	..

(1) The figures cover the Cyprus operations of all domestic and foreign credit institutions operating in Cyprus on a consolidated basis. * Local NPL definition was used until end-2014. Starting with 2015, the EU NPL definition was used, as defined in Commission Implementing Regulation (EU) 2015/227, later amended by Commission Implementing Regulation (EU) 2015/1278. Figures exclude exposures to central banks and credit institutions.
Source: Central Bank of Cyprus, ECB.

ANNEX 2
Main macroeconomic and financial indicators

Table A2.1: **Selected economic indicators**

	2018	2019	2020	2021	2022	2023	2024
Real economy			*(percent change)*				
Real GDP	5.6	5.5	-4.4	6.6	5.6	2.3	2.7
Domestic demand incl. inventories	3.5	6.1	-3.7	3.0	9.8	1.7	2.0
Private consumption expenditure	5.1	3.9	-6.8	4.5	7.7	1.9	2.2
Government consumption expenditure	3.6	12.0	11.5	9.0	0.1	1.7	1.6
Gross fixed capital formation	-4.9	6.9	4.5	-4.2	6.6	0.8	1.7
Exports of goods and services	7.2	8.7	2.2	13.6	13.7	2.8	3.7
Imports of goods and services	4.3	9.5	3.2	9.0	18.8	2.1	2.9
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	2.8	5.5	-1.6	3.6	5.9	1.7	1.9
Foreign trade	2.1	-0.5	-0.7	3.6	-3.9	0.7	0.8
Changes in inventories	0.7	0.5	-2.0	-0.6	3.7	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.0	1.3	-1.2	2.9	6.4	5.0	2.8
HICP	0.8	0.5	-1.1	2.3	8.1	3.8	2.5
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	8.4	7.1	7.6	7.5	6.8	6.9	6.4
Employment	5.3	3.8	-1.2	1.3	2.9	1.7	1.9
Compensation per employee	1.5	4.4	-0.5	3.8	3.8	6.3	4.0
Labour productivity	0.3	1.7	-3.2	5.3	2.7	0.6	0.8
Unit labour costs	1.2	2.7	2.8	-1.4	1.0	5.6	3.2
Public finance			*(percent of GDP)*				
General government balance	-3.6	1.3	-5.8	-2.0	2.1	1.8	2.1
Total revenue	39.0	39.4	38.8	41.5	41.9	42.1	42.7
Total expenditure	42.6	38.1	44.6	43.5	39.8	40.2	40.6
General government primary balance	-1.3	3.5	-3.7	-0.2	3.6	3.2	3.4
Gross debt	98.1	90.8	113.8	101.2	86.5	80.4	72.5
Balance of payments			*(percent of GDP)*				
Current external balance	-3.9	-5.5	-10.0	-6.8	-9.1	-7.3	-6.9
Ext. bal. of goods and services	1.4	1.0	-1.4	2.9	-0.4	1.3	2.4
Exports goods and services	75.0	76.5	81.4	86.6	91.5	90.5	90.8
Imports goods and services	73.6	75.5	82.8	83.7	91.9	89.2	88.4
Memorandum item			*(EUR bn)*				
Nominal GDP	21.7	23.2	21.9	24.0	27.0	29.0	30.7

Source: European Commission.

ANNEX 3

Debt Sustainability Analysis

This Annex assesses fiscal sustainability risks for Cyprus over the short-, medium- and long-term. It follows the same multi-dimensional approach as the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 spring forecast.

1 - Short-term risks to fiscal sustainability are low overall. The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks (Table A3.2). ([28]) Government gross financing needs are expected to reach around 5% of GDP in the short term (i.e. in 2024) and to decline compared with the recent peak in 2020 (Table A3.1). ([29]) Financial markets' perceptions of Cyprus are favourable as its debt rating continued to be upgraded in 2023. The main credit-rating agencies (except Moody's) now rate Cyprus' sovereign debt at investment grade (two notches within the investment-grade area).

2 - Medium-term fiscal sustainability risks appear medium overall (Table A3.1).

The DSA for Cyprus shows that, under the baseline, the government debt-to-GDP ratio is expected to substantially decline to a low level over the medium-term (at 40.6% of the GDP in 2033) (Table A3.1). ([30]), ([31]) The assumed structural primary balance (a surplus of 2.6% of GDP) supports these developments. It appears relatively ambitious compared with past fiscal performance. At the same time, the baseline projections up to 2033 benefit from a favourable (although diminishing) snowball effect, with real GDP growth at around 1.7% of GDP over 2025-2033. Government gross financing needs are expected to remain small over the projection period, diminishing to around 3% of GDP in 2033, below the level forecast for 2024.

The baseline projections are stress-tested against four alternative scenarios to assess the impact of changes in key assumptions (Table A3.2). For Cyprus, reverting to historical fiscal trajectories under the 'historical structural primary balance (SPB)' scenario would lead to a higher government debt ratio. If the SPB gradually converged its historical 15-year average (1.5% of GDP), the projected debt-to-GDP ratio would be about 7 pps. of GDP higher than in the baseline in 2033. A permanent worsening of the macro-financial conditions, as reflected under the 'adverse interest-growth rate differential' scenario (i.e. 1 pp. higher than the baseline) would result in a persistently higher government debt-to-GDP ratio, by around 5 pps. of GDP by 2033, as compared with the baseline. A temporary worsening of financial conditions, as reflected in the 'financial stress scenario' (i.e. temporarily increase of interest rates by 1 pp.), would lead to a broadly similar public debt-to-GDP ratio by 2033 compared with the baseline. The 'lower structural primary balance' scenario (i.e. SPB level permanently reduced by half of the cumulative forecast change) would also lead to a slightly higher government debt-to-GDP ratio by 2033 (around +2 pps. of GDP) compared with the baseline.

Stochastic projections show a medium sensitivity of these projections against plausible unforeseen events. ([32]) These stochastic simulations point to a 4% probability of the debt ratio in 2027 being greater than in 2022, entailing medium risk given the initial high debt level. In addition, such shocks point to substantial

([28]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of macro-financial and fiscal variables that have proven to perform well in the past in detecting situations of upcoming fiscal stress.

([29]) 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 spring forecast.

([30]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline notably comprise: (i) a structural primary surplus, before ageing costs, of 2.6% of GDP as of 2024; (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 from now); (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 spring forecast until 2024, followed by EPC/OGWG 'T+10 methodology projections between T+3 and T+10, i.e. for 2025-2033 (on average 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.

([31]) Table 1 shows the baseline debt projections and its breakdown into the primary balance, the snowball effect (the combined impact of interest payments and nominal GDP growth on the debt dynamics) and the stock-flow adjustment.

([32]) The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's budgetary position, economic growth, interest rates and exchange rates. The cone covers 80% of all the simulated debt paths, therefore excluding tail events.

uncertainty (i.e. the difference between the 10th and 90th debt distribution percentiles) surrounding the government debt baseline projections (Table A3.2).

3 - Long-term fiscal sustainability risks for Cyprus appear low overall. ([33])

The S2 indicator (-1.2 pps. of GDP) 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 favourable initial budgetary position (-2.2 pps. of GDP), which more than offsets the projected increase in ageing-related costs (contribution of 1.0 pp. of GDP). Ageing costs' developments are primarily driven by the projected increase of public pension expenditure (contribution of 0.9 pp. of GDP) (Table A3.1).

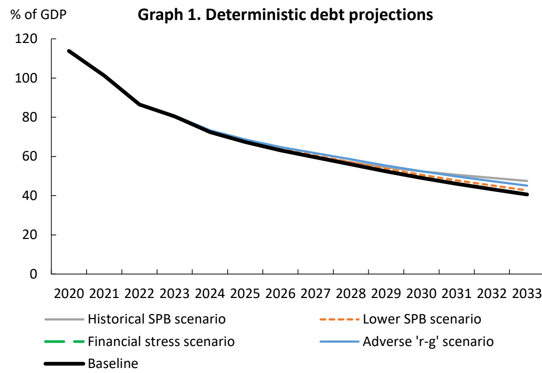
The S1 indicator (-2 pps. of GDP) also points to low fiscal sustainability risks, confirming the overall long-term assessment. The S1 sustainability gap indicator signals that no consolidation effort is needed to bring debt to 60% of GDP by 2070. This result is driven by the favourable initial budgetary position (-2.7 pps. of GDP), which is only partly offset by ageing costs (0.5 pp. of GDP) and the debt requirement (0.3 pp. of GDP) (Table A3.1).

Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors are related to the recent increase in interest rates, Cyprus' negative net international investment position and risks to the budget balance due to potential expansion of KEDIPES and potential extension of energy-related measures beyond June 2023. 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.

([33]) The S2 fiscal sustainability gap indicator measures the permanent fiscal effort (SPB adjustment) in 2024 that would be required to stabilise public debt over the long term. It is complemented by the S1 fiscal sustainability gap indicator, which measures the permanent fiscal effort required in 2024 to bring the debt-to-GDP ratio to 60% in the long term (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 pps. of GDP, 'medium risk' if it lies between 2 pps. and 6 pps. of GDP, and 'low risk' if the effort is negative or below 2 pps. of GDP. The overall long-term risk classification brings together the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 when it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

Table A3.1: Debt sustainability analysis – Cyprus

Table 1. Baseline debt projections	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Gross debt ratio (% of GDP)	**113,8**	**101,2**	**86,5**	**80,4**	**72,5**	**67,4**	**63,2**	**59,6**	**56,0**	**52,4**	**49,1**	**46,1**	**43,3**	**40,6**
Changes in the ratio	23,0	-12,6	-14,7	-6,1	-8,0	-5,1	-4,2	-3,6	-3,6	-3,6	-3,3	-3,0	-2,8	-2,7
of which														
Primary deficit	3,7	0,2	-3,6	-3,2	-3,4	-3,1	-2,8	-2,5	-2,5	-2,7	-2,6	-2,5	-2,4	-2,3
Snowball effect	7,4	-8,2	-9,7	-4,7	-3,0	-2,0	-1,5	-1,1	-1,1	-0,9	-0,7	-0,5	-0,4	-0,4
Stock-flow adjustments	11,8	-4,6	-1,4	1,7	-1,6	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Gross financing needs (% of GDP)	25,4	6,3	6,9	8,6	5,0	7,0	8,2	8,0	8,1	7,4	6,5	6,3	3,5	3,3



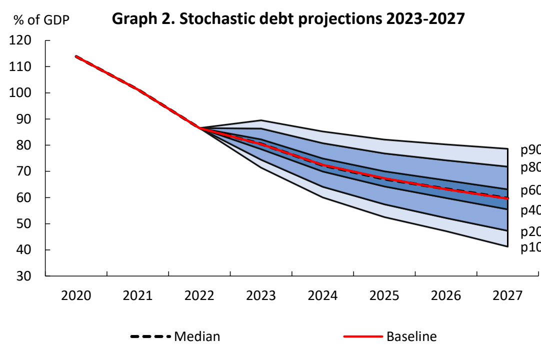


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

		S1	S2
Overall index (pps. of GDP)		**-2,0**	**-1,2**
of which			
Initial budgetary position		-2,7	-2,2
Debt requirement		0,3	
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 A3.2: Heat map of fiscal sustainability risks – Cyprus

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
Overall (S0)	Overall		Deterministic scenarios: 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 (2033), % GDP	40,6	47,5	42,7	45,1	40,9				
		Debt peak year	2022	2022	2022	2022	2022				
		Fiscal consolidation space	28%	31%	29%	28%	28%				
		Probability of debt ratio exceeding in 2027 its 2022 level						4%			
		Difference between 90th and 10th percentiles (pps. GDP)						37,3			

(1) *Debt level* in 2033. 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 2027 its 2022 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.

EUROPEAN ECONOMY INSTITUTIONAL PAPERS SERIES

European Economy Institutional Papers series can be accessed and downloaded free of charge from the following address: Publications (europa.eu).

.

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/european_economy/index_en.htm
  (the main reports, e.g. Economic Forecasts)

- http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm
  (the Occasional Papers)

- http://ec.europa.eu/economy_finance/publications/qr_euro_area/index_en.htm
  (the Quarterly Reports on the Euro Area)

GETTING IN TOUCH WITH THE EU

In person
All over the European Union there are hundreds of Europe Direct Information Centres. You can find the address of the centre nearest you at: http://europa.eu/contact.

On the phone or by e-mail
Europe Direct is a service that answers your questions about the European Union. You can contact this service:

- by freephone: 00 800 6 7 8 9 10 11 (certain operators may charge for these calls),
- at the following standard number: +32 22999696 or
- by electronic mail via: http://europa.eu/contact.

FINDING INFORMATION ABOUT THE EU

Online
Information about the European Union in all the official languages of the EU is available on the Europa website at: http://europa.eu.

EU Publications
You can download or order free and priced EU publications from EU Bookshop at: http://publications.europa.eu/bookshop. Multiple copies of free publications may be obtained by contacting Europe Direct or your local information centre (see http://europa.eu/contact).

EU law and related documents
For access to legal information from the EU, including all EU law since 1951 in all the official language versions, go to EUR-Lex at: http://eur-lex.europa.eu.

Open data from the EU
The EU Open Data Portal (http://data.europa.eu/euodp/en/data) provides access to datasets from the EU. Data can be downloaded and reused for free, both for commercial and non-commercial purposes.

Publications Office
of the European Union