European Commission

ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Cyprus, Spring 2021

INSTITUTIONAL PAPER 151 | JUNE 2021

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://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

Luxembourg: Publications Office of the European Union, 2021

PDF ISBN 978-92-76-29722-2 ISSN 2443-8014 doi:10.2765/128608 KC-BC-21-008-EN-N

CREDIT
Cover photography: © iStock.com/benslimanhassan

European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Cyprus, Spring 2021

EUROPEAN ECONOMY

Institutional Paper 151

ACKNOWLEDGEMENTS

This report was prepared in the Directorate-General for Economic and Financial Affairs under the direction of Gabriele Giudice (Director), Moisés Orellana (Head of Unit for Cyprus) and Joern Griesse (Deputy Head of Unit for Cyprus).

The report was approved by Declan Costello, Deputy Director-General ([1]).

Contributors: Angela Droussiotou, Andreea-Alexandra Maerean, Paulina Rogowska, Zivile Didziokaite, Marios Christodoulou, Elena Pavlova, Marcus Sonntag, Jaime Ruiz Rocamora, Vallyon Emese, Arbak Emrah and Anda Patarau. Assistance was provided by Natalia Antoniuk.

The Post-Programme Surveillance assessment was prepared in liaison with staff from the European Central Bank (ECB) ([2]).

This report reflects information available and policy developments that have taken place until 14 April 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 spring forecast released on 12 May 2021 (with cut-off date 30 April 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the Cypriot Recovery and Resilience Plan and cannot in any way serve to pre-judge the Commission assessment of the Plan.

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

Moisés Orellana
European Commission
Directorate-General for Economic and Financial Affairs
CHAR 12/006
B-1040 Brussels
Belgium

e-mail: moises.orellana@ec.europa.eu

([1]) The executive summary of this report was adopted as Commission Communication C(2021) 3948 on 27 May 2021. The rest of the report reflects the findings of the staff working document SWD(2021) 127 accompanying that Communication.
([2]) ECB staff participated in this mission and in the drafting of this report in line with the ECB's competences, providing expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

EXECUTIVE SUMMARY

This report summarises the main findings from the tenth post-programme surveillance (PPS) mission for Cyprus, which took place from 8-18 March 2021. Given the COVID-19 related travel restrictions, the mission was conducted in virtual format, via video and teleconferences involving European Commission staff, in liaison with staff from the European Central Bank (ECB). The institutions held several online meetings with the Cypriot authorities, major banks and credit-acquiring companies. This report is more limited in scope than usual. Staff from the European Stability Mechanism (ESM) participated in the conference calls on aspects relating to the ESM's Early Warning System. Staff from the International Monetary Fund (IMF) joined as well under the framework of the Article IV.

After the sharp contraction of economic activity in 2020 due to the pandemic and ensuing lockdown measures, with the tourism sector bearing the brunt, a gradual recovery is expected in 2021 and 2022. Real GDP contracted by 5.1% in 2020. Domestic demand, helped by fiscal measures, was more resilient than external demand. Tourism plummeted in 2020 with receipts falling by 85.4%. In 2021, a modest recovery is expected, with GDP forecast to grow by 3.1%, as the renewed lockdown at the beginning of the year and in April has clouded the short-term growth outlook of the Cypriot economy and travel restrictions are assumed to be in place until the pace of vaccinations picks up. In 2022, the recovery is forecast to accelerate to 3.8%, mainly on the back of rising domestic demand and a small positive contribution from net exports. The Recovery and Resilience Plan is expected to gradually have a positive impact on the economy as of the end of 2021 with the implementation of reforms and investments and ultimately boost the growth potential of the country over the medium term. Unemployment increased only moderately in 2020 to 7.6% from 7.1% in 2019, helped by income support measures to preserve employment, which were partly financed by a loan under SURE (Support to mitigate Unemployment Risks in an Emergency). In 2022, unemployment is expected to decrease to 7.2%. Plummeting external demand led to a considerable increase of the current account deficit from 6.3% of GDP in 2019 to 11.9% of GDP in 2020, with only a slight improvement foreseen over the forecast horizon. This would further deteriorate the net international investment position of Cyprus. Inflation turned negative in 2020 (-1.1%), dragged down by energy prices, but is expected to pick up in 2021 and 2022. Downside risks to the growth outlook are significant, mainly regarding the course of the pandemic. On the positive side, swifter-than-expected progress in the EU’s vaccination campaign could be a significant benefit for the tourism sector in Cyprus.

While macroeconomic developments and the policy response to the COVID-19 crisis strongly impacted Cyprus’s public finances in 2020, the fiscal situation is foreseen to improve in 2021 and 2022. In 2020, a government deficit of 5.7% of GDP was reported, following a surplus of 1.5% of GDP in 2019. This strong deterioration is explained by lower general government revenue and higher general government spending. Revenue recorded a drop by around 3% of GDP in 2020, mainly explained by the lower collection of various categories of taxes, in particular VAT. Meanwhile expenditure increased by 4.4% of GDP in 2020, reflecting the introduction of support measures to fight the pandemic and to mitigate the adverse socio-economic effects of the economic downturn. The budgetary impact of the implemented support schemes amounted to 3.6% of GDP in 2020. For the year 2021, additional measures have been legislated with an estimated budgetary impact of 3.4% of GDP. While the government debt-to-GDP ratio increased significantly in 2020 to 118.2% of GDP, it is projected to resume a declining path this year on the back of the recovery of the economy, the running-down of cash reserves that had grown substantially in 2020, and an improved fiscal performance. The fiscal outlook is surrounded by considerable risks, which are mainly on the downside. The main one relates to the future evolution of the COVID-19 pandemic and its adverse effects on the recovery, which may require further fiscal support. The continuity of government’s fiscal policy to counter the crisis is crucial and a premature withdrawal of fiscal measures could negatively affect the economic situation. In addition, contingent liabilities - in particular related to the financial sector - could materialise, with a further adverse fiscal impact. Higher-than-estimated costs related to the recently reformed National Health System could also affect the fiscal outlook in the medium and long run.

Banks made further progress in reducing non-performing loans (NPLs), but important challenges remain in the banking sector. Despite the pandemic, the NPL ratio declined by 10 percentage points throughout 2020 (reaching 17.7% at the end of the year), due to both asset sales and write-offs. Banks are highly liquid and capital buffers remain solid, with some variation across institutions. Nevertheless, the offloading of legacy NPLs and increased provisioning affected profitability, which was already under pressure before the pandemic. About 50% of performing loans benefited from the first loan payment moratorium - representing the highest share in the EU. While early signs were encouraging following the lifting of the 2020 moratorium, the outlook is uncertain with respect to the new inflows of NPLs. Prolonged financial problems for firms and households could pose threats to their debt repayments, and ultimately weaken banks' balance sheets. As such, finalising the organisational structure of the new Department of Insolvency, digitalising its tools and promoting the insolvency proceedings are important measures that should be accelerated. It is also important to preserve the foreclosure framework in order to make further headway with NPL workouts, asset sales and improving payment discipline. Going forward, ESTIA (the government's subsidy scheme for debtors with primary residence collateralised loans) will have a marginal impact on supporting NPL reduction due to its low take-up. Nevertheless, as the scheme served to indicate the presence of strategic defaulters, the authorities are considering complementing ESTIA with a more targeted scheme for the most vulnerable borrowers. KEDIPES, the state-owned vehicle managing the predominantly non-performing assets left from winding down the Cyprus Cooperative Bank, is in the final stages of completing the loan servicer agreement with Altamira, but staffing and data cleansing issues remain to be addressed. Its performance has been held back due to the pandemic: cash inflows declined in 2020 as compared to 2019, but embarked on a recovering path in the final quarter of 2020. The authorities plan the sale of a loan portfolio of around EUR 1 bn and are considering expanding the scope of KEDIPES into a national asset management company. Such an initiative should be carefully considered and have the necessary built-in features to ensure proper asset management on a par with private investor practices to minimise the risk to taxpayers and ensure sound recoveries of assets. The success of this initiative would also crucially depend on a well-functioning insolvency and foreclosure framework. Furthermore, widening the scope of assets managed by KEDIPES may delay the repayment of the state aid granted in the context of the resolution of Cyprus Cooperative Bank in 2018. Progress on merging the insurance and pension fund supervisors is slow, while staffing issues persist.

Cyprus' sovereign financing and capacity to repay remain sound. Throughout 2020, the government built a significant cash buffer in order to secure the necessary firepower to fight the pandemic, support the economy and address possible adverse scenarios. Cyprus' liquidity position is projected to cover the financing needs of this year. Through its bond issuances, Cyprus demonstrated stable market access and favourable financing conditions - supported by the accommodative monetary stance in the euro area. With a zero coupon rate, the most recent international issuance is illustrative (a 5-year bond placement worth EUR 1 bn, which took place in February 2021). Looking forward, gross financing needs are expected to decrease in the next two years. Furthermore, the public debt-ratio is projected to decline amid the economic recovery and as the government plans to use part of the accumulated liquidity to cover upcoming financing needs. Nevertheless, Cyprus and its debt dynamics remain sensitive to the volatility of the macro-financial environment and external developments.

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

1. MACROECONOMIC SITUATION AND OUTLOOK

1.1. MACROECONOMIC DEVELOPMENTS IN 2020 [3]

The pandemic and the accompanying lockdown measures resulted in a sharp real GDP contraction in 2020 (5.1%), albeit less than the EU average (6.1%). Following the severe hit in spring 2020, the economy recovered some ground in the summer months due to the relatively good epidemiological situation in the country. However, the rising infection rate at the end of the year resulted in local lockdowns, which in particular affected the hospitality industry and led to a deceleration of the recovery in output to 1.4% in the fourth quarter compared to the third.

Domestic demand held up relatively well, in contrast to plummeting external demand, notably for tourism. Domestic demand increased by 0.7% in 2020 compared to 2019, helped by policy measures adopted to contain the COVID-19 crisis. Government consumption increased by 13.1% in 2020 due to support measures, higher expenditure for the national health system, as well as a rise in the public sector payroll. Meanwhile, private consumption decreased by 3.9%. Gross fixed capital formation decreased by 2% and excluding ships and aircrafts by around 6%. Construction for both residential and non-residential buildings decreased by 8.2% in 2020. Exports of goods and services saw the deepest fall (12.4%, and 14.2% for exports of services). The tourism sector was severely affected. Arrivals of tourists decreased by 84.1% in 2020 and revenues by 85.4%. Accommodation and food service activities exhibited a historic contraction of 39.1%.

The impact of the pandemic on the labour market has been mitigated by temporary income support measures. Employment decreased by only 0.6% in 2020 and the unemployment rate increased to 7.6%, from 7.1% in 2019. All sectors of economic activity showed an increase in unemployment; however, in the sectors of accommodation, restaurants, trade, art and recreations services and real estate it was particularly high. Temporary measures to protect employment were adopted by the government in 2020, which were partly financed by a loan under SURE (temporary Support to mitigate Unemployment Risks in an Emergency). Their uptake was around 60% among eligible employees and around 50% among eligible self-employed in 2020.

Inflation fell to -1.1% in 2020, driven by lower prices for energy and services. The prices of services decreased mainly as a result of the temporary reduction of the VAT rate for food and accommodation services in the second half of 2020.

The long-standing current account deficit deteriorated further, reflecting the sharp contraction in exports. It stood at 11.9% of GDP in 2020, compared to 6.3% in 2019. Excluding special purpose entities, it stood at 11.4%. The deterioration is mainly attributed to plummeting receipts from travel.

1.2. ECONOMIC OUTLOOK IN 2021 AND 2022

In 2021, a moderate recovery is forecast, with real GDP growth expected to reach 3.1%. The rising infection rate at the end of 2020 led to stricter lockdown measures in Cyprus in the first quarter of 2021, but they affected a smaller share of economic activity than in spring 2020. The retail trade sector reopened in mid-February and the food service sector in mid–March, the latter after a 3-month lockdown. The retail trade and restaurants had to close down again on 26 of April for at least two weeks. Construction activity has so far escaped disruptions from the lockdown measures in 2021. As Member States are still tackling the pandemic and facing further restrictive measures, a durable recovery is expected to take place in the second half of 2021. The deployment of vaccines in the EU has gotten off to a slower start than hoped for. This in conjunction with rising infections due to new variants, negatively affected the demand for tourism for Easter

(3) This report reflects information available and policy developments that have taken place until 14 April 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 spring forecast released on 12 May 2021 (with cut-off date 30 April 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the Cypriot Recovery and Resilience Plan and cannot in any way serve to pre-judge the Commission assessment of the Plan.

holidays and is likely to adversely impact also the summer tourist season.

Domestic demand is expected to be again the main positive contributor to growth. Policy measures adopted to mitigate the impact of the crisis have been extended into 2021, in particular concerning sectors such as tourism. The loan repayment moratorium was extended until June 2021, albeit with stricter criteria and thus significantly less uptake. These measures should continue to support employment and household incomes and help businesses to maintain their capacity. Private consumption shows signs of a moderate rebound as reflected by the increased use of credit cards. However, consumer confidence remained depressed in April 2021 despite the slight improvement. Public consumption is expected to again make a positive contribution to growth, as several support measures to contain the crisis continue and the public sector pay-roll has increased (see Section 2 Public Finances). Investment is expected to recover in 2021 and to return to its pre-crisis level, mainly on the back of construction activity and subsidised interest rate schemes adopted by the government for small and medium enterprises. Construction has so far escaped disruption from the lockdown measures in 2021 and the planned large-scale infrastructure projects continue, including marinas, tourist accommodation, energy efficiency upgrades for buildings and university expansions. Moreover, new lending for housing has picked up since the third quarter of 2020, helped by the mortgage subsidisation scheme adopted by the government for first residences (see section 3 Financial Sector). The forecast for public investment in 2021 reflects increased infrastructure projects and purchase of equipment by the public sector under the Cypriot RRP, which will start gradually to have an impact as of the end of 2021. The abolition of the citizenship-by-investment scheme in November 2020 is expected to gradually reduce demand for high-end residences over the next years.

Tourism is set to only moderately recover in 2021 as the pandemic continues to disrupt air travel. The outlook for the summer season, which is the most important for Cyprus, depends on the deployment of vaccinations in the EU, as well as in the country's main tourist markets, i.e. UK, Israel and Russia. On the supply side, interruptions to airline capacity may also weigh on the sector's recovery. Domestic tourism is expected to have a mitigating impact on the hospitality industry.

In 2022, real GDP is forecast to grow by 3.8% and exceed the 2019 level. This will be mainly on the back of rising domestic demand, including the positive contribution of the RRP, as well as a small positive contribution from net exports.

The labour market is expected to slightly recover in 2021 and 2022. Employment is expected to increase by around 0.6% in 2021 and 1% in 2022. Unemployment will gradually decrease to 7.5% in 2021 and 7.2% in 2022, approaching the 2019-level. Cypriot authorities monitor the need for support measures to ensure that their removal would not impact adversely the labour market, notably in the sectors mostly affected by the pandemic.

Inflation is expected to return to positive territory in 2021. Headline inflation is expected to edge up to 1.7% in 2021 due to significantly higher oil prices. In 2022, it is expected to moderate to 1.1%. Inflation, excluding oil prices, is expected to be 0.8% in 2021 and 1.2% in 2022.

As a result of the slow recovery in tourism, the current account deficit is expected to remain large. It is forecast to slightly improve to 11% of GDP in 2021 and to 8.9% in 2022. The persistent deficit underlines Cyprus' dependence on sustained foreign financing flows. This would further deteriorate the already high net international investment position of (-141% of GDP and excluding special purpose entities -52% of GDP in 2020), which makes the country vulnerable to sudden reversals of financing flows.

Downside risks to the growth outlook are significant due to persisting uncertainty, mainly regarding the course of the pandemic. Further delays in the deployment of vaccinations, increasing transmission of new variants and accompanying lockdown measures, would take a further toll on consumer and business confidence and the economy. In this context, tourism is particularly vulnerable as holiday planning would be further impeded. In addition, the risk of scarring effects from the crisis is still high, especially in the tourism sector. However, the risk seems lower than initially expected, as first indications show that most businesses have started repaying their loans after the lifting of the first moratorium. The coming months are crucial for seeing more clearly the impact of the lifting of the moratorium. Additional NPLs arising from the crisis could adversely impact the financial sector and the flow of credit to the economy (see Section 3 Financial Sector). In addition, the sizeable pre-pandemic private- and public-sector debt levels, as well as delays in key structural reforms, such as the justice system and title deeds, exacerbate these downside risks. The lower than expected take-up of subsidised loans to the business sector could also constitute a drag on growth in the medium term. On the positive side, the swifter-than-expected vaccination campaigns in the EU could be a significant benefit for the tourism sector in Cyprus.

2. PUBLIC FINANCES

2.1. FISCAL PERFORMANCE

Cyprus's public finances have been heavily impacted by the COVID-19 pandemic and the related measures adopted to support the economy in 2020. The headline balance substantially deteriorated in 2020 when a deficit of 5.7% of GDP was recorded, compared to a surplus of 1.5% in 2019. Reduced revenue and increased expenditure explain the worsening of public finances.

The substantial increase in public expenditure reflects mainly the fiscal impact of the measures implemented to address the economic and health effects of the crisis. Public spending increased by 9.8% in 2020 compared to 2019, bringing public spending levels to 46.3% of GDP. Subsidies were the spending category that rose significantly relative to GDP, reaching EUR 578.2 mn (2.8% of GDP) compared to EUR 70.1 mn (0.3% of GDP) in 2019 – boosted by the implementation of support schemes for employees, businesses and self-employed. Social payments also surged in 2020 (by 18.1% y-o-y), bringing their level to 16.9% of GDP, after 13.5% in 2019. This hike is mainly explained by higher compensations paid out by the Health Insurance Organisation (HIO) to private healthcare providers, reflecting the continued roll-out of the National Health System (NHS). The roll-out of the second phase of the NHS reform started in June 2020 with the integration of inpatient care (in hospitals) under the NHS. The sizeable rise in social payments also reflects the introduction of measures related to sickness allowance and special absence leave for parents. Meanwhile, compensation of employees rose more moderately, by 5.8%, reaching 13.8% of GDP in 2020 ([4]). Gross capital formation spending also increased relatively moderately, by 6.5% (to 2.9% of GDP). Public investment was boosted by spending related to natural gas infrastructure, as well as financing for new roads. Other expenditure decreased by around 24.3% (to 3.5% of GDP) ([5]) and interest expenditure by 11.4% (to 2.2% of GDP).

Public revenue decreased considerably in 2020, mostly reflecting the contraction of the economy due to the COVID-19 crisis. During 2020, government revenue registered a drop of around 7%, compared to the year before. This brought public revenue to 40.6% of GDP, compared to 41.2% in 2019. A key driver of this decrease was the negative development of taxes on production and imports (-14.3% y-o-y); bringing indirect tax collection to 13.6% of GDP, compared to 14.9% in 2019. This drop accounted for about half of the total revenue contraction. The plunge of VAT collection (-14.7% y-o-y), took VAT to 8.5% of GDP, after 9.3% in 2019, providing the biggest contribution given its relative size. Other indirect taxes (-25.7% y-o-y) and excise duties on hydrocarbon oils (-35% y-o-y) also contracted sizeably, taking these revenue sources respectively to 1.5% of GDP and 1.3% of GDP, compared to 1.9% for both in the previous year. It is worth recalling that VAT payments were deferred during the first lockdown and the outstanding amount is expected to be paid by the end of April 2021 ([6]). Current taxes on income and wealth registered a decrease of 2.6% (to 10% of GDP), in particular taxes paid by firms (namely corporate income tax revenue) saw a drop of 44.2% and reached 2.4% of GDP (4% of GDP in 2019), and personal income taxes decreased by 9.3% and amounted to 0.8% of GDP. Property income declined by 29.7%, bringing its level to 0.7% of GDP, compared to 1% in 2019 ([7]). Over the same time horizon, social contributions exhibited a slight rise of 1.1%, reaching 11.4% of GDP due to higher health contributions, as the NHS was being rolled out, which more than offset the negative effect from the pandemic.

([4]) This was driven by higher gratuity payments, the continued gradual abolition of wage cuts, increments, increased NHS contributions of the government as an employer (also part of the second phase of the rollout), and adjusted cost of living allowance (COLA).

([5]) This drop can be explained by the amendment of the Income Tax Law as of March 2019, which allows for the conversion of specific Deferred Tax Assets (DTA) into Deferred Tax Credit (DTC).

([6]) Firms were allowed to do a monthly payment of 1/6 of the total amount owed, starting in November 2020 to April 2021.

([7]) This drop may be explained by the non-disbursement of the CBC dividend during 2020 and by the methodological treatment of hydrocarbons signature bonus (incorporated in the accounts of the general government in 2017-2019, but no longer in 2020).

2.2. FISCAL OUTLOOK

The fiscal situation is expected to improve in 2021 and 2022. The anticipated improvement of public finances in 2021-2022 is mainly explained by the gradual phasing out of COVID-19 related support measures and the recovery of the economy. The headline balance is estimated to improve but remain in deficit in 2021 and reach 5.1% of GDP. Government revenue is forecast to increase by 9.1% in 2021 compared to 2020. For the same time horizon public expenditure growth is expected to return to a decreasing path, although increasing by 7.2%. With the recovery continuing in 2022, the deficit is projected to narrow further to 2% of GDP. The debt-to-GDP ratio is estimated to return to a decreasing trajectory, from 118.2% of GDP in 2020 to 112.2% of GDP in 2021 and 106.6% of GDP in 2022. The strong decrease in 2021 is largely due to the drawing down of substantial cash buffers that were accumulated since the beginning of the pandemic.

The budgetary impact of the support measures to mitigate the effects of the pandemic is expected to reach 3.4% of GDP in 2021, and to decrease to 0.2% in 2022. In 2020 the introduced support measures to tackle the effects of the pandemic reached 3.6% of GDP, mainly including wage subsidisation and support schemes for businesses. Following the resurgence of the pandemic over winter and its impact on the economy, additional measures to mitigate the impact of the crisis have been included in the budget approved by the Parliament in January 2021 and a supplementary budget in April. The wage compensation scheme has been extended and the estimated cost is about EUR 260 mn (1.2% of GDP) in 2021. In addition, subsidisation for small businesses and self-employed in order to cover their operating expenses is expected to reach EUR 230 mn (1.1% of GDP) in 2021. An additional amount of EUR 50 mn (0.2% of GDP) was allocated in line with the extension of the lockdown as well as higher health related spending of about EUR 60 mn (0.3% of GDP) mostly for vaccination purposes. Finally, interest rate subsidy schemes for new business and housing loans are expected to amount to EUR 31.3 mn in 2021 and 2022, amounting to around 0.1% of GDP annually (until 2024).

The fiscal outlook is surrounded by uncertainties, in particular related to the pandemic. A more negative evolution of the pandemic than currently assumed would have adverse effects on the recovery, causing public finances to improve more slowly than currently projected or to deteriorate. Corporate tax revenue may decrease when Cyprus or other countries take measures to address aggressive tax planning opportunities, as this could induce some companies to relocate to other jurisdictions ([8]).

Contingent risks relate mostly to the State's exposure to the financial sector and the NHS. The potential realisation of contingent liabilities remains an important risk to public finances, notably those relating to the financial sector. Higher risk of bankruptcies and increasing NPLs due to the pandemic could also imply a higher realisation of explicit contingent liabilities. The establishment of the financial autonomy of the public healthcare providers under the State Health Service Organisation (SHSO) has been impaired by the COVID-19 pandemic. This increases the risk from contingent liabilities for the state during the 5-year transitory period until they have attained full autonomy, during which the state has committed to cover the losses of the public healthcare providers. Furthermore, achieving financial autonomy of the SHSO by the target date set in law (June 2024) is also more challenging due to the COVID-19 pandemic. A 5-year business plan for the SHSO by an external consultant, due in April 2021, should further operationalise the process. The actuarial studies (commissioned from the International Labour Organisation), the first of which is expected by 2022, would allow to better ascertain longer-term sustainability of the HIO. The major risk for the HIO appears to be the potential oversubscription of healthcare services, including through the large number of referrals, leading to higher than currently estimated costs. This is being mitigated by the actions of the authorities, including the HIO, to control costs and the volume of services.

([8]) See Section 4.1.3 of 2020 Country Report for Cyprus, SWD(2020) 512 final.

3. FINANCIAL SECTOR

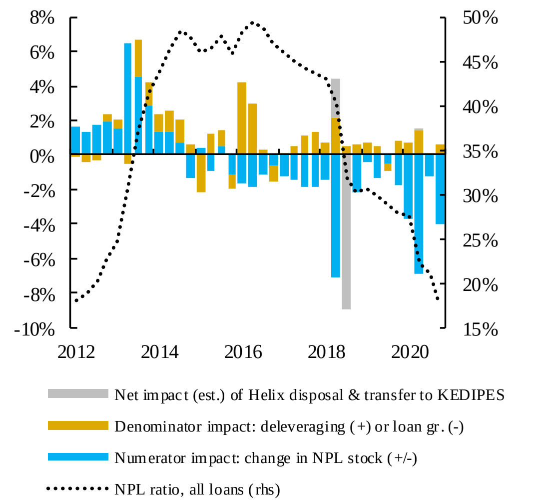
3.1. BANKING SECTOR DEVELOPMENTS

Asset quality

Despite the pandemic, non-performing loans (NPLs) were reduced in 2020, through both sales and write-offs. At the end of December 2020, the total stock of NPLs held by banks stood at EUR 5.1 bn (17.7% of gross loans), down from EUR 9 bn (27.9%) a year earlier (see Graph 3.1) ([9]). The EUR 3.9 bn decline was mainly the result of sales (EUR 2.0 bn) and write-offs (EUR 1.1 bn) ([10]). Bank of Cyprus' sales of two NPL portfolios *(Helix II Portfolios A and B)* lowered the NPL ratio in the sector significantly, but ensuing recognition of losses for the bank acted as a major drag on aggregate profitability. Meanwhile, Hellenic Bank reduced its NPL stock through write-offs. Overall, NPLs declined for both non-financial corporations and households. For the latter segment progress was achieved primarily through write-offs. The remaining stock of NPLs is dominated by terminated accounts, and furthermore, a high share of NPLs (45%), have been in arrears for five years or more, highlighting the need for additional efforts to facilitate asset disposal, notably via an effective foreclosure framework.

The loan moratorium that expired at the end of 2020 resulted in a high level of payment deferrals. The first moratorium scheme was in force until December 2020 and covered EUR 11.7 bn, or 42%, of all loans and advances, the highest uptake in the EU ([11]). All economic sectors participated in these moratoria to some extent, especially the hospitality sector (81% of all performing facilities) as well as construction (88%) and entertainment (90%), but also a large part of professional services (81%). In January 2021, a second loan moratorium was launched, to last until June and subject to considerably stricter eligibility criteria. It is open to borrowers who (i) did not utilise the 2020 moratorium, (ii) have not yet exhausted the maximum duration of nine months, and (iii) fall under three different groups. These are (a) mortgage loans on the primary residence up to EUR 350,000; (b) companies and self-employed persons whose operations are subject to lock-down measures by the Minister of Health; and (c) the hotel industry. The take-up of this scheme has been considerably lower than the previous one, with only EUR 112 mn applications by early March 2021, compared with a total of EUR 11.7 bn approved in the first scheme.

Graph 3.1: NPL ratio (rhs) and breakdown of changes (lhs)



Source: Central Bank of Cyprus

Following the lifting of the loan repayment moratorium, early performance signs have been positive, but more time is needed for a clearer view of the impact of this measure. Even though the first moratorium has already ended, it is not yet clear how many of the loans coming out of the moratorium will go into arrears. Up until end-January 2021, performance indicators were encouraging, with total facilities presenting arrears of about 5%. Nevertheless, not all loans have had due instalments until then, in particular business loans which can have quarterly repayment profiles. Elevated risk is apparent from the increase in the loan portfolio classified as 'exposures with material deterioration of credit quality', since origination (Stage 2 exposures) almost doubled since end-2019, and stood at 17% in December

([9]) The NPL ratios (i.e. ratios of NPL stock to total gross loans) in this report are based on the data and scope used by the Central Bank of Cyprus. In particular, no account is taken of banks' exposures to central banks and credit institutions, or their overseas operations (branches and subsidiaries located abroad).

([10]) Loan repayments were about EUR 470 mn. Cures offset new defaults, resulting in EUR 174 mn net cures.

([11]) The Parliament could not agree on providing a loan guarantees support scheme during 2020, which may explain the high take-up of the moratorium.

2020, the highest percentage observed since 2018, and one of the highest across the EU. The duration of the crisis and the timing for lifting travelling restrictions will determine the damage to households' and companies' capacity to service their debts, and in turn banks' asset quality. The banks' exposures to vulnerable sectors are significant ([12]). An already high level of private indebtedness and a weak payment culture, as well as the difficulties to seize collateral, pose additional risks.

Provisioning continues to be high and may have to increase going forward. The average coverage ratio for the banking sector declined to 46.1% in January 2021, down from 53.3% a year earlier--driven by sales and write offs of NPLs. Most of the new provisions were created in the first half of 2020, to account for the revision of the macroeconomic models under IFRS9. Additional provisions were created in Q4 2020, most likely to anticipate the expiry of loan moratoria. While the aggregate coverage level continues to exceed the EU average, 45.9% in Cyprus vs. 44.9% in the EU at end December 2020 ([13]), this reflects the significantly lower quality of the remaining NPLs. The coverage ratio for Stage 2 loans remains low. A particularly important risk factor is the amount of loans coming out of payment moratoria and their provisioning levels. In line with the Central Bank of Cyprus (CBC) code of conduct, banks have been proactively engaging with borrowers to identify issues and work out possible solutions early on.

Since the beginning of 2021, foreclosure activity has been halted again for most primary residences and small businesses. After the onset of the pandemic, credit institutions and credit acquiring companies voluntarily suspended all foreclosure activities between mid-March 2020 and end-August 2020. Foreclosures resumed in September, but in December an act of parliament suspended foreclosures for primary residences with a value of less than EUR 350,000 as well as primary premises of small businesses ([14]). Ongoing discussions on reforms reversing the foreclosure framework pose risks to NPL resolution and endangers payment discipline (see subsection 3.2. on foreclosure developments).

Profitability, capitalisation and liquidity

The pandemic has further exacerbated the pre-existing profitability challenges faced by the banking sector. Low margins, a high level of NPLs, intense competition and high operating costs have been adversely affecting banks' profitability in recent years.

The sector recorded a pre-tax loss ([15]) of EUR 64.3 mn in 2020, after a profit of EUR 71.5 mn in 2019. Net interest and net fee and commission income were lower, by EUR 49.5 mn, while impairment charges increased by EUR 178.0 mn. The cost-to-income ratio of 60.6% in Q3 2020, a notable improvement from 64.9% a year earlier, is in the mid-range among EU banking systems ([16]). The capacity of Cypriot banks to generate profits continues to be challenged by low interest margins, which declined further to 1.8% in Q3 2020 from 1.9% a year earlier. Overall, the ongoing pandemic is likely to continue weighing on profits in 2021. The risk of new impairments and calls from the authorities to reduce interest rates and fees on new loans to affected borrowers may lower banks' income.

Banks' capital buffers improved slightly, supported by regulatory changes, but maintaining them might not be easy given weaker profitability. According to ECB data, the Common Equity Tier 1 (CET1) capital ratio of the banking sector increased slightly to 17.4% in September 2020 from 16.6% a year before. The strengthening was due to the lower risk-weighted assets, driven mainly from a reduced capital charge to SME exposures (CRR "quick fix"). Balance sheet deleveraging, potential migration of loans into non-performing category (following the moratorium) and weak capacity to generate capital

([12]) The total credit exposures of the banking sector to sectors expected to be heavily impacted by the containment measures (i.e. accommodation and food service, construction, wholesale, retail, transport, storage, arts and recreation) represent around two thirds of total corporate loans and more than twice the available CET1 capital – the highest shares in the EU.

([13]) See EBA Risk Indicators and CBC data.

([14]) This means businesses with less than ten employees and annual turnover not exceeding EUR 2 mn.

([15]) From continuing operations.

([16]) The cost-to-income ratio is artificially lowered by the inclusion of accrued interest income on impaired assets but not the offsetting provisioning charges (which are significant in Cyprus, due to the high NPL ratio).

through profits, may pose difficulty in maintaining the capital ratios going forward. Also, there is some heterogeneity in the sector with some banks operating with thinner capital buffers than others.

The banking system remains highly liquid, thanks to the ample availability of deposits. Total deposits were EUR 571 mn lower at end-January 2021 compared to a year earlier. Deposits have been on a clear and more pronounced downward path during March – July 2020, when NFCs were forced to cover running expenses amidst squeezed revenues and as negative deposit rates reduced the attractiveness of holding bank deposits. This development was partially offset by households, who were not affected by negative rates, and were able to increase their savings. The liquidity coverage ratio is close to 300% (well above the EU average). Therefore, the banking sector continues to have ample liquidity, for which it is difficult to find a profitable use in a context of a pronounced economic slowdown, high private indebtedness and a high stock of bad loans in the economy.

Lending

New lending to the real economy decreased in 2020. The gross volume of new loans (excluding renegotiated loans) to households and non-financial corporations was EUR 2.4 bn in 2020, dwindling from EUR 3.2 bn in 2019. Lending to both households and NFCs declined. The slump was particularly pronounced in the first half of 2020. In the second half total new lending recovered as housing loans increased, supported by the new interest subsidy scheme. In Q3 and Q4 2020, 28% of new loans benefitted from government interest subsidies, including EUR 292 mn in housing loans and at end 2020 EUR 96 mn in business loans. Loan interest rates do not seem to have been affected materially by the pandemic and remained relatively stable in the course of 2020 for both NFCs and households. Going forward, both credit demand and supply may soften in the face of heighted uncertainty and as banks see companies' medium-term profitability prospects as increasingly challenged.

Overview of the largest domestic banks

Bank of Cyprus (BoC), the largest domestic bank, improved its asset quality significantly. The bank improved its asset quality through a number of transactions, but also through an organic reduction of EUR 600 mn of NPLs. After the capital-neutral sale of EUR 133 mn of NPLs (project *Velocity 2*) in May 2020, in June the bank signed an agreement for the sale of Project *Helix II (Portfolio A)*, with a gross book value of EUR 898 mn. Furthermore, in September 2020, BoC signed another agreement for the sale of an additional portfolio of loans with a gross book value of EUR 545 mn, known as Project *Helix II (Portfolio B).* In total, Project *Helix II* (*Portfolio A and B*) combined with the organic decrease, reduced pro-forma the bank's stock of bad loans to EUR 1.8 bn at end 2020, equivalent to a NPL ratio of 16%.

In the first moratorium scheme, BoC offered payment holidays to more than 25,000 customers, with a total amount of EUR 5.9 bn. More than half of the amount, EUR 3.8 bn, was granted to businesses. Among those that had a payment due by mid-February 2021, 94% have resumed payments. Both interest and non-interest income were down compared to 2019. BoC made further progress in reducing operating expenses, including staff costs. BoC recorded a loss after tax of EUR 171 mn (compared with EUR 70 mn loss a year earlier), on the back of provisions and the net loss from NPL sales. The CET1 ratio stood at 12.9% at the end of 2020. On a *pro forma* basis, assuming the legal completion of *Helix II*, the ratio increases to 15.2% (compared to 14.8% at the end of 2019).

Hellenic Bank (HB) reduced its stock of NPLs mainly through write-offs. During 2020, net write-offs of loan impairment losses amounted to EUR 686 mn (2019: EUR 216,8 mn). The Bank was also successful in progressing and signing two other smaller transactions during this period of EUR 50 mn. The NPL ratio stood at 22.1% at end-December 2020, down from 31.4% at the end of 2019, with provisions of 46.9%. Of the gross NPL portfolio of EUR 1.5 bn, EUR 0.4 bn are covered by the government-backed asset protection scheme. The bank is currently preparing to launch a new process aiming to achieve a large scale deleveraging (following the cancelation of *Project Tide* in 2020 due to adverse market conditions).

HB continues to face profitability pressures, with a high cost base and low demand for loans amidst excess liquidity. The cost-to-income ratio rose to 67.9% in 2020 from 66.9% a year earlier, inter alia due to higher administrative costs and lower revenues. Nevertheless, the bank recorded an after tax profit of EUR 50.5 mn in 2020, compared to EUR 108.4 mn in 2019. Liquidity remains high, based on solid, mainly retail deposits, and a loan-to-deposit ratio of 43%, while the net interest margin remains subdued. In response, HB decided to apply negative interest rates (-60 bps) to corporate account balances exceeding EUR 100 000 as of 3 March 2020, which has so far led to only limited deposit outflows. Further rationalisation efforts will be required to contain costs. In the face of these challenges, the bank presented a new strategic plan with ambitious targets. The bank's CET1 capital ratio increased marginally to 20.1%, from 20% at the end of 2019, notwithstanding crisis-related lower capital requirements.

3.2. FOLLOW-UP ON THE 2018 THREE-PILLAR NPL REDUCTION STRATEGY

Foreclosure developments

The future of the foreclosure framework remains uncertain, as proposals for new amendments have been under discussion in the Parliament. The foreclosure framework was strengthened in 2018, but afterwards in 2019 new amendments were brought in, which backtracked on key elements of the previous year's reform ([17]). More recently, new discussions have resurfaced on potential further legislative amendments. The discussions emerged within the negotiations of the revised 2021 budget and several proposals have been submitted to Parliament since. Such proposals are a source of concern as they would increase legal uncertainty, weaken payment discipline even more, obstruct banks' efforts to reduce NPLs and threaten NPL resolution overall.

The authorities are preparing legal changes to the frameworks governing credit-acquiring companies (CACs). The Ministry of Finance in collaboration with the Central Bank of Cyprus, has prepared and submitted to Parliament a package of legislative proposals improving the regulatory framework for servicers and acquirers of credit facilities, by overcoming functional shortcomings when dealing with credit facilities (e.g. no online access to the Land Registry to check collateral values). Furthermore, an amendment of the Evidence Law is currently being discussed in Parliament, to enhance the admissibility of statements of loan accounts presented by credit acquiring companies before Court, in the same manner as credit institutions.

Electronic auctions of foreclosed real estate have seen a moderate increase in Q4 2020. Although potential buyers may not have been able to visit lots due to the lockdown restrictions, online sales saw a slight increase in Q4 2020. A total of 84 successful electronic auctions took place in 2020 and 41 successful auctions followed in the first two months of 2021. The authorities remain confident that more use will be made of electronic auctions going forward as the scope of users and the familiarity with the platform grow, which will be an important step towards the reduction of the NPL stock in Cyprus.

Cyprus Asset Management Company (KEDIPES)

While KEDIPES progressed on the loan servicing agreement, efforts need to be sustained in resolving remaining issues. The renegotiation of the Service Loan Agreement (SLA) with Altamira Cyprus, is well advanced by now (subject to Board approval and assessment of market conformity). The revised proposal entails an overall decline in service fees with a focus on a performance-based structure. KEDIPES expects the SLA to be finalised in spring 2021 and once the agreement is in place, the company will revise its business plan. While the top layer organisational structure has been finalised, KEDIPES continues to be oversized. Improving the quality of data on loans remains to be addressed.

The performance of the asset management company (AMC) has been affected by the crisis. The adverse effects of the pandemic weigh on the speed of recovery and the recoverable value of assets. Cash inflows increased in the second half of 2020, cumulatively reaching EUR 312 mn. Nevertheless, they have decreased by 24% compared to 2019. While the gross book value of the NPL stock declined from EUR 6.4 bn to EUR

([17]) The 2019 amendments were confirmed by the Supreme Court in 2020.

6.1 bn throughout 2020, the overall performance lags behind the planned results from the business plan. The suspension of auctions and foreclosures of real estate in 2020 has had an impact on recoveries. Furthermore, the latest extension of the suspension of foreclosures until end-March 2021 (for primary residences valued up to EUR 350,000 and mortgaged properties owned by small businesses), might affect NPL workouts, including by KEDIPES. As regards ESTIA, the scheme will not achieve its purpose of being a key driver behind NPL reduction in the AMC. The take-up of the scheme has been very low. Complete applications correspond to a total of 2123 accounts amounting to EUR 486 mn (out of which only EUR 151 mn are assessed as approved by EUR 151 mn are assessed as approved by KEDIPES), far below the originally estimated perimeter of EUR 1.3 bn. The 2020 moratorium covered a perimeter of EUR 742 mn or around 11% of the assets under KEDIPES management (corresponding to instalments of EUR 59 mn). The take-up for the second moratorium is negligible.

Going forward, KEDIPES is planning to sell a portfolio predominantly consisting of performing assets and implement a mortgage-to-rent scheme. A sale of up to around EUR 1 bn of loans (*Project Ledra*) is planned to be launched in tranches starting in Q2 2021. Work on a new mortgage-to-rent (MTR) scheme by KEDIPES is ongoing, targeting NPLs backed by a primary residence or prime commercial property worth up to EUR 350,000 and providing a buy-back option. Furthermore, for making further progress with reducing legacy NPLs in the banking system, the authorities are considering expanding the scope of KEDIPES. The initiative would entail KEDIPES to purchase NPLs collateralised by primary residences or primary business premises with a market value of up to EUR 350,000. For working-out these NPLs, a MTR scheme would be implemented. Such initiatives need to be carefully designed and assessed, minimise the fiscal impact, and mitigate risks and concerns for overall payment discipline (including moral hazard and strategic defaulters) ([18]). A stable and properly functioning foreclosure framework is also a key ingredient for ensuring these initiatives perform well.

ESTIA scheme

ESTIA had a low take-up and some of the borrowers who applied were non-viable ([19]). A total of 6,389 applications for the ESTIA scheme were received by the extended deadline of end-July 2020, to an estimated value of around EUR 1.9 bn ([20]). A large share of the submitted applications were incomplete (30%). Furthermore, rejected applications account for more than 60% of completed applications. About half of the rejected applications are due to failure to meet eligibility criteria for income or open market value, indicating the presence of strategic defaulters. Overall, the ESTIA scheme is expected to help address a perimeter of about EUR 170 mn of NPLs only. Therefore, it is not the tool the authorities had envisioned for significantly reducing NPLs in the economy. Although several factors might have contributed to the low take-up of the scheme, a key driver appear to be debtors' reluctance to reveal their net-wealth position, as well as expectations of a more generous scheme or reliance on a less stringent approach to collateral enforcement.

The authorities are considering complementing ESTIA with a more targeted scheme for the most vulnerable households. Around 14% of the completed ESTIA applications were rejected due to the non-viability of the borrower. As such, the authorities are planning to introduce a support scheme with a structure similar to ESTIA targeting the vulnerable borrowers ([21]). It is expected that the new scheme will provide bigger loan haircuts and/or a greater state contribution. Nevertheless, the burden-sharing mechanism (between the state, bank and the borrower) has not been set out yet as

([18]) Furthermore, it should be kept in mind that KEDIPES' task is to return to the taxpayers the fiscal costs arising from the orderly market exit of the Cyprus Cooperative Bank in 2018.

([19]) The ESTIA scheme is designed to provide debt reduction subsidies for eligible borrowers with NPLs backed by primary residences. Under the scheme, the government will pay a subsidy to lower the debt servicing costs, including interest charges, of all eligible performing borrowers by one third.

([20]) In terms of implementation steps: applications could be completed by end July 2020, creditors assessed the applications by end November 2020, while the conclusion of the scheme by the Ministry of Labour and Social Insurance took place by end March 2021.

([21]) The new scheme is expected to target ESTIA applicants who would not become viable even with the subsidy, e.g. very low- or no-income borrowers, such as single parents or older defaulters.

the specific design elements of the new scheme are still under discussion.

3.3. OTHER FINANCIAL SECTOR ISSUES

Insolvency developments

The amendments to transpose into Cypriot law Directive (EU) 2019/1023 on preventive restructuring will take longer than expected. Despite prior reluctance towards postponement, Cyprus informed DG JUST in January 2021 that the authorities will benefit from the prerogative granted by Article 34 of the Directive, which means that the transposition could be delayed for one year (i.e., until 17 July 2022). The transposition was expected to boost the use of examinership (e.g. a process whereby viable debtors are court-protected in order to restructure their debt), which remains considerably scarce. Besides, the Cypriot authorities are considering the implementation of new tools to facilitate out-of-court restructuring. Nevertheless, these initiatives are at a very early stage of discussions, so there is no tentative calendar.

The major overhaul of the Companies Law announced in the previous mission is on hold. The forthcoming parliamentary elections in Cyprus have stalled this initiative, which could simplify the various procedures that co-exist in the legislative framework governing insolvency in Cyprus, enhancing the use and the effectiveness of these tools.

The deployment of the new organisational structure of the Department of Insolvency (DoI) is further delayed. The progress made in the first half of 2020 (when a new law governing the DoI and related matters was adopted) has halted since October. The schemes of services of the personnel of the DoI (voted in March 2021 – several months after the voting was planned) need further endorsement by the Ministry of Finance, whereby the timeline of such approval remains uncertain.

The new insolvency portal may go live in April 2021, but with limited capabilities. The authorities could not provide details of which functions will be available and whether the online eligibility tool would be among the first wave of e-tools to be deployed. The digitalisation of insolvency proceedings should be prioritised. Cyprus has a worrying backlog of cases that seems bound to worsen in the aftermath of the COVID-19 pandemic (when all courts will resume their operations), particularly in the absence of a comprehensive plan to tackle this issue.

Insurance and pension funds

The merger of the supervisors of pension funds and insurance companies has been cumulating delays. The draft legislation on the functioning of the new independent supervisory authority was submitted to Parliament at end-2019. While discussions took place in the House of Parliament it remains unclear when the legislation may be adopted. The forthcoming 2021 elections will likely create further delays. Staff transfers (notably legal impediments to permanent transfer of pension supervisory staff) and funding issues stemming from the social partners' opposition to the fees by the new supervisory authority remain the main problems.

Resolution cases

The liquidations of FBME Bank and Laiki Bank are ongoing. On FBME, the Court decided in 2020 to hear two liquidation applications, one by CBC and one by the Tanzanian liquidator. Objections persist as to whether the appointment and distribution should be made under Tanzanian law (based on the parent bank's location) or Cypriot law, given that FBME operated as a branch in Cyprus. The restricted banking licence of Laiki Bank was revoked by the CBC in September 2020, while applications for its liquidation and the appointment of a liquidator were submitted to the Court in January 2021.

Capital markets

Diversifying the investment and funding possibilities for corporations remains a challenge. The current crisis is posing new challenges, notably regarding the valuation of assets under fund management (in particular real estate holdings) and difficulties to raise capital by newly established funds within the required timeframe. Authorities consider liquidity risks to the operation of funds in Cyprus related to possible higher redemptions requested by funds' investors during the crisis as contained. Most investment funds in Cyprus have followed the recommendation to refrain from dividend pay-outs for 2020. The long-overdue plan for privatising the Cyprus Stock Exchange recently received new impetus, which would be an important step in attracting new listings and providing the market with more liquidity.

4. SOVEREIGN FINANCING AND ABILITY TO REPAY

The Cypriot government tapped international markets in February 2021, issuing a EUR 1 bn bond. The bond has a 5-year maturity and was priced with the lowest reoffer yield (0.053%) and lowest coupon (0%) that has ever been achieved by Cyprus since its return to international capital markets in 2014. According to the Public Debt Management Office, the new benchmark attracted a high quality and diverse set of investors ([22]). The total offer reached EUR 8 bn, a sizeable oversubscription indicative of the prevailing large investor interest. The issuance of this bond enhanced Cyprus's liquidity further.

The Cypriot debt structure and cost continued to develop favourably. The debt maturity profile is well balanced over forthcoming years, not exceeding EUR 2.6 bn of debt redemption related financing needs per year until 2030. In 2020, Cyprus' weighted average cost of outstanding public debt further reduced to 1.8% on the back of a sharp decrease of weighted average cost of new debt at issuance (1.0%). In terms of structure of debt, at the end of 2020, 50% of debt was composed of foreign bonds and 32% of official loans, the rest consisted of domestic and retail securities and T-bills. Concerning the buyers of foreign bonds (EMTNs) upon issuance, over the last years there was a positive shift from hedge funds to fund managers and insurance and pension funds as major investors.

Cyprus has received its second instalment under the EU's SURE instrument in the form of a loan of EUR 229 mn. Under the scheme, the Commission approved in 2020 the provision of EUR 479 mn of funding to Cyprus, with an average maturity of 15 years. This funding is related to increased expenditure for supporting employment during the pandemic. The first disbursement, of EUR 250 mn, took place in November 2020, while the remaining amount of EUR 229 mn, was received in early February 2021. On top of this support, Cyprus is expected to receive an additional top-up of EUR 125 mn, bringing the total SURE envelope to EUR 604 mn.

The government financing needs for 2021 are lower than the previous year. Furthermore, the liquidity buffer remains sizeable. Gross financing needs (GFN) for 2021 are estimated at 14.2% of GDP (excluding T-bills expected to be rolled over) – a level which is lower compared to 2020 (when it reached 16% of GDP on account of the pandemic). In nominal terms GFN are about EUR 3.1 bn, consisting of debt redemption needs of EUR 2.2 bn and fiscal needs of around EUR 0.9 bn ([23]). A key source of financing of this year was through the issuance of the international bond in February 2021. Furthermore, part of the GFN of 2021 will be covered by use of cash reserves ([24]). Overall, the government has plenty of liquidity and is projected to continue to maintain a cash buffer that meets the gross financing needs of the following 9-12 months, as defined in the Medium-Term Debt Management Strategy 2021-2023 (MTDS 2021-2023).

Looking forward, GFN for 2022-2023 are expected to decrease. In 2022, GFN are estimated to be significantly lower than in 2021 (about 10.3% of GDP (excluding T-Bills), while for 2023 they are expected to decrease further, supported by much lower debt redemptions.

Debt repayments of 2021 (estimated at EUR 2.2 bn) consist mainly of domestic securities. The largest redemption of EUR 1.2 bn, took place in April, when the 52-weeks T-Bill reached maturity. The other key debt redemption is the repayment of a EUR 0.6 bn bond held by Hellenic Bank, in December. There are no Euro Medium-Term Note (EMTN) repayments in 2021 ([25]).

Market financing conditions remain favourable for the Cypriot government. ECB monetary policy measures, including the pandemic emergency purchase programme, have helped compress sovereign bond yields and hence average debt servicing costs. Against this backdrop, Cyprus enjoys favourable yields (at around 0.4% in mid-April 2021, broadly back to the levels at the end of 2019, prior to the outbreak of the COVID-19

([22]) With regard to the geographical distribution, 85% of orders came from international investors. Of these participants, most originated from the United Kingdom and Nordic countries.

([23]) The figures for fiscal needs are derived from the Commission's 2021 spring forecast.

([24]) The government built a sizeable cash buffer throughout 2020, in order to secure the necessary firepower to fight the pandemic and support the economy.

([25]) Loan repayments to the ESM are due to start in 2025.

pandemic) and favourable financing conditions, as illustrated by the low borrowing costs of the latest EMTN issuance. Furthermore, major credit rating agencies continue to assign investment grade rating to Cyprus sovereign debt, except for Moody's which maintains its sovereign rating in the sub-investment category.

ANNEX 1
Soundness indicators for the banking sector in Cyprus

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

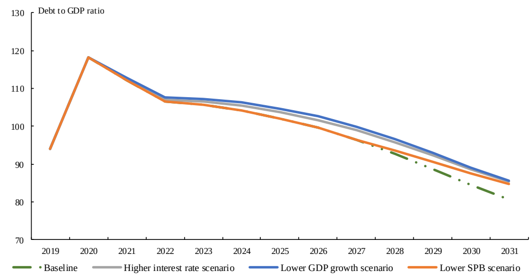
	2016	2017	2018	2019		2020				2021
	Dec	Dec	Dec	June	Dec	Mar	June	Sept	Dec	Jan
NPLs*, all loans (EUR billions)	23.8	20.6	10.3	9.7	9.0	8.9	6.7	6.3	5.1	5.1
NPLs*, all loans (% of total)	47.2	43.7	30.3	29.8	27.9	27.7	22.3	21.1	17.7	17.7
NPLs*, loans to NFCs (% of total)	56.4	50.3	33.2	29.7	24.5	24.2	19.6	18.1	14.5	14.4
Restructured non-performing (% of total)	25.8	22.8	14.4	13.0	10.8	10.7	9.3	8.5	6.4	6.4
Restructured performing (% of total)	9.4	8.6	6.8	6.1	4.5	3.9	3.0	3.4	3.1	3.1
NPLs*, loans to households (% of total)	56.0	53.9	37.6	37.1	35.2	35.1	27.9	26.7	23.7	23.8
Restructured non-performing (% of total)	20.1	19.7	17.1	16.5	15.7	15.4	12.4	11.8	10.4	10.4
Restructured performing (% of total)	7.7	8.3	7.1	5.8	4.8	4.5	4.8	4.7	4.6	4.4
Coverage rate (Impairments / NPLs)*****	40.3	45.9	49.6	51.1	53.5	53.4	52.7	53.1	45.9	46.1
Cost-to-income ratio	52.6	53.6	62.5	62.0	72.3	67.1	61.9	60.6	..	..
Net interest margin	2.6	2.3	1.8	1.9	1.9	2.4	1.9	1.8	..	..
Common Equity Tier 1 ratio	15.9	14.9	15.1	16.3	17.4	16.8	17.1	17.4	..	..
Return on assets (annualised)	-0.3	-1.1	0.2	0.8	0.4	-0.2	-0.2	0.0	..	..

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

ANNEX 2
European Commission Debt Sustainability Analysis

After a sharp surge in 2020 triggered by the pandemic, the government debt-to-GDP ratio is projected to decline over the 10-year projection period ([26]). Whilst Cyprus' government debt was on a declining path prior to the COVID-19 crisis, the debt-to-GDP ratio soared by more than 20 pps. on the back of the pandemic and the necessary measures to protect the economy, reaching 118% of GDP at the end of 2020. This increase reflects additional borrowing to build a significant cash buffer, unfavourable snowball effects driven by the nominal GDP slump, and the large primary deficit. For 2021 and 2022, the debt-to-GDP ratio is forecast to fall to some 112% and 107%, respectively. This reduction is mainly supported by the planned reduction of the cash buffer, the forecast economic recovery, and an improved fiscal performance (as supporting measures taken by the government will progressively unwind). Thereafter, the government debt ratio is projected to continue its downward path and to gradually decline under the baseline, to about 81% of GDP by end of 2031 (see Graph A3.1).

Graph A2.1: **DSA deterministic debt scenarios**



Source: European Commission

The DSA indicates that Cyprus faces medium risks to fiscal sustainability over the medium term. This signal emerges consistently from all key DSA components - the baseline, debt scenarios relevant for the risk classification, and stochastic projections. Under the **baseline,** which assumes an unwinding of the extraordinary toll the COVID-19 crisis took on public finances ([27]), as well as under alternative adverse scenarios, the Cypriot debt-to-GDP ratio peaked in 2020 and is set to follow downward trajectories in the coming years. However, at the end of projections, government debt will remain well above the Treaty's reference value of 60% of GDP in all cases, thus pointing to risks (see Graph A3.1). The **adverse scenarios** illustrate the vulnerability of the government debt path to macroeconomic and fiscal shocks, indicating that the pace of debt reduction could be slower than under the baseline. Specifically, a lower real GDP growth scenario ([28]) or a higher interest rate scenario simulating a permanent deterioration of sovereign financing conditions ([29]) or a lower structural primary balance (SPB) scenario of weaker fiscal improvement ([30]) would all imply somewhat slower debt reduction and correspondingly higher debt ratios, of about 85-86% of GDP by 2031 compared to the baseline of about 81% of GDP (see Graph A3.1). Government debt sensitivity to shocks is also evident in **stochastic projections** based on the historical volatility of the Cypriot economy, which show that debt projections are surrounded by considerable uncertainty (see Graph A3.2) ([31]).

([26]) The debt sustainability analysis (DSA) uses the Commission's spring 2021 forecast (2021-2022) as a starting point to ensure consistency across EU Member States. For more information on the Commission's fiscal sustainability assessment framework, see European Commission (2021), Debt Sustainability Monitor 2020, European Economy Institutional Paper, No. 143.

([27]) The structural primary balance is set to progressively adjust over the projection period, converging back to a level close to its pre-crisis forecasted value (i.e. the level forecasted by the Commission services in the autumn forecast 2019 for the year 2021). Other assumptions are set in line with the Commission standard DSA methodology (see Debt Sustainability Monitor 2020).

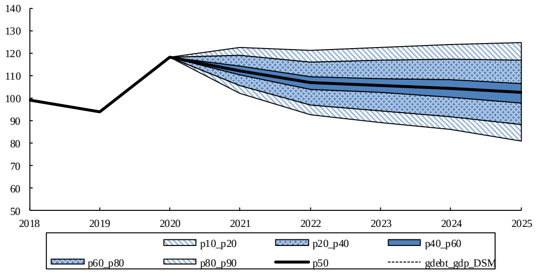
([28]) GDP growth is 0.5 percentage point (pp.) lower compared to the baseline over the entire projection period.

([29]) Market interest rates increase by 1 pp. compared with the baseline over the entire projection period.

([30]) This could be the case if some exceptional measures adopted during the crisis had more permanent impact than assumed in the baseline. In particular, under this stress test, the SPB convergence value is reduced by half compared with the baseline.

([31]) Stochastic debt projections allow assessing the uncertainty surrounding macroeconomic and fiscal projections. Projections have a 5-year projection horizon. Results are based on 80% of all possible debt paths obtained by simulating 2 000 shocks to the primary balance, nominal growth and interest rates (the lower and upper lines delimiting the cone represent respectively the 10th and the 90th distribution percentiles). In the chart, the projected debt path under the baseline (around which shocks apply) is reported as a solid black line at the centre of the cone. The differently shaded areas within the cone represent different portions of the distribution of possible debt paths. The dark blue area (delimited by the 40th and the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline.

Graph A2.2: **Stochastic projections of public debt-to-GDP for 2020-2025**



Source: European Commission

Prudent fiscal policies and growth-enhancing structural reforms are key to contain fiscal risks. The uncertain impact of the pandemic on revenue collection, the potential costs of additional fiscal measures and contingent liabilities linked to the health sector reform and the financial sector constitute additional risk factors. In view of these risks and the high level of debt, continuing with prudent fiscal policies and implementing growth-enhancing structural reforms will help reducing debt vulnerabilities over the medium term.

ANNEX 3

European Commission macroeconomic and fiscal projections (2021 Spring Forecast)

Table A3.1: **Selected economic indicators**

	2016	2017	2018	2019	2020	2021	2022
Real economy			*(percent change)*				
Real GDP	6.4	5.2	5.2	3.1	-5.1	3.1	3.8
Domestic demand incl. inventories	8.4	7.2	2.7	4.9	0.7	2.2	2.0
Private consumption expenditure	5.1	4.9	4.7	1.8	-3.9	1.1	2.3
Government consumption expenditure	-0.9	2.1	3.5	15.1	13.1	4.0	-1.6
Gross fixed capital formation	49.5	21.3	-5.2	2.0	-2.0	3.8	4.8
Exports of goods and services	7.2	9.9	8.0	-0.4	-12.4	5.3	7.6
Imports of goods and services	10.0	12.9	4.5	2.0	-4.2	3.7	4.8
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	9.7	7.4	2.5	3.8	-0.7	2.3	2.1
Foreign trade	-1.7	-1.9	2.6	-1.7	-5.8	0.8	1.7
Changes in inventories	-1.5	-0.3	0.2	1.0	1.4	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	-0.6	1.1	1.2	0.9	-1.5	1.4	1.2
HICP	-1.2	0.7	0.8	0.5	-1.1	1.7	1.1
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	13.0	11.1	8.4	7.1	7.6	7.5	7.2
Employment	4.7	5.4	5.3	3.1	-0.6	0.6	1.0
Compensation per employee	-0.9	1.7	1.3	1.9	-3.2	1.6	1.8
Labour productivity	1.7	-0.2	-0.1	0.0	-4.6	2.5	2.8
Unit labour costs	-2.6	1.9	1.4	1.9	1.5	-0.9	-1.0
Public finance			*(percent of GDP)*				
General government balance	0.3	1.9	-3.5	1.5	-5.7	-5.1	-2.0
Total revenue	37.7	38.7	39.5	41.2	40.6	42.3	41.8
Total expenditure	37.5	36.8	43.1	39.7	46.3	47.4	43.8
General government primary balance	2.9	4.4	-1.2	3.8	-3.5	-3.0	-0.2
Gross debt	103.1	93.5	99.2	94.0	118.2	112.2	106.6
Balance of payments			*(percent of GDP)*				
Current external balance	-4.2	-5.3	-3.9	-6.3	-11.8	-11.0	-8.9
Ext. bal. of goods and services	1.7	-0.4	1.5	-1.1	-6.2	-5.6	-3.8
Exports goods and services	70.5	73.5	75.2	71.9	67.7	67.9	70.7
Imports goods and services	68.8	73.9	73.7	72.9	73.9	73.5	74.5
Memorandum item			*(EUR bn)*				
Nominal GDP	18.9	20.1	21.4	22.3	21.1	22.1	23.1
Memorandum item			*(EUR bn)*				
Nominal GDP	18.9	20.1	21.4	22.3	20.8	21.8	22.9

Source: European Commission

EUROPEAN ECONOMY INSTITUTIONAL PAPERS SERIES

European Economy Institutional Papers series can be accessed and downloaded free of charge from the following address:
https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value[value][year]=All&field_core_tags_tid_i18n=22621.

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