INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/125

CYPRUS

June 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- A **Press Release.**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse-of-time basis, following discussions that ended on March 29, 2021, with the officials Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 30, 2021.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/178

IMF Executive Board Concludes 2021 Article IV Consultation with Cyprus

FOR IMMEDIATE RELEASE

Washington, DC – **June 16, 2021:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Cyprus and endorsed the staff appraisal without a meeting on May 18, 2021.

The COVID-19 pandemic has interrupted Cyprus's strong economic growth over the past few years. At end-April 2021, Cyprus was in the midst a third wave of new COVID-19 infections, leading to a renewed lockdown, and the vaccination rate stood near the European average level. Reflecting strict containment measures and the high dependence on tourism services, the economy contracted by 5.1 percent in 2020 while the current account deficit widened to 11.9 percent GDP. Weaker demand and declining energy prices led inflation to turn negative. To cushion the impact of the crisis, the authorities rapidly introduced a targeted set of fiscal and financial policy support measures. These crisis-related fiscal measures and the adverse macroeconomic developments led the overall general government fiscal balance to swing to a deficit of 5.7 percent of GDP in 2020 and public debt to increase to 119 percent of GDP. These support measures and balance sheet buffers that were built up before the COVID crisis have helped limit loan defaults and job losses, enabling a rapid, albeit uneven, recovery.

GDP is projected to grow by 3 percent in 2021 as the vaccine rollout gathers pace and international tourism gradually recovers. The current account deficit is expected to narrow moderately. While fiscal support measures are being maintained, with the recovery of the economy, fiscal balances are expected to improve, allowing the public debt ratio to start declining from 2021. However, the outlook remains highly uncertain with risks tilted to the downside, due to the high uncertainty of the path of the pandemic and the pace of vaccine rollout.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

In concluding the Article IV consultation with Cyprus, Executive Directors endorsed the staff's appraisal as follows:

Cyprus has managed the COVID-19 pandemic shock relatively well. Swift implementation of containment measures and high testing rates have kept hospitalization and mortality rates at relatively low levels. Despite the economy's dependence on tourism and the high private and public debt levels, wide-spread defaults and high unemployment have largely been avoided so far, thanks in part to timely policy support and balance sheet buffers accumulated before the COVID-19 crisis.

The near-term outlook points to a gradual but uneven recovery, with significant risks on the downside. Growth is projected to recover moderately to 3 percent in 2021 after output fell by 5.1 percent in 2020. However, the pace of the vaccine rollout and potential new waves of infection are key uncertainties. A weakening of the underlying fiscal position leading to increased risk premia and a larger than expected drop in foreign direct investment inflows due to the termination of the Cyprus Investment Program could further dampen the recovery. Given the large economic exposure to tourism and related sectors, risks of wider bankruptcies and loan repayment difficulties leading to permanent scarring are high if policy support is withdrawn prematurely or if the economic recovery, particularly in the tourism sector, lags.

Policy priorities depend crucially on the evolution of the health and economic crises. Near-term policies should focus on mitigating the impact of the crisis and ensuring rapid distribution of vaccines, and the withdrawal of broad support measures should thus be gradual. As recovery takes hold, policies should shift towards achieving sustainable and inclusive growth, with policies aimed at supporting the efficient reallocation of resources to minimize scarring and enhance growth potential.

In the financial sector, extending targeted support measures and effective resolution of the legacy and potential new NPLs by banks, and increasingly by the CACs, will be crucial for supporting new credit and economic recovery. Targeted credit support measures such as interest subsidy schemes for SMEs and guaranteed loans are needed to incentivize banks to supply much needed credit. Support measures should seek to ensure viability of firms, fully utilizing banks' assessments of the creditworthiness of borrowers. Supervisory guidance that encourages banks to flexibly use capital buffers and continue limiting dividend distributions is welcome, as these will help to address potential new NPLs, provide new credit and deal with legacy NPLs.

NPL resolution and sustainable debt workouts remain key priorities. Close monitoring and transparency for assessing and addressing asset quality should be continued. Timely restructuring of viable businesses is key to preserving production capacity. Continued progress with complementary judicial reforms is needed to improve collateral execution and incentives for debt workouts. A reversal of reforms to the foreclosure framework should be avoided, as failure to do so would obstruct ongoing NPL resolution and pose risks for financial stability. As the Estia scheme is approaching its conclusion, banks should consider stepping up foreclosure on NPLs of borrowers who did not apply for the scheme, while the authorities should ensure further burden sharing or consider targeted support measures for applicants deemed unviable. Oversight of the CACS should continue to be strengthened. The current proposed expansion of the public AMC, subject to EC state aid approval, should be carefully assessed with respect to its costs and benefits, and its impact on repayment behavior.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Given the high economic uncertainties, a premature withdrawal of fiscal support should be avoided. With near-term financing risks limited, policies need to cushion the adverse impact of the crisis and mitigate risks of economic scarring. To this end, the fiscal stance in 2021, which includes continued sizeable policy support, is appropriate. Recalibrating fiscal support measures to target viable but vulnerable firms (such as in the tourism sector) would help avoid unnecessary bankruptcies. Measures encouraging equity increases could help address potential solvency problems. Efforts to front-load mature public investment projects and promote private investment through the utilization of the EU's RRF are welcome. Providing transparency and accountability on the use of COVID-19 related spending will be important to build public support.

As the recovery takes hold, the focus should shift to maintaining fiscal sustainability and promoting inclusive, growth-enhancing policies. Efforts should continue to further modernize tax administration, contain the growth of the public wage bill, and reorient spending in a more growth-friendly direction, including by improving human capital, facilitating digitalization, and transitioning to a green economy. Fiscal risks from the NHS should be contained as it embarks on the first year of the full implementation of the NHS reform.

Structural reforms should support resource reallocation and strengthen growth potential. Labor market policies should gradually transition from preserving jobs toward facilitating efficient labor reallocation such as through active labor market policies and public employment services. Improving digital infrastructure and upgrading digital skills will enhance Cyprus's competitiveness. In addition, implementing climate-friendly policies and facilitating the transition to a green economy such as through greater investment in renewable energy and green taxation, would help meet the 2030 emission targets set in the Cyprus National Energy and Climate Plan.

Priority should be given to mitigating the repercussions of the crisis on inequality. The crisis has had a more adverse impact on young people and women. Policies should seek to enhance female labor participation and job search for young people. Any consideration of a national minimum wage should take due account of the potential impact on competitiveness and youth employment. These priorities will be crucial to ensure a more inclusive and sustainable recovery.

Cyprus: Selected Economic Indicators, 2018–2022

				Projections	
	2018	2019	2020	2021	2022
Output/Demand					
Real GDP	5.2	3.1	-5.1	3.0	3.9
Domestic demand	2.6	5.1	0.8	1.2	3.4
Consumption	4.4	4.5	-0.3	1.1	3.6
Private consumption	4.7	1.8	-3.9	0.7	3.2
Public consumption	3.5	15.1	13.1	2.2	4.8
Gross capital formation	-4.5	7.7	5.3	1.5	2.4
Foreign balance 1/	2.5	-1.8	-5.8	1.9	0.3
Exports of goods and services	8.0	-0.4	-12.4	3.8	7.8
Imports of goods and services	4.5	2.0	-4.2	0.9	6.7
Potential GDP growth	2.0	2.1	1.2	2.4	3.3
Output gap (percent of potential GDP)	3.9	4.9	-1.6	-1.1	-0.5
Prices					
HICP (period average, percent)	0.8	0.6	-1.1	0.5	0.8
HICP (end of period, percent)	1.0	0.7	-0.8	0.8	0.8
Employment					
Unemployment rate (EU standard, percent)	8.4	7.1	7.6	7.5	7.0
Employment growth (percent)	5.6	3.9	-1.5	2.0	1.4
Public Finance					
General government balance	-3.5	1.5	-5.7	-4.8	-1.1
Revenue	39.5	41.2	40.9	42.9	44.0
Expenditure	43.0	39.7	46.6	47.6	45.0
Primary Fiscal Balance	-1.1	3.8	-3.6	-2.4	1.2
General government debt	99.2	94.0	119.1	114.0	106.4
Balance of Payments					
Current account balance	-3.9	-6.3	-11.9	-8.1	-6.0
Trade Balance (goods and services)	1.5	-1.1	-6.2	-4.8	-4.3
Nominal GDP (billions of euros)	21.4	22.3	20.8	21.5	22.7
Memorandum Item:					
Underlying primary fiscal balance 2/	6.3	3.8	-3.6	-2.4	1.2

Sources: Statistical Service of the Republic of Cyprus, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth (percentage points).
2/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction and state-owned AMC of 7.4 percent of GDP.

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

April 30, 2021

KEY ISSUES

Economic Context: The COVID-19 pandemic has interrupted Cyprus's strong economic growth over the past few years. High dependence on service sectors and strict containment measures led real output to contract by 5.1 percent (yoy) during 2020. Growth is projected to recover to 3 percent in 2021 as the vaccine rollout gathers pace despite the ongoing new wave of infections, but significant downside risks remain, reflecting the high uncertainty of the path of the epidemic.

Policy Challenges: The authorities have deployed a series of targeted fiscal measures aimed towards job retention, and liquidity and income support, and extended a wide range of financial measures, including a blanket loan repayment moratorium. These measures have helped mitigate the crisis's impact and reduced the immediate risk of widespread default despite high indebtedness in the economy. While banks have increased capital and liquidity buffers, sizable exposure to vulnerable contact-intensive sectors such as tourism and retail, and a high level of legacy nonperforming loans (NPLs), will test their capacity to cope with a possible new wave of borrower distress. And although fiscal buffers have strengthened, high public debt and the potential risk of sovereign credit rating downgrades from investment grade status limit room for fiscal maneuver.

Key Policy Recommendations: Policy priorities will depend crucially on the evolution of the pandemic and the vaccine rollout. The fiscal policy stance, which is underpinned by a sizable policy support package, is appropriate. Fiscal measures should continue to be well-calibrated and targeted, avoiding a premature withdrawal of support while increasing the focus on viable firms to mitigate risks of scarring. Fiscal risks from the National Health System (NHS) should be contained as it transitions to a public health insurance system. Financial sector support measures should be state-contingent, fully utilizing banks' assessments of the creditworthiness of borrowers. Bank supervisors should encourage banks' timely recognition and adequate provisioning of potential loan losses and full utilization of debt resolution tools. The released capital buffers should be used to provide new credit and address potential new NPLs with restructuring solutions.

As the recovery takes hold, policies should aim to facilitate a firm and sustained recovery, by efficiently reallocating resources and enhancing new growth engines such as the digital and green economy, while eventually aiming for a gradually declining debt path to address medium-term risks to debt sustainability that have increased through the pandemic. Labor market policies need to switch from preserving jobs towards facilitating efficient labor reallocation through active labor market policies, while addressing the impact of the crisis on inequality, especially among young people and women. Investment in human capital, digital connectivity, and green infrastructure should be scaled up. Full utilization of the Recovery and Resilience Facility Fund can help facilitate this transformation.

Approved By
Philip Gerson (EUR) and Bjoern Rother (SPR)

Virtual discussions were held during March 8–29, 2021. The mission team comprised Ms. Anita Tuladhar (head), Ms. Estelle Xue Liu and Mr. Ruifeng Zhang (all EUR), Mmes. Ke Wang (SPR), Machiko Narita (MCM), and Amira Rasekh (LEG). Mr. Boyang Sun and Ms. Ritzy Dumo (EUR) supported the mission from headquarters. Messrs. Paul Hilbers and Dries Cools (office of the Executive Director) joined some of the meetings.

CONTENTS

ANNEXES

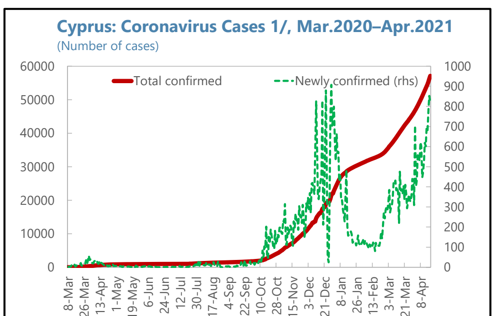
PRE-COVID DEVELOPMENTS: STRONG RECOVERY[1]

1. **The Cypriot economy was undergoing a strong recovery from the 2012–13 financial crisis before the onset of the COVID-19 pandemic.** Real GDP growth, while gradually decelerating, remained strong, supported by the services and construction sectors, and financed by foreign direct investment. The unemployment rate and income inequality declined to close to pre-crisis levels. Underscoring the strong economic recovery, Cyprus repaid early the remaining balance of the outstanding credit to the Fund at end-February 2020 and successfully exited the Fund's Post-Program Monitoring.

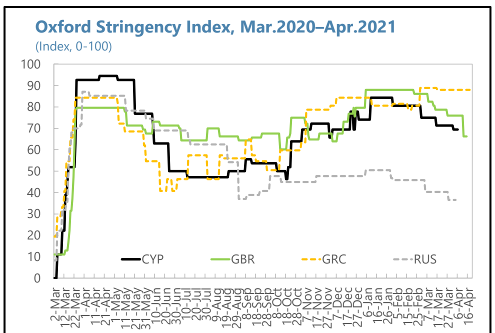
2. **Economic resilience improved considerably in recent years, but legacy issues remain** (Figure 1 and Annex I). Following significant efforts to clean up bank balance sheets through the disposal of distressed assets, capital increases, and public interventions, banks entered the crisis stronger than at the onset of the 2012–13 financial crisis, with reduced nonperforming loans (NPLs), higher provisions and increased capital and liquidity buffers. Fiscal space was being rebuilt as public debt declined, helped by strict spending discipline and large fiscal surpluses. Nevertheless, the economy remains highly leveraged: NPLs on bank balance sheets remain high, hindering profitability and the ability to supply new credit. With workouts of offloaded NPLs ongoing, private indebtedness is among the highest in the euro area. Public debt also remains high while the sovereign debt rating stands at the lowest investment grade, creating risks of losing favorable access to international capital markets.

THE COVID SHOCK: INITIAL IMPACT AND POLICY RESPONSES

3. **Cyprus is in the midst a third wave of new COVID-19 infections.** The government successfully managed the first wave in March 2020 when it swiftly implemented a broad range of strict containment measures, eventually reopening almost all domestic businesses by early summer.



Source: Johns Hopkins University.
1/ Data is as of April 19, 2021.



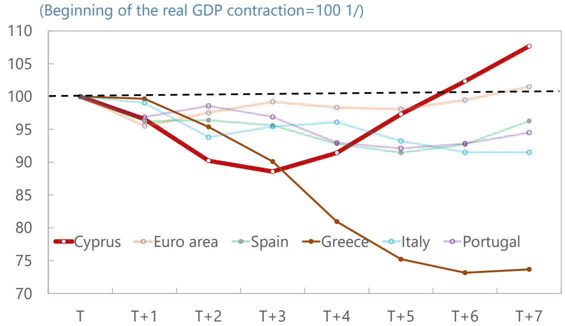
Source: Oxford COVID-19 Government Response Tracker.

[1] This report does not cover areas of Cyprus not under the effective control of the Republic of Cyprus and assumes no change in status quo.

Figure 1. Cyprus: Pre-Covid Economic Conditions

Cyprus recovered from the 2012–13 crisis faster than many regional peers. Nevertheless, crisis legacies remain.

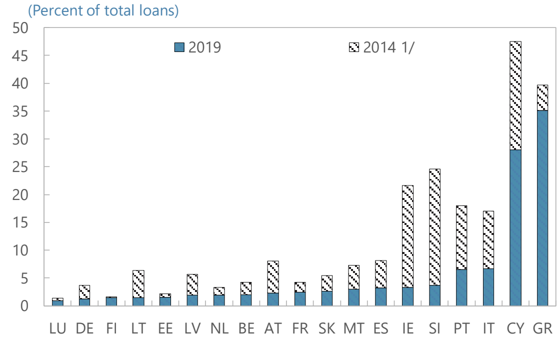
Real GDP Levels: Latest Crises of Selected Countries
(Beginning of the real GDP contraction=100 1/)



Sources: WEO; and IMF staff calculations.
1/ Base years are 2011 for Cyprus; 2007 for Greece, Italy; and 2008 for the rest.

Despite substantial reduction, the NPL ratio in Cyprus is among the highest in the euro area.

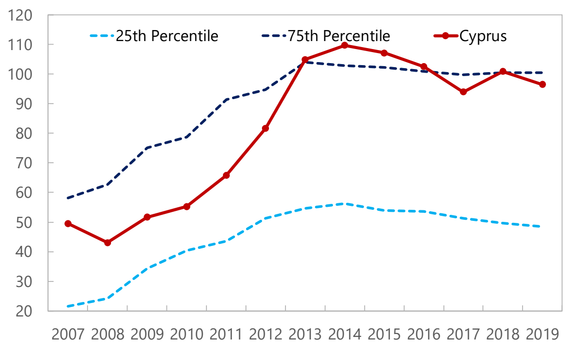
NPL Ratios: 2014 vs 2019
(Percent of total loans)



Sources: Haver, Central Bank of Cyprus and IMF Staff Calculations.
1/ 2015Q1 for Estonia and Malta, 2015Q3 for Slovenia.

Public debt has improved since 2014 but remains high following financial sector interventions.

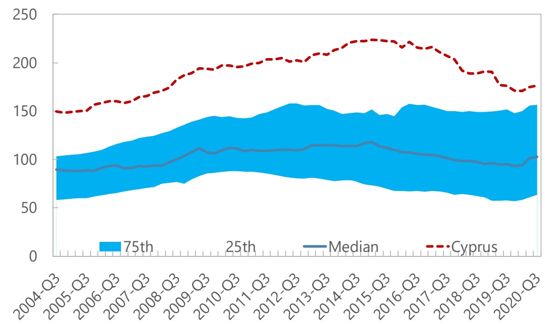
Public Debt: Interquartile of the Euro Area and Cyprus
(Percent of GDP)



Sources: Haver, and IMF staff calculations.

While the economy has been deleveraging, non-financial corporates are highly indebted, …

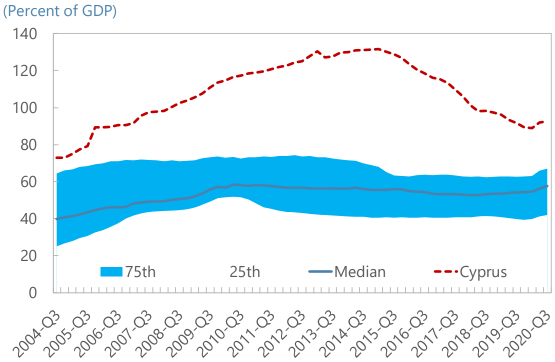
NFCs Debt: Interquartile Range of the Euro Area
(Percent of GDP)



Sources: ECB Statistical Warehouse, and IMF staff calculations.
Note: NFC debt includes debt securities and loans.

…as well as households. Nonetheless, since the 2012–13 crisis, …

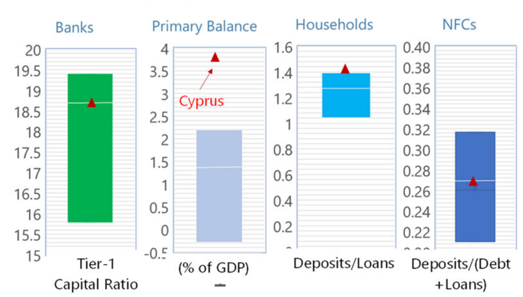
Households Loans: Interquartile Range of the Euro Area
(Percent of GDP)



Sources: ECB Statistical Warehouse, and IMF staff calculations.

…Cyprus has built sizable buffers in the economy which helped it weather the Covid-19 pandemic shock.

Buffers by Economic Sectors at 2019: Cyprus and the Euro Area (Interquartile and Median)



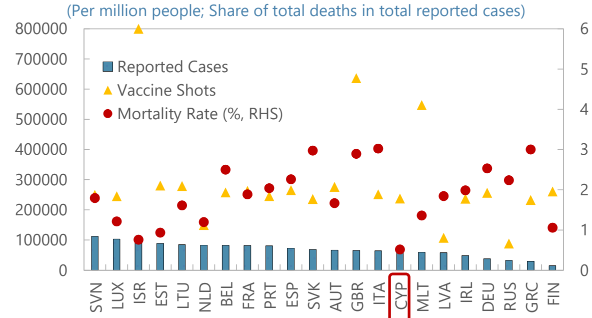
Sources: ECB Statistical Data Warehouse, IMF WEO and IMF staff calculations.

Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; IMF and IMF staff calculations.

With the onset of the second wave in mid-October, localized containment measures were introduced and were incrementally tightened, including a temporary strict lockdown in January. New infections are again picking up, leading to a renewed lockdown and slowing the reopening process. Cyprus's testing rate is relatively high while the pace of vaccination has so far covered around 15 percent of the population, on par with many EU peers. With most of the cases concentrated among the younger population, the hospitalization and mortality rates have been relatively low.

Covid-19 Reported Cases, Vaccine Shots and Mortality Rates 1/

(Per million people; Share of total deaths in total reported cases)



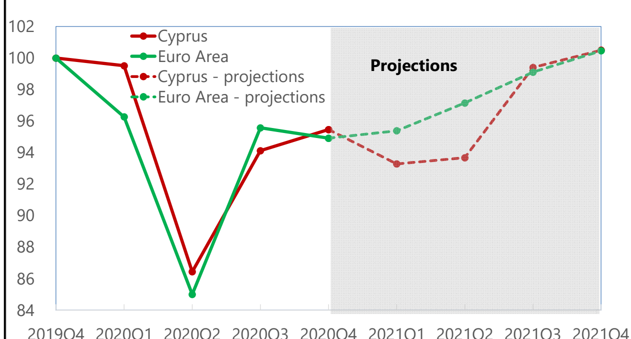
Sources: Bloomberg; and IMF WEO.

1/ Data is as of April 19, 2021. Vaccine shots data for ISR is capped at 800,000 per million people.

4. Reflecting the containment measures and the high dependence on service sectors, the economy contracted substantially by 5.1 percent in 2020, while the recovery has been uneven across sectors (Figure 3). After plummeting by 12.6 percent (yoy, sa) in 2020:Q2, real output rebounded in 2020:Q3 (8.9 percent qoq, sa, -4.7 percent yoy, sa) with the easing of containment measures. Private consumption grew strongly (14.0 percent, qoq) as consumer confidence recovered and domestic tourism substituted trips abroad.[2] GDP grew 1.4 percent (qoq, sa) in 2020:Q4 despite tightening containment measures. Net exports continued to decline following the sudden stop of international tourism since April. High frequency indicators suggested deterioration of economic activities in 2021:Q1, amid reduced real incomes, surging infection rates and new lockdown measures.

Quarterly Real GDP Levels

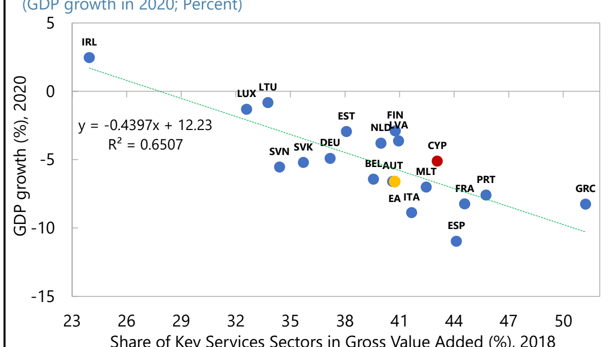
(Seasonally Adjusted, 2019Q4=100)



Sources: Cystat; and IMF staff forecasts.

Share of Key Services Sectors and GDP Growth 1/

(GDP growth in 2020; Percent)



Sources: Haver Analytics; and IMF staff estimates.

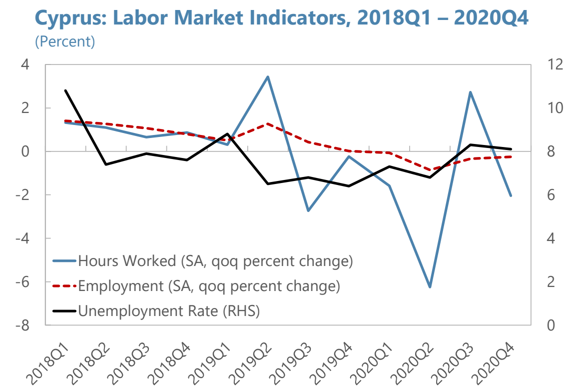
1/ Retail; arts and recreation; public administration, education and social work; accommodation and food services; and real estate activities.

5. The underlying current account deficit widened as external demand for Cypriot services declined (Figure 5). Cyprus's large exposure to the slowing EU and UK markets, as well as its heavy dependence on international tourism, makes it particularly vulnerable to the COVID-19 shock. Adjusted for the effects of special purpose entities (SPEs), the CA deficit widened to 11.6 percent GDP in 2020, compared to 6.8 percent of GDP in 2019. Tourism service receipts

[2] International tourism revenue was 12½ percent of GDP in 2019.

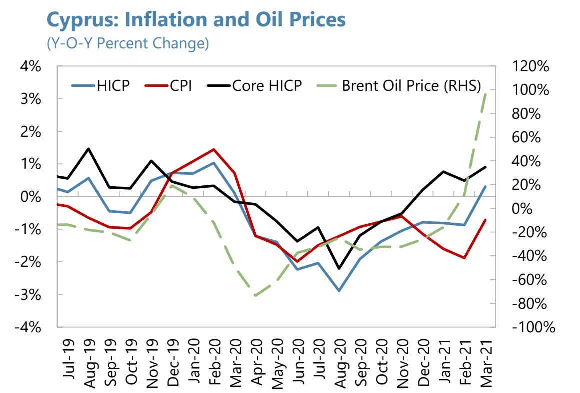
collapsed which more than offset the decline in goods imports and net investment income inflows. FDI inflows also slowed, owing to lower domestic investment activities and the termination of the Cyprus Investment Program (CIP) scheme. Overall, the external position—adjusted for the SPEs and temporary tourism and oil effects—was weaker than the level implied by medium-term fundamentals and desirable policies in 2020 (Annex II. External Sector Assessment and Annex III. Debt Sustainability Assessment).

6. **Despite the unprecedented economic contraction, job losses have been largely contained** (Annex IV). An immediate surge in unemployment was avoided, following the introduction of a job retention scheme providing wage support that helped maintain worker-employer ties. However, working hours and wages were significantly reduced. As the scheme entered its second phase from mid-June with a narrower coverage, the unemployment rate increased, reaching 8.0 percent in 2020:Q4.



Source: Eurostat.

7. **Weaker demand and declining energy prices led inflation to turn negative** (Figure 4). The initial decline in headline inflation until May mainly reflected a steep drop in energy prices. Subsequently, both headline and core inflation declined further, reaching -2.9 percent and -2.2 percent in August, respectively, due to lower prices in restaurants and hotels, VAT cuts, and continued decline in transportation and gas prices. Although the overall price level recovered somewhat since September, inflation stood at around -1 percent since end-2020, among the lowest levels within the euro area.



Source: Statistical Service of Cyprus; and Eurostat.

COVID-Related Fiscal Measures

	2020 % of GDP	2021 % of GDP
Health Sector	0.2	0.6
Support for employment	1.8	1.2
Support for households	0.5	0.1
Support for firms	1.0	1.5
Other support	0.4	0.2
Total:	3.9	3.6
Memorandum:		
VAT deferral	1.5	

Sources: MoF and staff estimates.

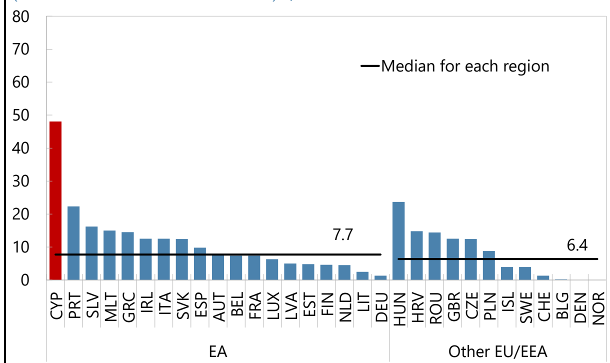
8. **The authorities rapidly deployed a series of fiscal measures while adapting them to mitigate the crisis impact.** Expenditure measures accounted for about 80 percent of the total (3.9 percent of GDP implemented in 2020), mostly directed toward health spending and efforts to preserve jobs through wage subsidy schemes. The government also implemented liquidity support measures such as VAT deferrals, grants to small businesses, and interest subsidy

schemes for new business loans and housing loans, which was partially supported by the EU-wide stimulus package[3]. Following this first phase, in June, measures targeted to the tourism sector were introduced. As the lockdown was tightened, the authorities extended the support measures, including the wage subsidy schemes and unemployment benefits, allowed longer repayment period for the deferred VAT and introduced one-off grants to defray operational costs (Table 1).

9. A wide range of supervisory and regulatory measures has also been taken to avoid widespread default and support credit flows (Table 2). They include temporary capital and liquidity relief and a nine-month loan repayment moratorium from March 2020 for all performing borrowers. The moratorium was subsequently extended by a further six months for targeted borrowers. With around half of previously performing loans under the moratorium in 2020, an immediate surge in NPLs was avoided. Liquidity strain was largely absent due to stable bank deposits. Payment arrears following the end of the 2020 moratorium have been limited so far, partly reflecting a seasonal repayment schedule that means repayments are not yet due for the most affected businesses.[4]

COVID-19 Pandemic-Related Repayment Relief–Usage Rate

(Percent of Total HH and NFC Loans) 1/



Sources: EBA; and IMF staff calculations. Note: 1/ as of end-June 2020.

10. Credit growth has slowed substantially (Figure 6). Euro area monetary easing led to a significant drop in interest rates on new loans. Nevertheless, pure new loans to both non-financial corporates (NFCs) and households have contracted sharply since April. Low credit demand due to limited mobility, reduced refinancing needs, and high private sector indebtedness has contributed to subdued credit growth, while banks have also tightened lending standards to preserve capital ahead of higher provisioning needs for potential waves of default. This decline eased in 2020:H2 as activities resumed and demand for housing loans was boosted by interest subsidies. Nonetheless, credit growth remains among the weakest in the euro area.

[3] The package also includes guarantees on or financing of credit facilities up to €1.7 billion through participation in the Pan-European Guarantee Fund, increased state guarantees to expand existing European Investment Bank (EIB)-supported loans to SMEs, and increased government borrowing from EIB to expand an existing funding scheme for SMEs.

[4] Payment arrears arising from the termination of the moratorium has been moderate in the first two months in 2021 for selected banks, at around 5 percent of loans previously under the moratorium. Furthermore, only a very small proportion of performing loans remain under the new, targeted moratorium in 2021.

Table 1. Cyprus: Summary and Estimated Cost of Fiscal Policy Response to Covid- 19 Pandemic

Measures	2020	Duration
	% of GDP	
Health Sector Support		
Budget allocation to the health care sector to combat the pandemic	0.2	
Support for Employment		
Operation suspension scheme providing wage compensation to the employees of suspended or significantly impacted businesses	1.2	March to June; re-introduced in November
Three schemes providing wage compensation targeted to the tourism sector	0.6	June to October; extended in November
Support for Households		
"Special Absence Leave" for parents when schools/childcare were suspended	0.1	March to June
Subsidized sick leave for individuals in quarantine and vulnerable workers	0.1	March to June
Overseas student allowance covering the costs of students staying overseas	0.1	March to June
Repatriation Scheme covering cost of the accommodation of quarantine	0.05	March to June
Schemes to support the self-employed and unemployed workers	0.2	March to June
Support for Firms		
Subsidy scheme for very small and self-employed enterprises	0.5	April to May
Subsidies not subject to contributions (indirect estimated cost)	0.3	
Additional budget and co-promotional program to support the tourism sector	0.1	
Reduction of the special VAT rate from 9 percent to 5 percent for tourist accommodations and restaurants	0.1	July to December
Special Plans for farmers/ fisheries/animal welfare organizations; media; arts/culture professionals	0.1	
Other Measures		
Suspending the increased NHS contributions for three months	0.2	April to June
Tax credit equivalent to 50 percent of the reduction granted to the amount of rent	0.2	Any three months in 2020
Total:	3.9	

Measures	2021	Duration
	% of GDP	
Health Sector Support		
Budget allocation to the health care sector to combat the pandemic	0.6	
Support for Employment		
Wage compensation to the employees of businesses that are suspended due to the lockdown	1.2	January to June
Support for Households		
Interest subsidy scheme for housing loans to encourage home ownership	0.1	For loans contracted till June 30
Unemployment benefit	0.1	
Support for Firms		
One-off grants to cover operating expenses of companies and self-employed	1.1	One-off grant
Subsidies not subject to contributions (indirect estimated cost)	0.3	
Interest subsidy scheme for New Business Loans	0.1	For loans contracted till June 30
Other Measures		
Reserve for emergency expenditures	0.2	
Total:	3.6	

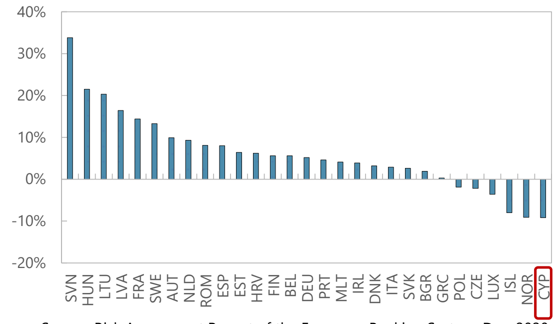
Sources: MoF and staff estimates.

Table 2. Cyprus: Financial Sector Policy Measures During Covid-19 Pandemic

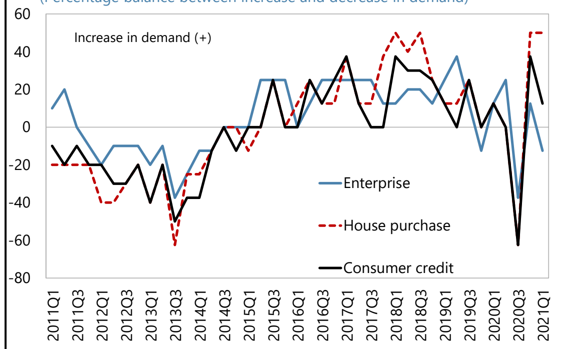
Measures	Application Period
Capital and Liquidity Reliefs	
1. Allow banks to use certain capital buffers (P2G &CCB).	2020-
2. Allow banks to temporarily operate below the minimum liquidity requirements (LCR).	2020-
3. Allow using lower quality own funds to meet Pillar 2 Requirements (P2R).	2020-
4. Delay of phasing- in of Jan. 1 2021 O-SII buffer (0.5percent for banks) by 12 months.	2021
Interest Rate Subsidies	
1. **SME financing** through Cyprus Entrepreneurship Fund (CEF). Co-financing and risk sharing (50 percent-50 percent) between the government and the participating banks.	Pending the signing of the Agreement with the EIF*
2. **New business loans:** for all businesses facing pandemic related difficulties.	June 30, 2021 (pending for approval by the EC* an extension up to December 31, 2021).
3. **New mortgages:** to support households for new home ownership.	up to Dec. 31, 2020
Forbearance: Nine-Month Loan Moratorium	
1. **Public Covid-19 moratorium** available to all customers with arrears of less than 30 days.	April 2020–December 31, 2020
2 **A subsequent moratorium** was issued in January 2021, targeting specific categories of borrowers (secured by primary residence of OMV* less than € 350,000, and SMEs whose operations have been suspended by the lockdown measures, and entities in the hotel industry. Application deadline: January 31, 2021.	January - June, 2021.
3 The moratoria apply to both capital and interest, while interest continues to accrue, with maximum duration of the payment suspension of 9 months.	
4 Not an automatic trigger for increased credit risk, and flexibility is allowed in related provisioning requirements.	
CBC's Relaxation on Criteria for New Loans and Restructuring	
1. **Relaxation from the requirements of the Loan origination Directive** of the CBC to specific existing customers of the banks for new short-term loans/overdrafts for a certain amount.	Until March 31, 2021
2. A recommendation to banks to **assess borrowers who have applied for the suspension of payments** and in cooperation with the borrowers, to reach, without undue delays, a **viable restructuring solution**, should such a need arise. In such restructuring plans, any charges/fees should be kept at reasonable levels and be fully justifiable.	
Restriction of Dividend Distributions, Bonus Pay-Outs and Share Buy-Backs	Until September, 2021
1. Credit institutions are recommended to refrain from distributing cash dividends or conducting share buy-backs, or to limit such distribution.	
2. Insurance and re-insurance companies, and Cyprus Investment Firms are recommended to refrain from underlying pay-outs.	
Supervisory Flexibility	2020-
1. The 2020 stress tests is postponed.	
2. Adjusted timetables, including rescheduling on-site inspections, extending deadlines for certain non-critical supervisory measures and data requests.	
2. Adjusted SREP process, recovery planning, digital operational resilience, and ICT risks.	
3. Leeway for banks concerning the submission of supervisory reporting data.	

Sources: ECB, CBC and EBA.

* EIF stands for European Investment Fund. EC stands for European Commission. OMV stands for open market value.



Source: Risk Assessment Report of the European Banking System, Dec. 2020.
1/ Including cash balance at the Central Bank.



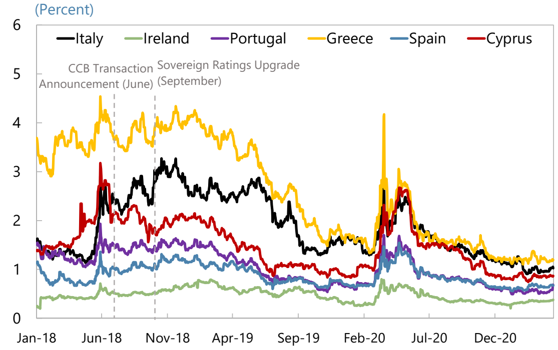
Sources: CBC; and Eurostat.

11. The crisis-related fiscal measures and the adverse macroeconomic developments worsened the fiscal balance significantly (Figure 9). Total revenue declined by 7.1 percent in 2020. Social contributions were stable because the National Health System (NHS) rate increases from June more than offset the adverse condition of the labor market. Nominal expenditure increased by 9.8 percent due to the crisis-related spending and the implementation of the second phase of NHS. The overall balance swung to -5.7 percent of GDP in 2020, compared with a surplus of 1.5 percent of GDP in 2019. Public debt also jumped from 94 percent of GDP in 2019 to 119 percent of GDP in 2020. Nonetheless, risks to refinancing of sovereign debt appear limited in the near term since Cyprus has successfully issued Eurobonds and started accessing EC's Support to Mitigate Unemployment Risks in an Emergency (SURE) funds[5] to pre-finance anticipated needs, building up a large cash buffer (DSA Annex III). Bond spreads have narrowed from their earlier spikes in 2020:Q2 back to 2019 levels.

Fiscal Developments, 2019–20
(in millions of euros)

	2019	2020	Percentage Change
Total Revenue	**9,176**	**8,524**	-7.1
Current revenue	9,086	8,410	-7.4
Indirect taxes	3,329	2,872	-13.7
Direct taxes	2,156	2,100	-2.6
Social security contributions	2,378	2,404	1.1
Capital revenue	90	114	26.9
Total Expenditure	**8,850**	**9,717**	9.8
Current expenditure	7,853	8,954	14.0
Goods and services	984	908	-7.7
Subsidies	70	578	724.8
Social transfer	3,007	3,552	18.1
Capital expenditure	**997**	**763**	-23.4
Overall Balance	**326**	**-1,193**	
(In percent of GDP)	**1.5**	**-5.7**	

Sources: Cystat and MoF.



Source: Bloomberg Finance L.P.

[5] In 2020, the government issued 5–30 year bonds with the total amount of 4.5 billion euros at yields ranging from 0.35 percent to 2.34 percent for pre-financing and debt management operations. Cyprus has already received as a loan amounts to 479 million euros under SURE. Cyprus received the first disbursement of 250 million euros in 2020 and the second disbursement of 229 million euros in 2021. ECB's net purchase of Cyprus's sovereign bonds under PEPP and PSPP amounted to €1.71 billion through end-January 2021 and €3.43 billion through end-February 2021, respectively.

ECONOMIC OUTLOOK AND RISKS

12. Staff's baseline projections assume a gradual and uneven recovery with persistent economic scarring. An effective vaccine and/or treatments are assumed to be widely distributed in Cyprus and other EU countries from mid-2021. Before mass vaccination is completed, renewed waves of contagion along with bouts of local lockdowns will continue to drag on economic growth, with a larger negative impact on contact-intensive sectors, such as retail, accommodation, food services, and entertainment. These sectors will continue to be impacted by a slower recovery of international tourism, which is not expected to return to pre-crisis levels until 2024.[6] At the same time, the economy has shown its resilience already in the aftermath of the 2012–13 crisis, when growth recovered relatively quickly even as credit growth remained subdued. Moreover, widespread defaults are expected to be avoided helped by continued policy support, while banks' capital buffers would absorb expected near-term losses. Without adequate policy support, emerging bankruptcies and destruction of jobs will leave long-term scars on the economy, weakening growth potential.

13. In the near term, staff projects output to rebound moderately to 3 percent in 2021. Economic activities are expected to deteriorate in 2021:Q1 as the second wave of contagion and new lockdown measures reduce consumption, albeit more mildly than in 2020:Q2 given behavioral adaptations and less restricted mobility. The economy is expected to partially bounce back in 2021, supported by private consumption and catchup of capital accumulation that have both seen a stronger-than-initially expected rebound already in the second half of 2020. External demand is projected to remain subdued reflecting low tourism receipts while goods deficits would widen due to increasing investment-related imports financed by the EU Recovery and Resilience Facility (RRF).[7] The current account deficit is projected to narrow to 8.1 percent in 2021.

14. Over the medium term, the projected gradual growth recovery is expected to leave permanent output losses relative to the pre-crisis trajectory (Box 1 and Annex IV). Real GDP is expected to return to its pre-crisis level by 2022 but to remain 5.4 percent below the pre-crisis projected level by 2025. The outlook will depend crucially on the recovery in tourism and related SMEs, especially as fiscal support policies are phased out. Furthermore, the termination of the Cyprus Investment Program (CIP) scheme is expected to permanently reduce the growth contribution of the construction and real estate sector.[8] Private debt deleveraging and NPL

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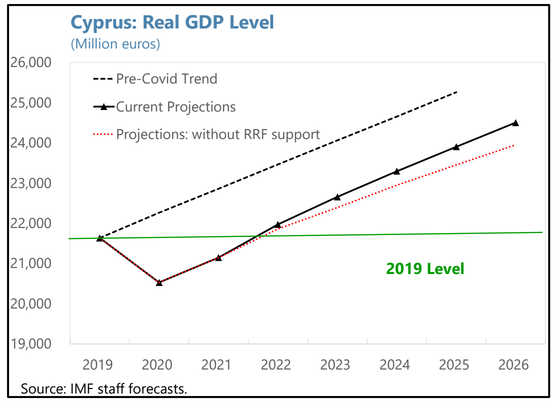
[6] Staff assume that international tourist revenues will recover to around 30 percent of the 2019 level in 2021, and further rebound to 70 and 90 percent in 2022 and 2023, respectively, before returning to the 2019 level in 2024.

[7] Staff estimates that Cyprus's receipt of grants from the EU Recovery and Resilience Facility (RRF) amounts to €1 billion (about 5 percent of 2020 GDP). Staff assumes that the implementation of the funds will be spread between 2021–26 with peak spending in 2023 when more than half of the allocation would be absorbed. Most of the funds will be used on capital spending and to finance new projects. The growth impact is estimated at 0.5 percent on average annually over 2022–26.

[8] The Cyprus Investment Program (CIP) was implemented in 2013 and terminated in November 2020. The program was designed to encourage foreign direct investment and attract high-income individuals in Cyprus. Investments in real estate sector accounted for more than 60 percent of all investments made through CIP during the period

(continued)

provisioning needs will also lower bank profitability and prospects for rapid credit growth. Nevertheless, Cyprus's economic resilience, as seen in its strong pre-crisis growth momentum, and availability of large policy support including from the EU's RRF, are expected to mitigate the adverse impact of the crisis avoiding widespread bankruptcies and facilitate faster reallocation into new economic sectors, raising growth to 2.5 percent over the medium term.



15. Uncertainty around the outlook is very high, and risks continue to tilt towards the downside (Annex V. Risk Assessment Matrix).

- **On the upside,** faster than expected distribution of vaccines could result in an earlier reopening of borders and normalization of economic activities, leading to a faster recovery of tourism and stronger economic rebound.

- **On the downside,** new waves of contagion or the slower than expected distribution of the vaccine could worsen the economic outlook as lockdown measures resume. Spillover effects could include a sharp fall in expected tourist arrivals and reduced FDI. Higher than expected credit default rates by the highly indebted firms, in the absence of additional policy support, could erode bank capital and disrupt domestic credit supply, reducing investment and employment. Realization of contingent liabilities from the banking system, including from the Asset Protection Scheme, higher-than-expected cost of the newly introduced National Health System or higher wage bill growth could also weaken the underlying fiscal position and increase risk premiums. A larger-than-expected drop in FDI inflows as well as domestic real estate and construction activities, due to the termination of CIP, could further dampen growth recovery. In staff's stylized downside scenario, slower than expected application of the vaccine could result in a near-zero growth recovery in 2021.

Authorities' Views

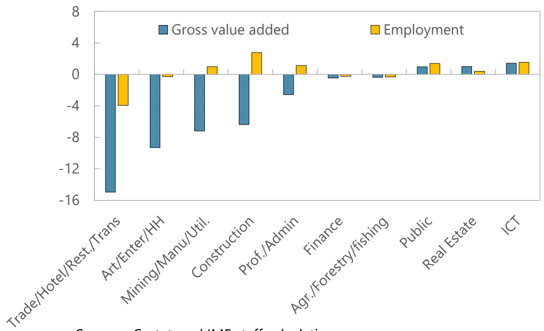
16. The authorities broadly agreed with staff's growth outlook and sources of risks. While acknowledging the uncertainties, they considered that tourism could recover faster in 2021, particularly given the recovery in UK and other European countries. They agreed that risks are on the downside and support measures should be continued in the near term. From 2022 onwards, growth will be supported by RRF funded projects, rather than through additional fiscal measures. To this end, funding from the RRF should be used efficiently and promptly.

2013– 2019, and the second largest investment category was business investment. The CIP made positive contribution to GDP growth and employment through construction sector investments, and helped provide new financing sources. Regarding real estate prices, the CIP had a more pronounced impact on the prices of apartments in Limassol.

Box 1. Sectoral Impact of the COVID-19 Pandemic

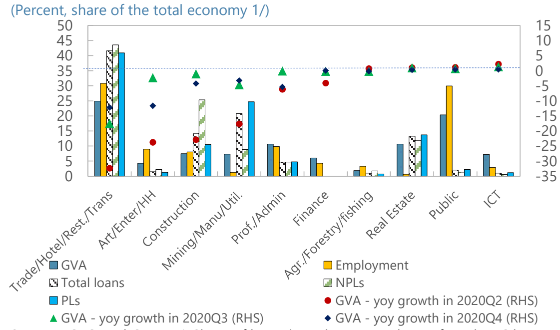
The impact of the pandemic has varied by business sectors. Reduced mobility and a standstill in international tourism continue to take a heavy toll on contact-intensive and tourism-dependent sectors such as wholesale and retail trade, restaurants, transportation. Together, they contributed 25 percent of the gross value added (GVA) and 31 percent of total employment. Meanwhile, the manufacturing, mining, utility and the construction sectors, which account for 14.8 and 9.2 percent of GVA and employment, respectively, rebounded quickly in the third quarter as the lockdown measures were eased.

Impact of Covid-19 Pandemic Economic Sectors, 2020
(Y-O-Y Percent Change)



Sources: Cystat; and IMF staff calculations.

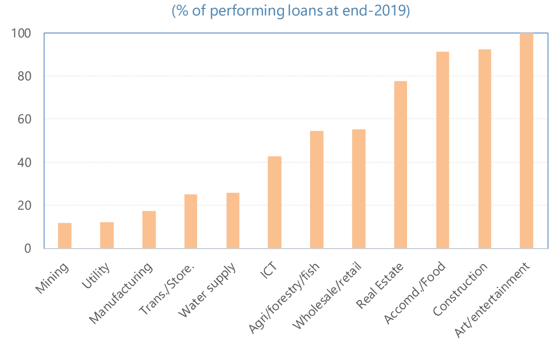
Economic Impact of Covid by Sectors vs Economic Contribution by Sectors
(Percent, share of the total economy 1/)



Sources: CBC; and Cystat. 1/Share of loans is each sector's share of total NFC loans.

Although corporates have been resilient since the pandemic, underlying stress is building up. Corporates have reduced leverage, accumulated higher deposits, and avoided wide-spread defaults owing to sizable policy support measures. The high take-up rate of the public loan repayment moratorium and employment support, however, underscores substantial underlying stress with potential widespread business closures and defaults once these support measures end. The sectors with the largest contractions, comprising mostly SMEs in trade, hotels, restaurants and transport are also the largest borrowers increasing risks of bankruptcies and macrofinancial feedback loop.[1/] If the crisis continues and policy support unwinds, accumulated distress in these sectors could engender permanent losses in employment and production capacity.

Gross Carrying Amount of Loans Under Moratorium: Cyprus
(% of performing loans at end-2019)



Sources: Central Bank of Cyprus, and IMF staff calculations.

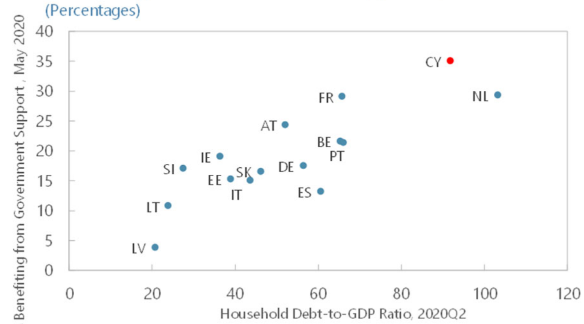
The degree of long-term scarring crucially hinges on the success of preserving capacity, facilitating reallocation of resources and rebuilding the growth model. With tourism-related sectors expected to remain below pre-COVID levels for a few years and the construction and real estate sectors being negatively impacted by the termination of the CIP sheme, the development of new growth engines is crucial (Annex VII). In recent years, the government has started to pivot towards new emerging sectors such as education, ICT and shipping while non-tourism service sectors have also seen strong growth of exports. Nevertheless, the development of the new economy is not expected to replace the lost output, given the larger economic contributions of the declining sectors. However, a smoother and faster reallocation of labor and investment resources among sectors will increase growth potential and reduce the scarring.

1/ See "Corporate Liquidity and Solvency in Europe During the COVID-19 Pandemic: The Role of Policies", Chapter 3 of the October 2020 Regional Economic Outlook for Europe, which estimates higher solvency gaps in these sectors based on simulations of firm level data in 13 Euro area countries.

POLICY ISSUES FOR DISCUSSION

17. Policy priorities will depend crucially on the evolution of the health and economic crises. In the near term, policies should focus on mitigating the impact of the crisis and risks to macro-financial stability. Withdrawal of support measures should be gradual and largely demand-driven to avoid cliff effects, especially given the significant cushioning impact these measures have had against the underlying vulnerabilities. In the medium-term as the recovery takes hold, policies should aim to facilitate a firm and sustained recovery, by avoiding unnecessary bankruptcies and efficiently reallocating resources, in order to minimize scarring and enhance growth potential.

Household Debt-to-GDP Ratio and the Share of Jobs Benefiting from Government Support 1/
(Percentages)

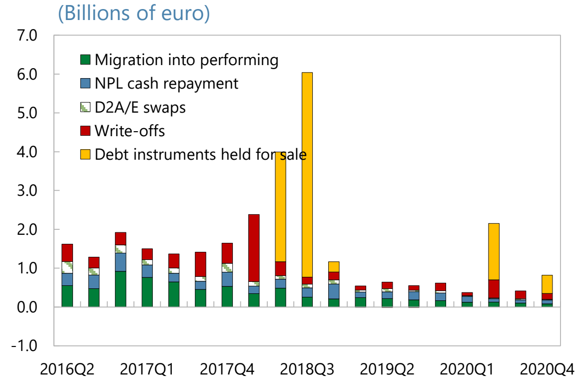


Source: ECB Financial Stability Review, November 2020.
1/ The latest available data points from April were used for Cyprus and Italy.

A. Financial Sector Policies: Address NPLs to Strengthen Bank Balance Sheets and Support Credit Growth

18. Banks have so far been resilient to the pandemic shock (Figure 7). Liquidity remains abundant and capital ratios (with Tier1 capital at nearly 19 percent) have been stable. Bank profits narrowed due to increased impairment costs, while declining net interest income is mostly offset by consolidation of bank operations. Large NPL portfolio sales[9] and sizable write-offs helped NPLs decline to 17.7 percent at December 2020 from 27.9 percent in February 2020. Provision coverage of NPLs declined to 46.3 percent, near the euro area average.

Cyprus: Outflows from NPLs
(Billions of euro)

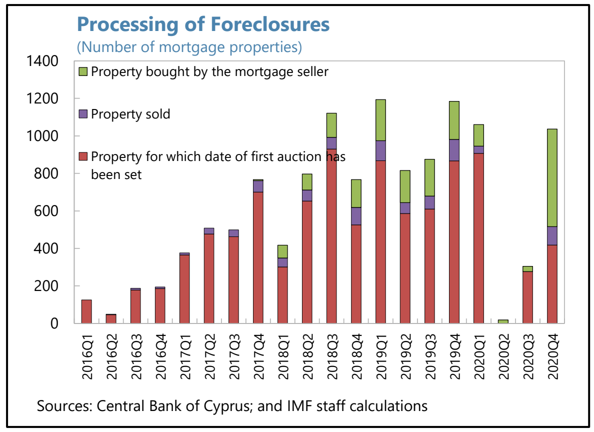


Sources: Central Bank of Cyprus; and IMF staff calculations.

19. Nevertheless, challenges are building. Nearly half of legacy NPLs were terminated five years earlier, potentially requiring sizable write-downs (Annex VI). Foreclosures have been suspended until end-July for smaller, collateralized loans and proposals under discussion in Parliament are expected to weaken the framework (¶22, third bullet). More than 80 percent of bank loans are to highly leveraged households and SMEs, concentrated in sectors like accommodation, food and retail, implying a high risk of an escalation of default rates and lower recovery value of

[9] The largest NPL sales were the Bank of Cyprus' Helix II transactions of €1.3 billion.

assets after the expiry of loan repayment and foreclosure moratorium (Box 1). Banks are also exposed to property market risks through real estate holdings and collateral valuation. Although regulatory forbearance and fiscal support have prevented an immediate surge in loan impairments, a new wave of defaults as loan repayment obligations resume amidst tapering fiscal support could quickly consume the capital buffers of banks. Based on a stylized scenario with a 10 percent increase[10] in NPLs that would push the latter to some 19.5 percent of total loans from the current 17.7 percent, staff estimates that restoring capital and provisions to pre-pandemic levels would entail capital needs of 1.5 percent of GDP.



20. Extensions of existing measures on a targeted basis would help avoid cliff effects. An extension of debt repayment forbearance targeting individuals and business sectors that are most at risk is welcome. Existing interest subsidy schemes targeting SMEs should continue in order to support new lending to these firms. Fiscal measures such as loan guarantees could further incentivize banks to supply credit. The formulation of additional support measures should be state-contingent, fully utilizing banks' assessments of the creditworthiness of borrowers.

21. Macroprudential buffers should be used flexibly to support restructuring and banks' capacity to supply credit. The released capital buffers (i.e., the capital conservation buffer and Pillar 2 guidance) can help support banks' ability to address potential new non-performing exposures with suitable restructuring measures (Annex VIII) by expanding their capacity to absorb losses.[11] In this context, bank supervisors need to encourage banks' timely recognition of potential loan losses with updated risk assessments of the loan portfolio and maintaining of adequate provisions against potential loan losses. The buffers will also continue helping banks provide new credit and deal with legacy NPLs, while maintaining financial stability. Dividend distribution and share buybacks should also continue to be limited to preserve the buffers.

22. Appropriate NPL strategies are also crucial to ensure timely bank balance sheet repair and debt workouts.

- **Monitoring and transparency.** The repayment moratorium masks the borrowers' underlying repayment capacity and risks under-provisioning of impaired loans. Priorities should thus focus

[10] The scenario would provide space for an increase in NPLs especially in the sector of accommodation and food services, which would be most vulnerable to continued weakness in the economic environment. Total loans under the public moratorium in this sector accounted for nearly 30 percent (or about EUR 1.8 billion) of the total NPLs at end-September 2020. Staff believes that the calibration of this scenario is plausible given the fiscal policy support and banks' liquidity levels.

[11] See "Special Series on Financial Policies to Respond to COVID-19: Main Operational Aspects for Macroprudential Policy Relaxation."

on assessing and addressing the impact of the crisis on asset quality and challenges arising from the removal of temporary government and supervisory support measures. Under supervisory guidance, banks have stepped up efforts to scrutinize the risks and make provisions to ensure timely recognition of losses. Data reporting requirements should continue to be updated to support enhanced supervisory monitoring, which should include information on loan restructuring to prevent potential evergreening.

- **Examinership and restructuring tools** (Annex VIII). The current crisis has heightened the urgency of having appropriate tools enabling the timely restructuring of viable businesses and avoiding unnecessary insolvencies. To date, the use of the examinership procedure has been limited, partially reflecting the complexity of the process, lack of culture/incentives for debtors to seek help early on, unavailability of necessary financial information, and limited capacity of the courts. The ongoing transposition of the EU Directive on Preventive Restructuring and Second Chance provides a good opportunity to address issues posing obstacles to the use of the process. In this context, consideration could be given to introducing an out-of-court or hybrid restructuring procedure with the view of reducing complexity, cost and duration for viable debtors seeking to restructure their debts.

- **Foreclosure framework.** An effective foreclosure framework is critical to address strategic defaults and provide incentives for borrowers to enter restructuring negotiations or avail themselves of insolvency tools. Current proposals under discussion in Parliament risk reducing the threat of foreclosures and create uncertainties by weakening prospects for collateral recovery necessitating additional provisions and capital increases. It is important that any uncertainties arising from the implementation of the 2019 amendments of the Foreclosure Law be addressed.

- **Estia scheme[12].** The take-up rate on this state subsidy scheme for restructuring and repayment of NPLs collateralized by primary residences has been below expectations, likely reflecting strategic default behavior. Banks should consider stepping up foreclosure on NPLs collateralized by primary residences if the borrowers did not apply for the subsidy scheme. For applicants deemed unviable, the authorities should ensure further burden-sharing or consider targeted support measures to protect living conditions of the vulnerable borrowers. Any scheme should consider the fiscal and implementation costs, as well as moral hazard implications.

- **Asset Management Company (AMC) and Credit Acquiring Companies (CACs).** As CACs, including the public AMC, currently hold nearly two-thirds of the nation's NPLs, their oversight should continue to be strengthened. Further improvements of the working environment for CACs, including their access to the land registry database, is crucial for effective NPL workouts.

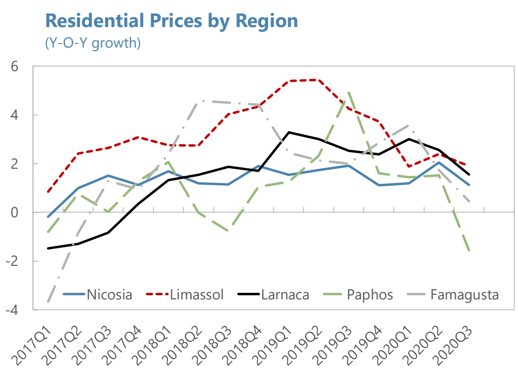
[12] Under the scheme, the government covers one-third of the eligible borrowers' total monthly installments at the end of each year, over the next 10–25 years, subject to the borrower continuing to pay their installments. Banks will also take a haircut upto the level of market price of underlying collateral. The authorities estimated that NPLs worth about €2 billion (10 percent of GDP) would benefit from the scheme. As of March 5, 2021, NPLs of €165 million were approved, of which 40 percent were with CACs.

Subject to the EC's state aid approval, the authorities are currently considering an expansion of the public AMC. The authorities should carefully assess the costs and benefits of such a move, including direct and contingent fiscal costs as well as implications for repayment behavior.[13] It will be crucial to ensure that safeguards are in place to identify and address willful defaults and non-cooperative borrowers as part of the legal enforcement framework. While the governance and operational frameworks of the public AMC are nearly complete, if the public AMC should expand, it will be even more important to ensure its transparency and sound governance to maximize the recovery of the transferred assets.

23. Macro-financial risks from possible declines in property prices should be closely monitored, especially given the continued active use of debt-to-asset swaps in NPL resolution by banks and CACs. Risks appear limited for now given stable residential price developments (Text Figure 5 and Figure 8) and limited size of commercial real estate transactions. To ensure proper collateral valuation, results of actual sales transactions of repossessed collateral properties should be used by banks and CACs to review adequacy of valuation methodologies of these assets. Supervisory guidance to prevent excessive holding of repossessed collateral assets by banks should be maintained.

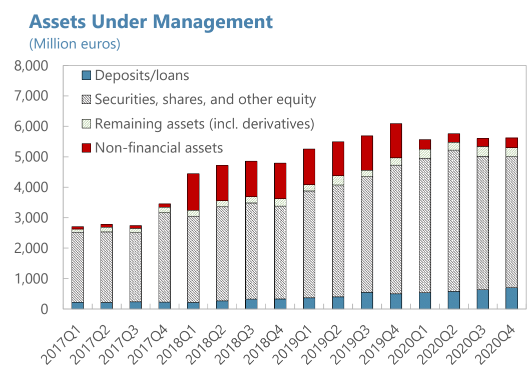
Figure 2. Cyprus: Property Market Developments

Residencial prices have generally continued to rise despite declining sales to non-residents.



Sources: Central Bank of Cyprus, and IMF staff calculations.

Real estate holding by investment funds increased in 2018, but has been stable since then.



Sources: CySEC; and IMF staff calculations.

Authorities' Views

24. The authorities broadly agreed with the key priorities under the NPL strategy. Under supervisory guidance, banks have stepped up efforts to scrutinize loan portfolios under the moratorium and provision accordingly. Work has been ongoing to strengthen the implementation of the insolvency framework. The authorities noted that an out-of-court mechanism, while helpful,

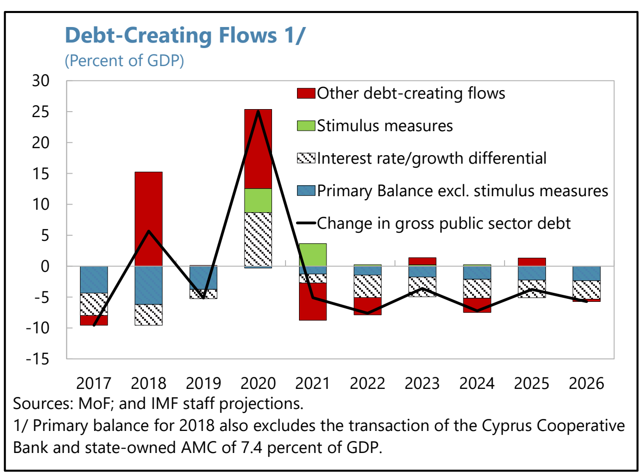
[13] Please see Dobler, Moretti, and Piris (2020) and "Special Series on Financial Policies to Respond to COVID-19: Unwinding COVID-19 Policy Interventions for Banking Systems" (forthcoming).

should not be used to freeze or delay existing legal processes. They recognized the risks of a reversal of reforms to the foreclosure framework for financial stability and are seeking to mitigate damages ahead of the May parliamentary election. Regarding the expansion of the public AMC, they considered that this measure, if properly structured, could help deal with a socially sensitive portfolio and create buffers for banks to deal with potential new NPLs. Fiscal costs will be carefully assessed to limit direct budgetary resource needs and the policy measure will be designed to avoid undermining the payment culture. A sound governance of the public AMC will be crucial for its handling of the expanded portfolio.

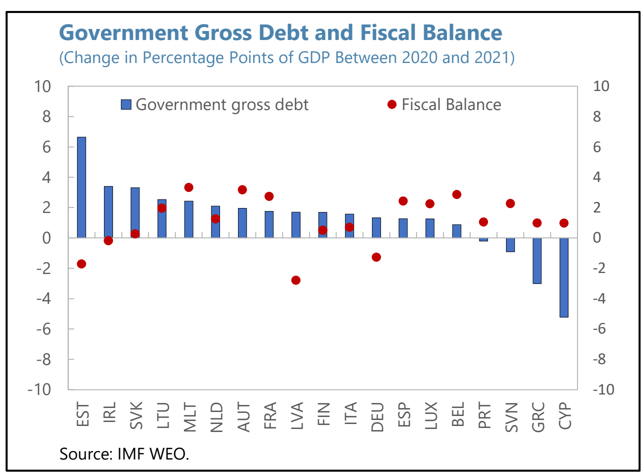
25. The authorities welcomed staff recommendations for additional targeted support. They have agreed on a proposal for providing state guarantees for enterprises that have been affected by the crisis, pending state-aid approval. The scheme, which should target primarily SMEs, would allow participation of banks to conduct eligibility assessments without government interference. While agreeing on the need for equity-type financing, they noted limited options for non-bank financing in Cyprus and underscored the importance of proper incentives to develop new forms of financing.

B. Fiscal Policies: Mitigate Crisis Impact and Maintain Debt Sustainability

26. The 2021 budget envisages continued policy support and a small improvement in the fiscal balance reflecting the economic recovery. Full implementation of the National Health System (NHS, ¶31) will also be underway. Although financing remains ample, the authorities are carefully balancing the need to cushion the impact of the crisis through targeted and time-bound measures while ensuring market access on favorable terms. Key risks arise from higher-than-expected transfers under the NHS and contingent liabilities from weak asset quality in the financial sector. Staff estimates the primary deficit to decline to 2.4 percent of GDP in 2021, compared to 3.6 percent of GDP in 2020. The fiscal balance is expected to improve considerably in 2022, supported by the rebounding of economic activity and expected phase-out of most crisis-related measures.[14] Sustaining this deficit reduction trend through the medium term to achieve a primary



Sources: MoF; and IMF staff projections.
1/ Primary balance for 2018 also excludes the transaction of the Cyprus Cooperative Bank and state-owned AMC of 7.4 percent of GDP.



Source: IMF WEO.

[14] Notwithstanding this improvement, RRF-funded grants and new loan guarantees are expected to continue providing fiscal policy support.

surplus of 1.9 percent of GDP by 2024 would anchor fiscal policies to meet the medium-term budgetary objective[15] and gradually reduce the public debt-to-GDP ratio to around 96 percent, largely reversing the build-up that occurred under the impact of the pandemic.

27. The near-term fiscal stance should continue to focus on fighting the health crisis and contain the adverse economic impact of the crisis. The 2021 revised budget includes additional resources for the health sector, extends targeted support, and provides new one-time fiscal measures, in order to alleviate the economic hardship of impacted firms and vulnerable groups. With the size of COVID-related measures expected to be similar to 2020, the fiscal stance in 2021 remains appropriate. The support measures should not be withdrawn prematurely, in order to mitigate risks of economic scarring. Given the high uncertainties related to the evolution of the pandemic, contingency measures should be formulated to cope with an adverse scenario and provide further support, including by fully utilizing the EU financing under the Next Generation EU Funds and temporary Support to Mitigate Unemployment Risks in an Emergency (SURE, €479 million in total). Although the debt level is elevated and risks to debt sustainability have increased, extremely low financing costs—which are expected to persist—will provide considerable cushion for some time. Hence, the risks associated with a premature tightening of fiscal policy that could derail an incipient recovery outweigh those arising from a modestly delayed tightening that results in a marginally higher debt ratio.

Cyprus: Fiscal Targets 2019–26

	2019	2020	2021	2022	2023	2024	2025	2026
	Act.	Act.			Proj.			
	(Percent of GDP, unless otherwise noted)							
Stability Programme 2021–2024								
Total revenue	41.2	40.9	42.9	42.0	41.3	41.3	...	...
Total expenditure	39.7	46.6	47.6	42.8	41.2	39.7	...	...
Overall balance	1.5	-5.7	-4.7	-0.9	0.1	1.6	...	...
Primary balance	3.8	-3.6	-2.7	0.9	1.5	2.8	...	...
Gross public debt	94.0	119.1	111.9	103.9	99.5	92.9	...	...
Staff Projections								
Total revenue	41.2	40.9	42.9	44.0	44.2	44.1	44.0	43.6
Total expenditure	39.7	46.6	47.6	45.0	44.6	44.0	43.4	42.8
Overall balance	1.5	-5.7	-4.8	-1.1	-0.4	0.1	0.6	0.8
Primary balance	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
Gross public debt	94.0	119.1	114.0	106.4	102.8	95.6	91.8	86.1
	(Percent of potential GDP, unless otherwise noted)							
Primary balance	3.9	-3.5	-2.3	1.2	1.5	1.9	2.3	2.4
Revenue	43.2	40.2	42.4	43.8	44.1	44.1	44.0	43.6
Cyclically-adjusted tax revenue	35.3	35.4	36.6	37.4	37.6	37.9	37.9	37.8
Cyclical tax revenue	1.7	-0.6	-0.4	-0.2	-0.1	0.0	0.0	0.0
Other revenue	6.2	5.4	6.1	6.5	6.6	6.2	6.1	5.8
Primary expenditure	39.2	43.7	44.7	42.5	42.6	42.2	41.7	41.3
Cyclically-adjusted primary balance	2.2	-2.9	-2.0	1.4	1.7	1.9	2.2	2.4
Structural primary balance	2.2	-3.1	-2.1	1.4	1.7	1.9	2.2	2.4
Structural primary balance excluding Covid-related measures	2.2	0.7	1.5	1.5	1.8	2.1	2.2	2.4
Output gap	4.9	-1.6	-1.1	-0.5	-0.3	-0.1	0.0	0.0

Sources: Cystat, MoF and staff estimates.

[15] According to the national balanced budget rule, the general government structural fiscal balance is balanced or in surplus in the medium term.

28. Well-calibrated and targeted fiscal support is needed to pave the way for a firm and sustained recovery going forward (Annexes IV, VII and VIII). Recalibrating fiscal support measures and improving their targeting to viable firms (for e.g., in the tourism sector) will help maintain capacity and limit economic scarring. Policies should also help facilitate restructuring and avoid unnecessary bankruptcies of viable firms. Increasing reliance on guaranteed/subsidized lending relying on viability assessments by banks would help with targeting while supporting credit flows. Measures to incentivize private equity injections or capital increases of firms, including by providing tax credits, could help address potential solvency problems. Well-designed state recapitalization measures for larger or strategic companies could also be considered. The measures should provide incentives to stimulate demand but also should connect to longer term policy objectives, including improving human capital, facilitating digitalization, and transition to a green economy. In this context, the authorities rightly aim to front-load mature public investment projects and promote private investment through the utilization of the EU's RRF and InvestEU.

29. When a firm recovery is underway, policy focus should gradually shift to maintaining fiscal sustainability and promoting a more growth-enhancing policy direction. To this end, the authorities need to both mobilize revenues and improve the composition of expenditure.

On the revenue side:

- *Continue the efforts to modernize tax administration and strengthen tax collection.* This includes enactment of a new tax procedure code and a new IT system to support tax administration. Increased use of new digital technologies could enhance transparency and compliance, simplify procedures, and reduce the burden on taxpayers.
- *Consider new revenue sources*, including reinstating the immovable property tax and increasing excises on alcohol, tobacco, and other unhealthy food, while providing mitigating measures on the most vulnerable households. Increasing fuel excise and introducing a gradually increasing carbon tax would also help meet the 2030 emission target.[16]

On the expenditure side:

- *Control the growth of the public sector wage bill.* The wage bill remains high by international standards, and the authorities should strengthen the civil services reform and gradually lower the share of wage bill in total spending.
- *Reorient to more growth-friendly and inclusive spending.* The authorities should speed up its work on identifying and implementing specific investment projects based on the prioritized areas under the RRF. More spending should also be directed to R&D and active labor market policies to facilitate efficient reallocation of resources and post-crisis recovery. Support

[16] It is estimated that a carbon tax of $35 will generate revenue of 0.7 percent of GDP for Cyprus by 2030 and a carbon tax of $75 will generate revenue of 1.3 percent of GDP by 2030. See IMF policy paper:" *Fiscal Policies for Paris Climate Strategies—From Principle to Practice*."

measures should seek to mitigate potential rise in inequality by targeting the groups most affected by the pandemic such as the young and women (¶33–36).

- *Local government (LG) reforms*: Implementation of LG legislation could enhance fiscal transparency and accountability and improve service delivery.

30. To maintain transparency and build public support, Cyprus should establish platforms to provide clear and timely information on the use of COVID-19 related spending. Transparent criteria for determining beneficiaries and actions eligible for support need to be set up front, enforced, and clearly communicated. It is particularly important that oversight bodies actively provide ongoing analysis and monitoring of COVID programs by undertaking ex-post assessments of program effectiveness and investigating potential abuse. In addition, there should be transparency about the distribution of relief funds and loans, including publishing beneficial ownership information of recipients and using open public procurement processes. Ex-post controls should also be done such as selective audit of procurement contracts once the crisis abates.

31. Containing the fiscal risks from the National Health System (NHS) is a key challenge as it embarks on the first year of full implementation of the NHS reform. Health contribution revenue is estimated to be lower-than-budgeted by 14 percent due to the temporary suspension of increases in contribution rates and the negative impact of the pandemic, while the public hospitals (SHSO) lost non-COVID patients, reducing their revenues. The health fund (HIO) has coped with the revenue loss by temporarily reducing payments to healthcare providers and delaying the implementation of the second phase of (In-patient) services. In the longer-term, the financial performance and efficiency of SHSO and rising healthcare demand pose challenges to the budget (text table). The NHS includes several mechanisms to ensure its financial sustainability, including the global budget, referral system, bulk purchasing of goods and supplies, and periodic reviews of contribution rates. Measures to improve the efficiency and enhance the competitiveness of the SHSO during the five-year transition period is key to contain the pressure on the budget going forward. To deal with the expected rise of healthcare demand, which stems from the increased health coverage of the reform and population ageing, the authorities need to contain prices for essential medicines and healthcare services and review the service coverage.

Authorities' Views

32. The authorities agreed on the key policy priorities. In the near term, they considered that the current support measures should provide sufficient support before the expected recovery in the tourism sector mid-year. Given the vaccine rollout, an adverse scenario is less likely, but they emphasized that regular support schemes for the tourism sector are in place if needed. In addition to a new loan guarantee scheme, they are also open to other support instruments targeted to viable firms, including solvency support for strategic firms, provided sufficient safeguards against fiscal risks are in place. They remain committed to contain the growth of the public sector wage bill. They also recognized the fiscal risks from the NHS and agreed that more measures should be undertaken to enhance the competitiveness and achieve the financial autonomy of the SHSO. They are finalizing, under the RRF, plans to increase spending to enhance human capital, encourage private sector R&D,

and facilitate the transition to digital and green economies. The government is also working on a green tax reform and will review the options of green taxation in a holistic way. The authorities agreed on the importance of transparency of fiscal spending and will publish the COVID-19 related spending. Institutional processes through Internal Supervision, the Auditor General and European guidelines are in place to assess COVID-19 related measures.

Impact of the NHS on the General Government Fiscal Balance

NHS effects (percent of GDP)	2019 1/	2020 2/	2021	2022
Revenue	**1.7**	**2.7**	**3.2**	**3.2**
Social security contributions 3/	1.4	2.3	2.8	2.8
Other revenue 3/	0.4	0.4	0.4	0.4
Expenditure	**1.3**	**4.0**	**5.5**	**5.7**
Compensation	0.2	0.5	0.5	0.5
Intermediate consumption 3/	0.2	0.5	0.6	0.6
Social transfer	0.9	2.9	4.3	4.6
Other expenditure 4/	0.0	0.1	0.1	0.1
Balance	**0.5**	**-1.3**	**-2.3**	**-2.5**

Sources: MoF and staff estimates.

1/ 2019 revenue reflects the collection of contributions starting from March 2019. 2019 expenditure reflects the implementation of phase I services from June 2019.

2/ 2020 revenue reflects the increases of contribution rates starting from March 2020 and the 3-month suspension of the increases from April to June. 2020 expenditure reflects the implementation of phase II services starting from June 2020.

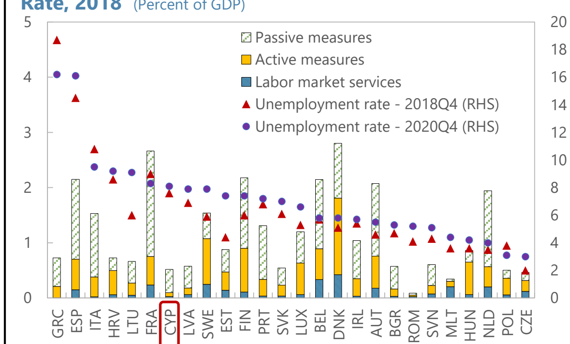
3/ Excludes government contributions as the third party and grants and payments from the HIO to SHSO.

4/ Excludes expected investments to upgrade SHSO infrastructure during the transition period.

C. Structural Policies: Support Resource Allocation, Strengthen Growth Potential, and Ensure Inclusive Growth

33. In order to strengthen growth potential, it will be crucial for labor market policies to support the post-COVID economic adjustment (Annex IV). Cyprus's labor market is relatively flexible but the ability to reallocate resources will depend crucially on the ability to address skills gap.[17] Policies will need to transition from preserving jobs towards facilitating efficient labor reallocation. Specifically, active labor market policies, such as retraining and public employment services, should be further boosted

Expenditure on Labor Market Policies and Unemployment Rate, 2018 (Percent of GDP)



Source: European Commission.

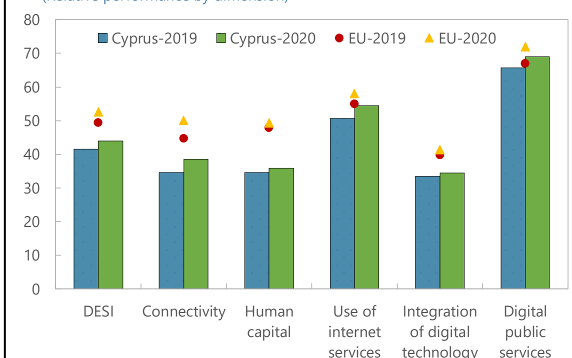
[17] Based on CEDEFOP's European Skills Index 2020, Cyprus ranks 28th out of 31 countries. This ranking is attributed to low performance in skills development, particularly in vocational educational and training, recent training, and reading math and science scores.

given that spending on training and direct job creation in Cyprus has been among the lowest in the European Union. Education spending could be conducted more efficiently to enhance the quality of education and labor market outcomes. Updating relevant curricula and enhancing training to teachers would help close the mismatch between education and the labor market. The changing landscape of work opportunities will require greater investment in reskilling and upskilling to become more employable with digital skills or vocational skills for a green economy.

34. Priority should be given to mitigate the repercussions of the crisis on inequality to ensure a more inclusive recovery (Figure 10). The distributional impact of the job losses has been uneven, with more adverse impact on young people and women. The share of youth not in employment, education or training remains high. Policies should seek to enhance female labor participation by improving childcare and flexible working arrangements. For young people, policies should aim towards job search assistance, incentives for part-time work, and payroll subsidies for newly-hired staff. Any consideration of a national minimum wage should keep in view the impact on competitiveness and the work opportunities for the youth.

35. The pandemic is accelerating the transformation to a digital economy. The recently established Deputy Ministry of Research, Innovation and Digital Policy (DMRID) has played a pivotal role in accelerating the use of digital products by providing various digital platforms, including for the payment of government support packages and text message alert for mobility monitoring. Efforts to build the digital government, upgrade the digital infrastructure and boost the digital economy are crucial.[18] The RRF funds should be fully utilized to advance the digital agenda, including on human capital development (¶33) and connectivity where Cyprus is lagging European peers.

Digital Economy and Society Index (DESI), 2019–2020
(Relative performance by dimension)



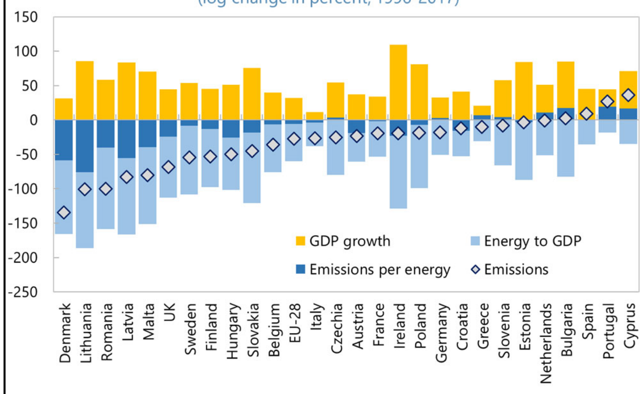
Source: European Commission.

36. The recovery package provides an opportunity to expedite the adoption of climate-friendly policies and close green investment gaps. In its National Energy and Climate Plan (NECP), Cyprus has set concrete objectives for 2030 to reduce greenhouse gas emissions, increase the share of Renewable Energy Sources (RES) in energy consumption, and improve energy efficiency (Text table). Policy priorities focus particularly in the areas of renewable energy, promoting natural gas, technological research, and major investment in energy and transport infrastructures. More investments are needed to improve electricity network to support renewable energy penetration and promote energy saving projects, including energy-efficient renovation of buildings. Given Cyprus's high car ownership ratio and high dependence on road transportation, a feebate system could be considered and investment in green infrastructure and public transportation could also be scaled up to facilitate the use of green vehicles and increase the use of public transportation system.

[18] See 2019 Article IV Report, Box 1. "Digitization and Technology Adoption in Cyprus".

GHG Emissions - Energy Industry: Drivers

(log change in percent, 1996-2017)



Source: UNFCCC.

Main Objectives for 2030 in the National Energy and Climate Plan (NECP)

Reducing greenhouse gas emissions and environmental objectives

- Emissions in the non-ETS sectors to be reduced by 20.9 percent 1/
- Emissions from land use, land use change or forestry are offset by at least an equivalent removal of CO_2 from the atmosphere
- Emissions in ETS sectors to be reduced by 24.9 percent 1/

Increasing the share of RES in energy consumption

- Share of RES in gross final energy consumption to reach 23 percent
- Share of RES in gross final electricity consumption can reach at least 26 percent
- Share of RES in heating and cooling to reach 39 percent
- Share of RES in the transport sector to reach 14 percent

Improving Energy Efficiency

- Final Energy Consumption of 2.0 Mtoe, representing 13 percent reduction 2/
- Primary Energy Consumption of 2.4 Mtoe, representing 17 percent reduction 2/
- Achieving cumulative energy saving of 243.04 ktoe during 2021–2030

Source: Cyprus' Integrated National Energy and Climate Plan

1/ Compared to 2005

2/ Compared to the respective projection for Cyprus in the EU PRIMES 2007 Reference Scenario.

37. **The authorities should continue their efforts to address identified weaknesses in the anti-money laundering and countering-financing of terrorism (AML/CFT) framework.** The authorities should continue to implement measures to strengthen the AML/CFT framework, as set out in the 2019 MONEYVAL AML/CFT assessment report,[19] in particular, improving financial sector supervision and preventive measures and increasing the transparency of beneficial owners of legal entities operating in Cyprus. The Council of Ministers' decision to terminate the CIP should have a positive mitigating impact on Cyprus' ML/TF and reputational risks in Cyprus.

38. **Continued judicial reform efforts are needed to better support the enforcement of commercial claims and the effective functioning of the insolvency regime as well as reduce costs.** The recent and ongoing recruitment of additional judges is a welcome step and should be complemented with the completion of the reforms of the rules for civil procedures, progress on the clearance of the backlog of cases and launching of the e-justice system. Continued progress on strengthening the institutional framework for the insolvency service and professionals is also important. Continued efforts are needed to ensure that a more efficient system for the issuance and transfer of title deeds is in place and related backlogs are cleared.

Authorities' Views

39. **The authorities highlighted ongoing efforts to train the labor force, protect the vulnerable and enhance the growth potential.** A mixture of measures is needed to maintain the labor market on a viable track through combining targeted active labor market policies and wage support schemes. These measures are partially financed by the SURE funds and are in place to support the training of the labor force and help the vulnerable groups to reenter and keep contact with the labor market. Measures such as vocational trainings for the unemployed and children's daycare are being provided for the young and women to reintegrate into the labor force. In

[19] Based on the 2020 MONEYVAL report, Cyprus did not meet the threshold to be identified by FATF as a country with strategic AML/CFT deficiencies ("grey listing").

addition, support will be provided to enhance the digital skills of the labor force through the proposed Digital Academy. Efforts are also underway to close green investment gaps, with investments in the energy sector largely financed by the RRF as well as European Investment Bank. In order to strengthen the AML/CFT framework, the authorities are developing an action plan to address the deficiencies in the 2019 MONEYVAL AML/CFT assessment report.

STAFF APPRAISAL

40. Cyprus has managed the COVID-19 pandemic shock relatively well. Swift implementation of containment measures and high testing rates have kept hospitalization and mortality rates at relatively low levels. Despite the economy's dependence on tourism and the high private and public debt levels, wide-spread defaults and high unemployment have largely been avoided so far, thanks in part to timely policy support and balance sheet buffers accumulated before the COVID-19 crisis.

41. The near-term outlook points to a gradual but uneven recovery, with significant risks on the downside. Growth is projected to recover moderately to 3 percent in 2021 after output fell by 5.1 percent in 2020. However, the pace of the vaccine rollout and potential new waves of infection are key uncertainties. A weakening of the underlying fiscal position leading to increased risk premia and a larger than expected drop in foreign direct investment inflows due to the termination of the Cyprus Investment Program could further dampen the recovery. Given the large economic exposure to tourism and related sectors, risks of wider bankruptcies and loan repayment difficulties leading to permanent scarring are high if policy support is withdrawn prematurely or if the economic recovery, particularly in the tourism sector, lags.

42. Policy priorities depend crucially on the evolution of the health and economic crises. Near-term policies should focus on mitigating the impact of the crisis and ensuring rapid distribution of vaccines, and the withdrawal of broad support measures should thus be gradual. As recovery takes hold, policies should shift towards achieving sustainable and inclusive growth, with policies aimed at supporting the efficient reallocation of resources to minimize scarring and enhance growth potential.

43. In the financial sector, extending targeted support measures and effective resolution of the legacy and potential new NPLs by banks, and increasingly by the CACs, will be crucial for supporting new credit and economic recovery. Targeted credit support measures such as interest subsidy schemes for SMEs and guaranteed loans are needed to incentivize banks to supply much needed credit. Support measures should seek to ensure viability of firms, fully utilizing banks' assessments of the creditworthiness of borrowers. Supervisory guidance that encourages banks to flexibly use capital buffers and continue limiting dividend distributions is welcome, as these will help to address potential new NPLs, provide new credit and deal with legacy NPLs.

44. NPL resolution and sustainable debt workouts remain key priorities. Close monitoring and transparency for assessing and addressing asset quality should be continued. Timely restructuring of viable businesses is key to preserving production capacity. Continued progress with complementary judicial reforms is needed to improve collateral execution and incentives for debt workouts. A reversal of reforms to the foreclosure framework should be avoided, as failure to do so would obstruct ongoing NPL resolution and pose risks for financial stability. As the *Estia* scheme is approaching its conclusion, banks should consider stepping up foreclosure on NPLs of borrowers who did not apply for the scheme, while the authorities should ensure further burden sharing or consider targeted support measures for applicants deemed unviable. Oversight of the CACS should continue to be strengthened. The current proposed expansion of the public AMC, subject to EC state aid approval, should be carefully assessed with respect to its costs and benefits, and its impact on repayment behavior.

45. Given the high economic uncertainties, a premature withdrawal of fiscal support should be avoided. With near-term financing risks limited, policies need to cushion the adverse impact of the crisis and mitigate risks of economic scarring. To this end, the fiscal stance in 2021, which includes continued sizeable policy support, is appropriate. Recalibrating fiscal support measures to target viable but vulnerable firms (such as in the tourism sector) would help avoid unnecessary bankruptcies. Measures encouraging equity increases could help address potential solvency problems. Efforts to front-load mature public investment projects and promote private investment through the utilization of the EU's RRF are welcome. Providing transparency and accountability on the use of COVID-19 related spending will be important to build public support.

46. As the recovery takes hold, the focus should shift to maintaining fiscal sustainability and promoting inclusive, growth-enhancing policies. Efforts should continue to further modernize tax administration, contain the growth of the public wage bill, and reorient spending in a more growth-friendly direction, including by improving human capital, facilitating digitalization, and transitioning to a green economy. Fiscal risks from the NHS should be contained as it embarks on the first year of the full implementation of the NHS reform.

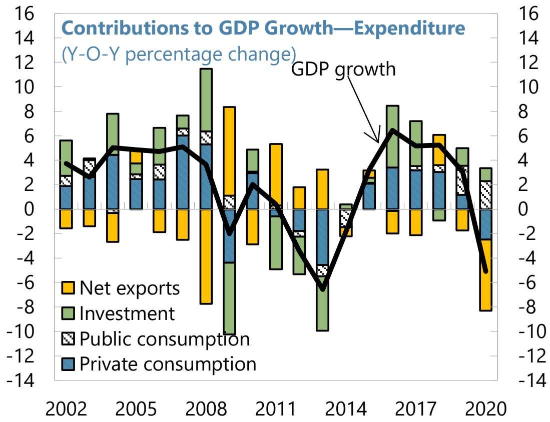
47. Structural reforms should support resource reallocation and strengthen growth potential. Labor market policies should gradually transition from preserving jobs toward facilitating efficient labor reallocation such as through active labor market policies and public employment services. Improving digital infrastructure and upgrading digital skills will enhance Cyprus's competitiveness. In addition, implementing climate-friendly policies and facilitating the transition to a green economy such as through greater investment in renewable energy and green taxation, would help meet the 2030 emission targets set in the Cyprus National Energy and Climate Plan.

48. Priority should be given to mitigating the repercussions of the crisis on inequality. The crisis has had a more adverse impact on young people and women. Policies should seek to enhance female labor participation and job search for young people. Any consideration of a national minimum wage should take due account of the potential impact on competitiveness and youth employment. These priorities will be crucial to ensure a more inclusive and sustainable recovery.

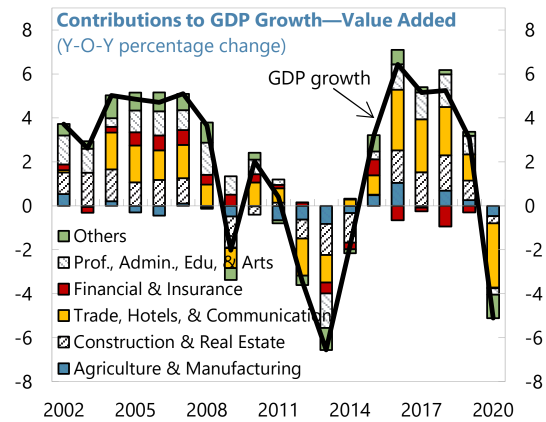
49. It is proposed that the next Article IV consultation take place on the standard 12- month cycle.

Figure 3. Cyprus: Macroeconomic Performance

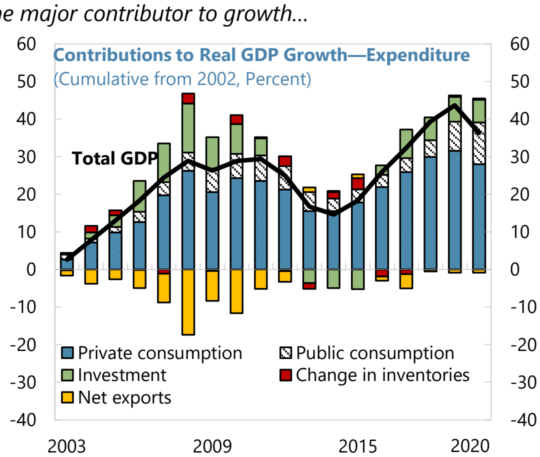
The real economy contracted sharply in 2020, mainly driven by investment and net exports, while public spending has mitigated the contraction.



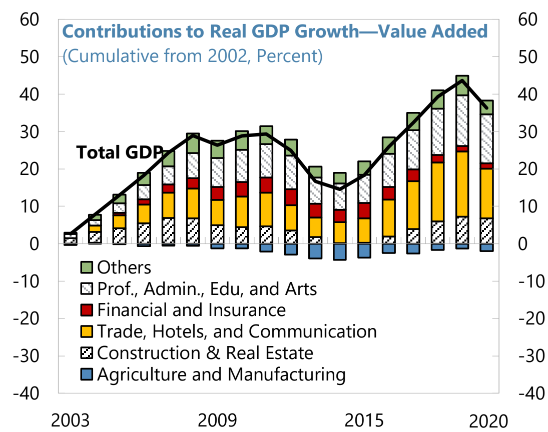
In particular, service sectors such as retail trade and hotels were hit hard.



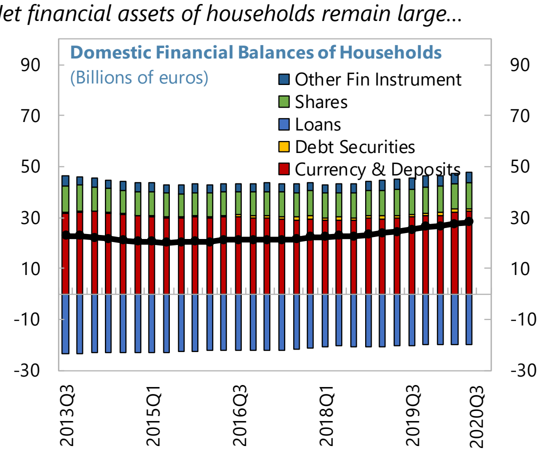
In cumulative terms, private consumption continued to be the major contributor to growth…



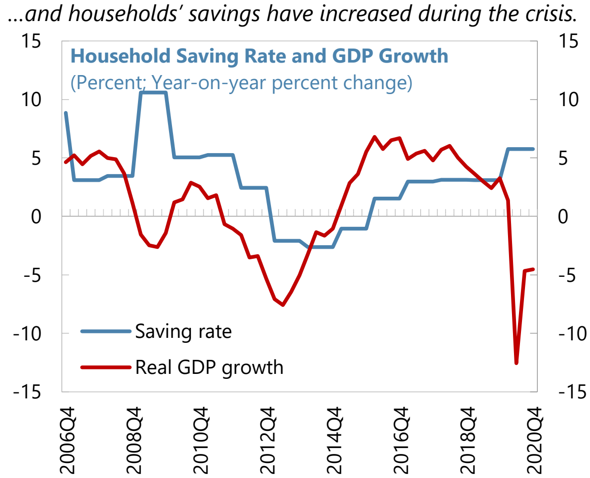
…as well as professional services, but contribution of tourism has declined.



Net financial assets of households remain large…



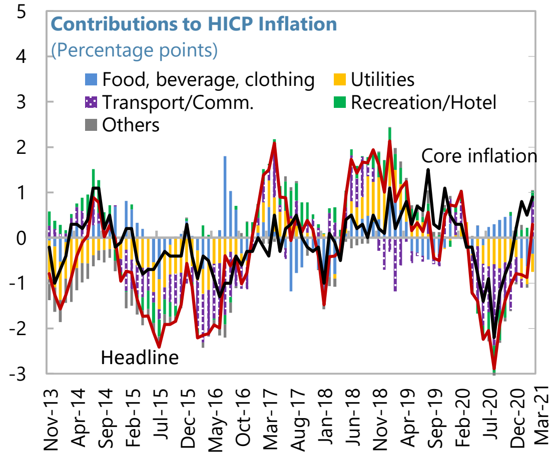
…and households' savings have increased during the crisis.



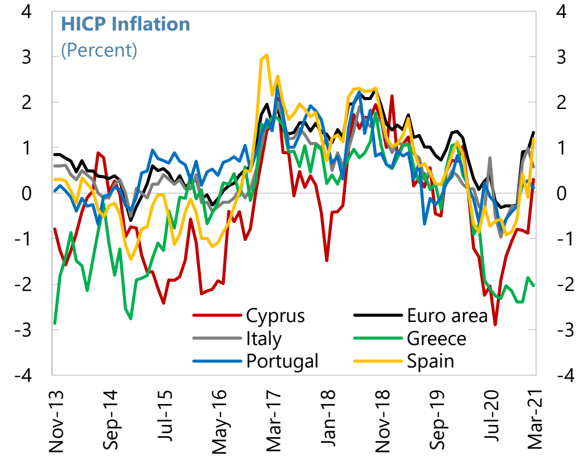
Sources: Central Bank of Cyprus; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Inflation and Labor Market

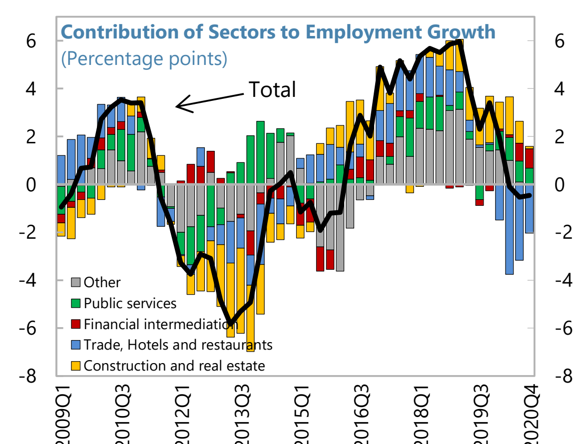
Headline and core inflation turned negative since the Covid-19 pandemic...



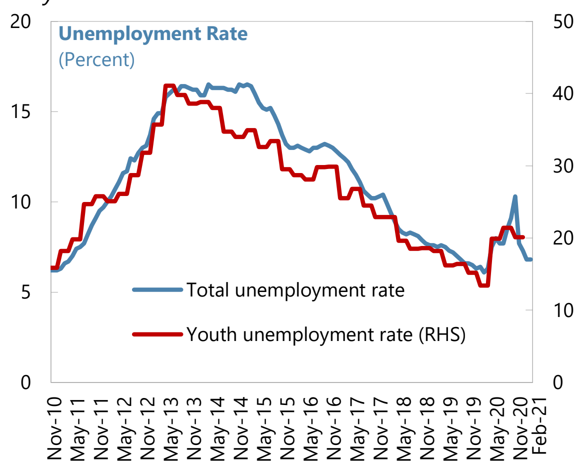
... at a level much lower compared with European peers.



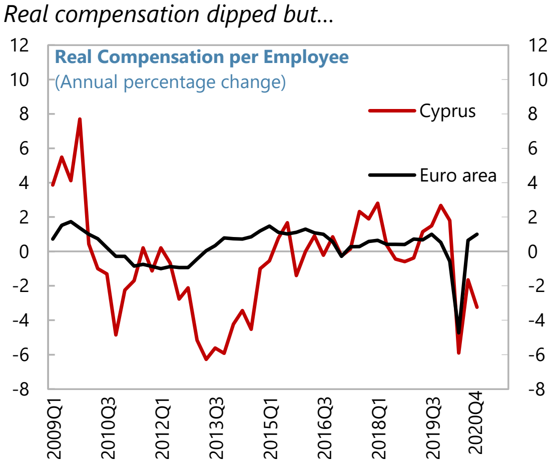
Job losses in the trade tourism-related sectors...



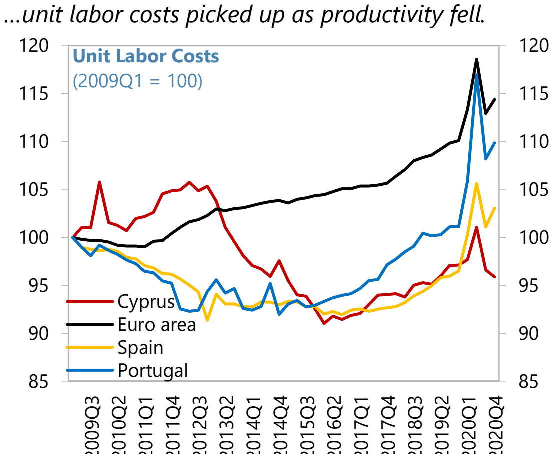
...pushed up the unemployment rate especially among the youth.



Real compensation dipped but...



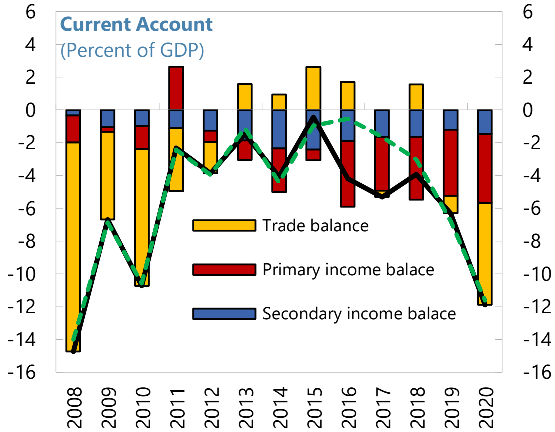
...unit labor costs picked up as productivity fell.



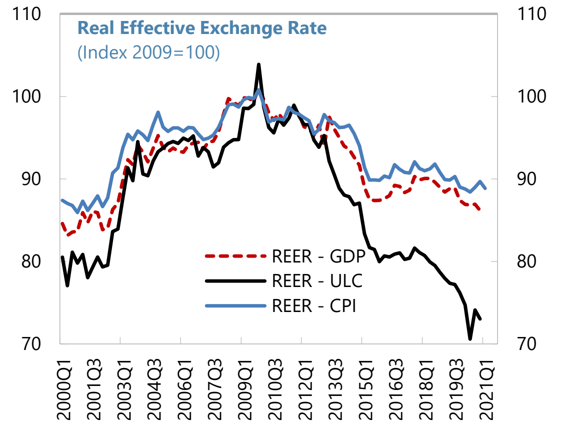
Sources: Cystat; ECB; Eurostat; and IMF staff calculations.

Figure 5. Cyprus: External Indicators

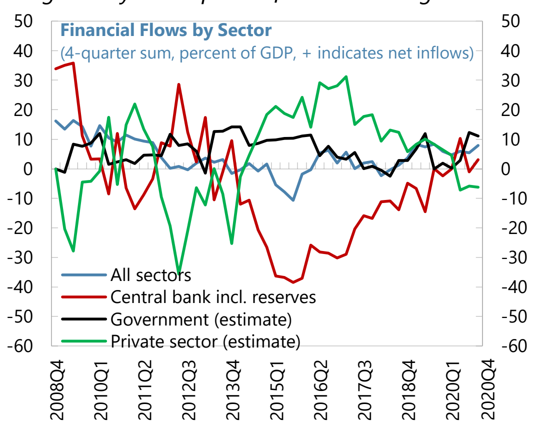
The underlying current account deficit has widened…



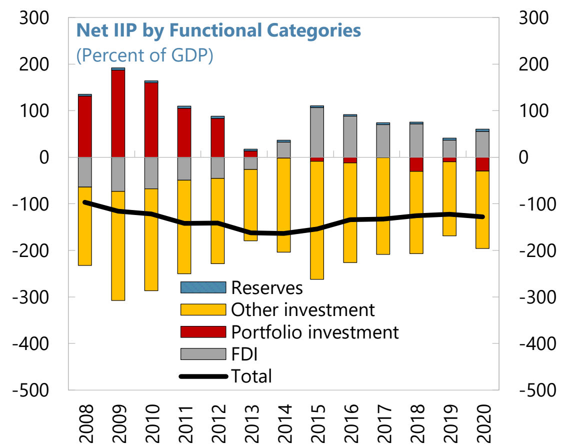
…while the real effective exchange rate increased from the post-crisis low.



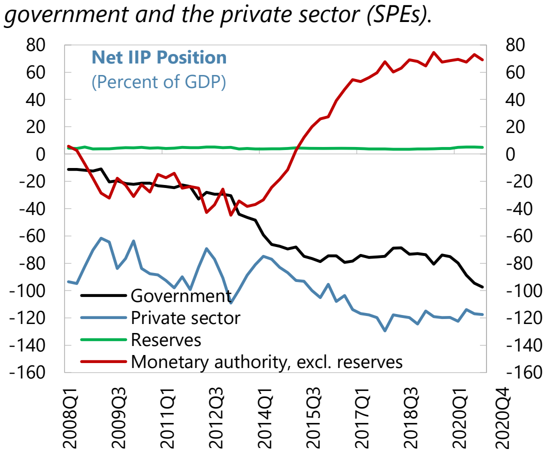
Net capital inflows to the private sector declined, but mitigated by net capital inflows into the government.



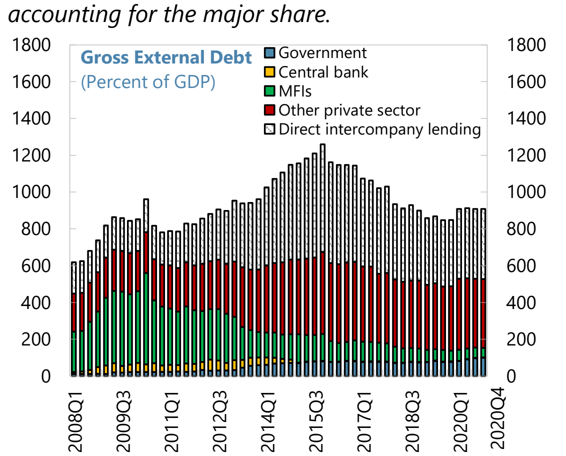
Net IIP remains highly negative…



…reflecting large negative IIP position of the government and the private sector (SPEs).



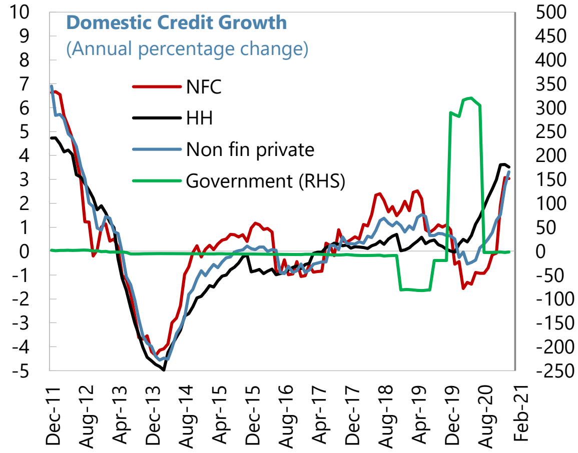
Gross external debt is near post-crisis low, with SPEs accounting for the major share.



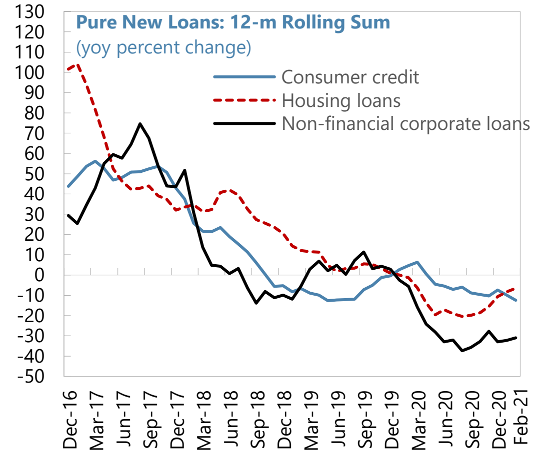
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 6. Cyprus: Credit and Balance Sheets

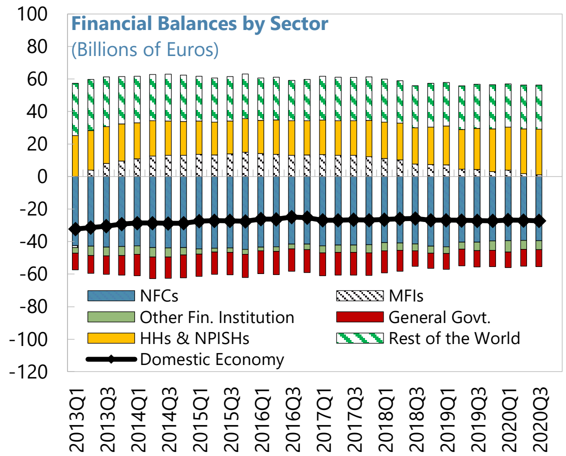
Domestic credit growth increased, mainly due to a moratorium on debt repayments…



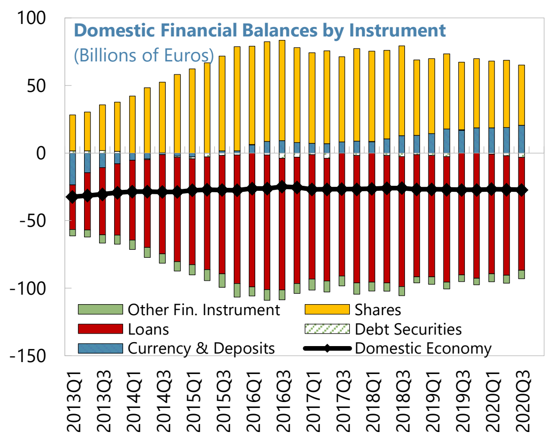
…while growth of pure new loans to households and NFCs accelerated in the second half of the year.



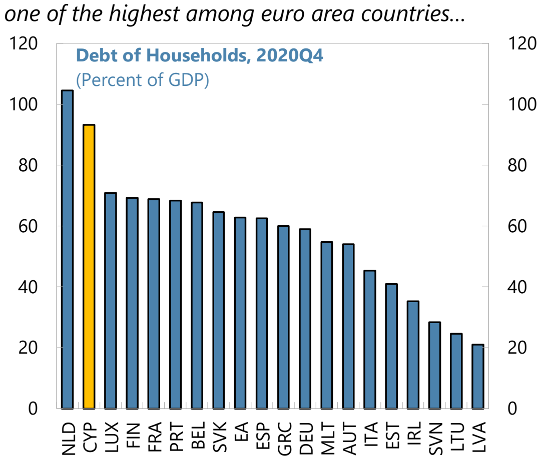
NFCs and the general government remain in large net debt position…



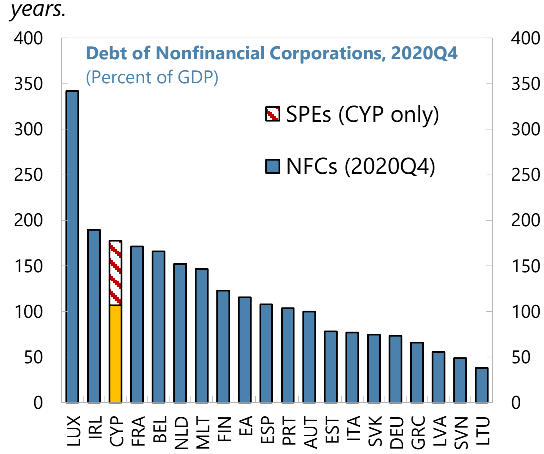
…and loans remain the largest component of net financial liabilities.



Household debt as a percentage of GDP continues to be one of the highest among euro area countries…



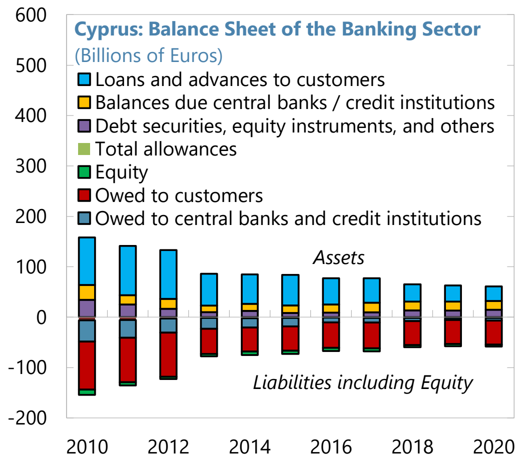
…as does NFC debt, despite the deleveraging in recent years.



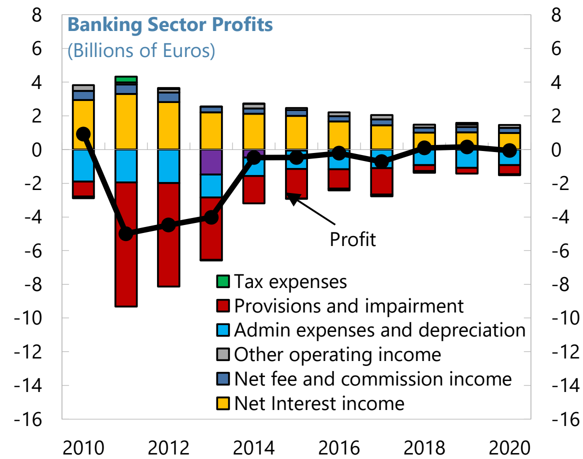
Sources: Central Bank of Cyprus; Cystat; Haver Analytics; and IMF staff calculations.

Figure 7. Cyprus: Banking Sector[1/]

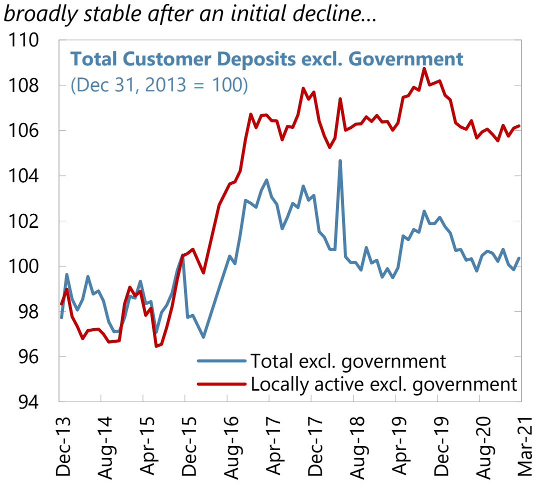
Banks have continued to deleverage.



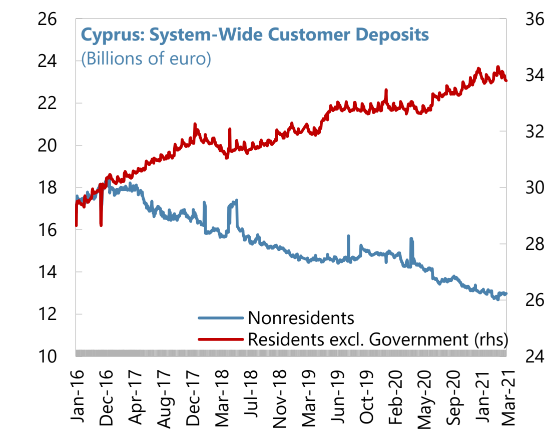
Total profit of the banking sector has declined to near zero as net interest income shrank.



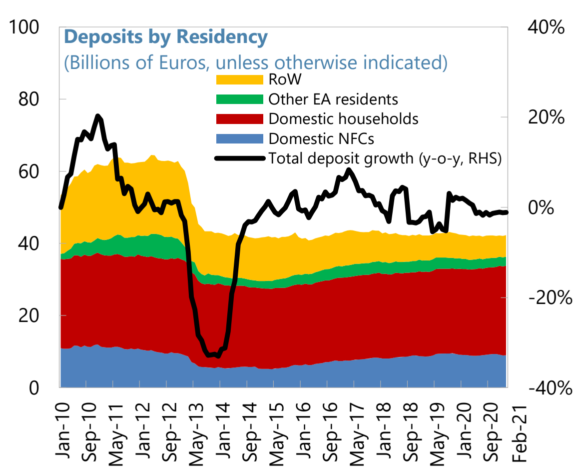
Total customer deposits of locally active banks were broadly stable after an initial decline...



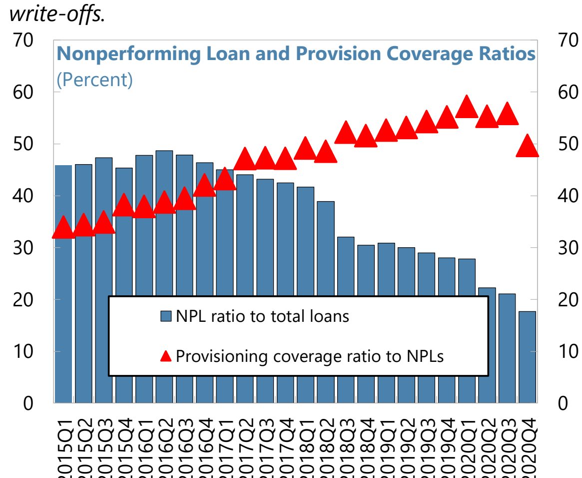
...as residents' deposits increased offsetting non-resident deposits...



Deposits from both households and NFCs are increasing steadily.



The NPL ratio has declined reflecting new NPL sales and write-offs.

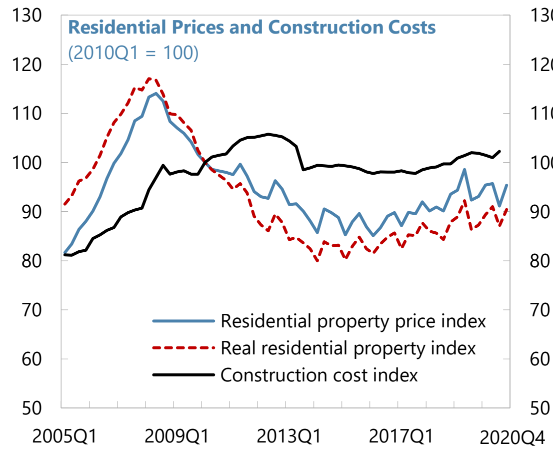


Sources: Central Bank of Cyprus; ECB; Haver Analytics; and IMF staff calculations.

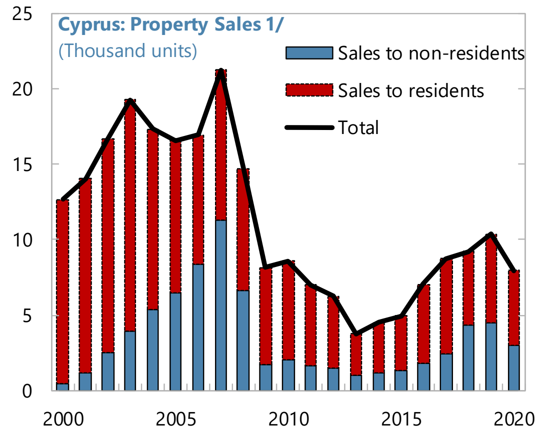
[1/] At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

Figure 8. Cyprus: Housing Market

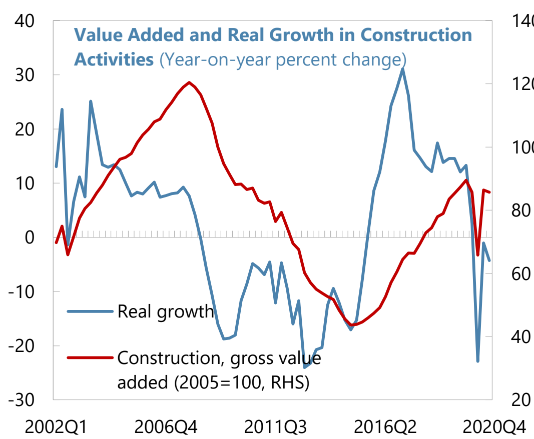
Transaction-based property prices are rising…



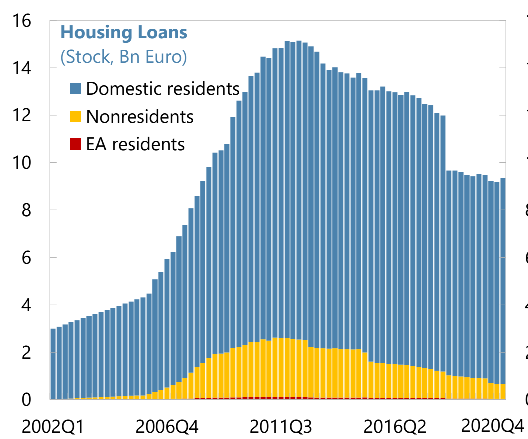
…but property sales have declined, due to lower sales to non-residents.



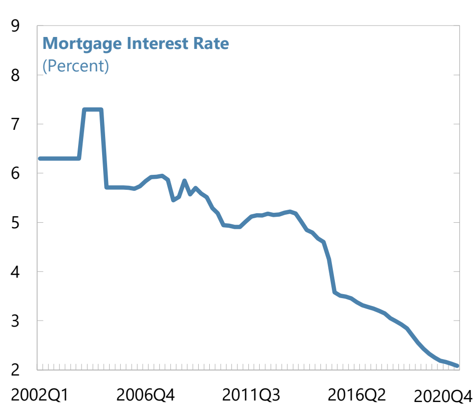
Growth in construction activities rebounded after an initial dip during the lockdown…



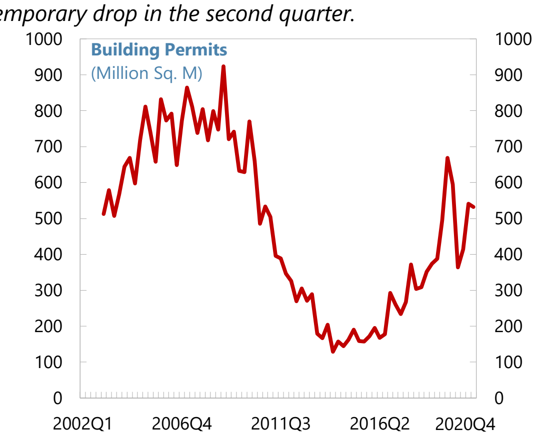
…while the stock of housing loans is gradually declining in line with the reduced external loans. Domestic loans are stable as…



…mortgage interest rates continue to decline…



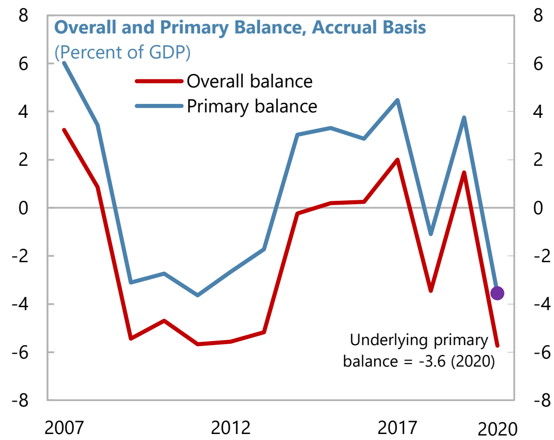
…and the issuance of building permits resumed after a temporary drop in the second quarter.



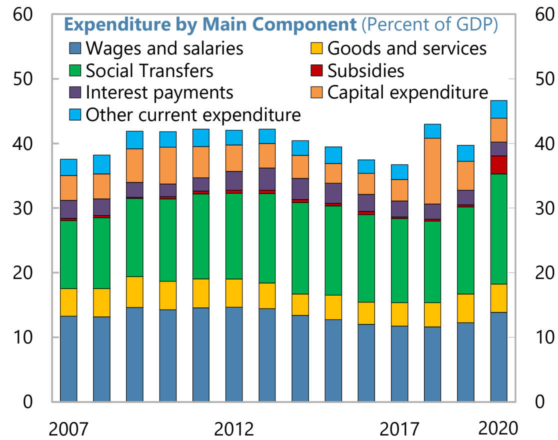
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.
1/ Post-2018 and pre-2018 data on sales to non-residents are not directly comparable as the methodology to compile data has changed.

Figure 9. Cyprus: Fiscal Developments

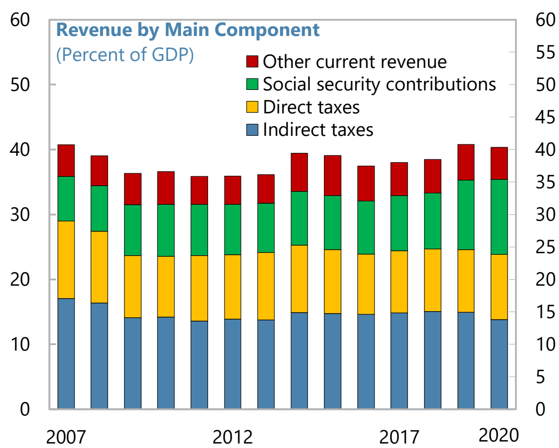
The fiscal balance worsened sharply in 2020…



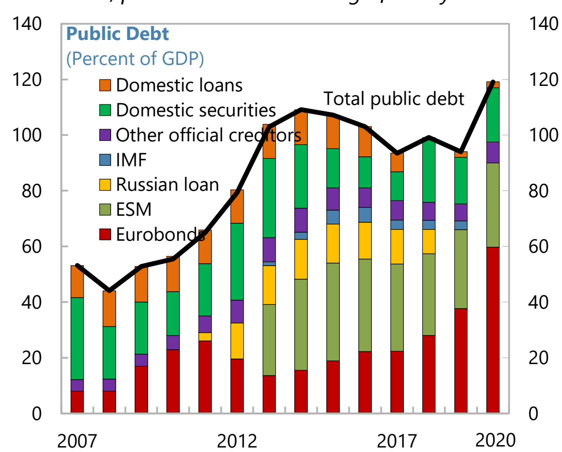
….as expenditure increased significantly due to crisis-related spending and implementation of NHS



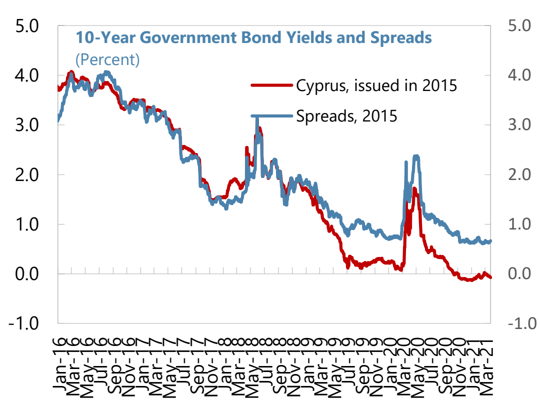
…while NHS contributions helped stabilize revenue.



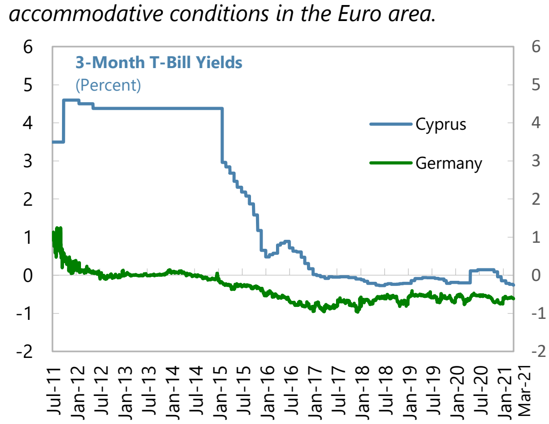
As a result, public debt increased significantly.



Market conditions have stabilized from the earlier spike in spreads in 2020Q2…



…and 3-month T-bill yields remains negative reflecting accommodative conditions in the Euro area.

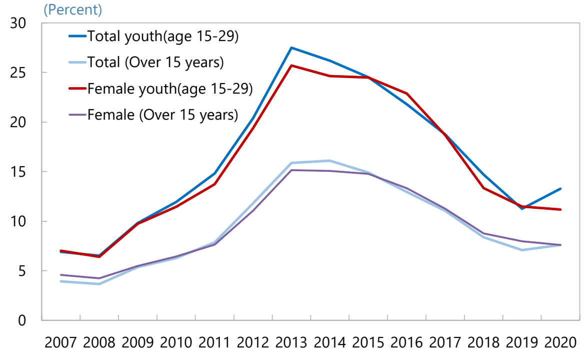


Sources: Bloomberg Finance LP; Ministry of Finance; and IMF staff estimates.

Figure 10. Cyprus: Growth Inclusiveness Indicators

Unemployment rates were approaching the pre-crisis low in 2019…

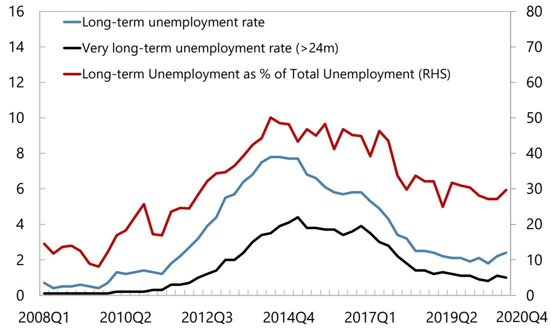
Unemployment Rate
(Percent)



Source: Eurostat, Haver Analytics, and IMF staff calculations.

…but long-term unemployment has increased moderately in 2020.

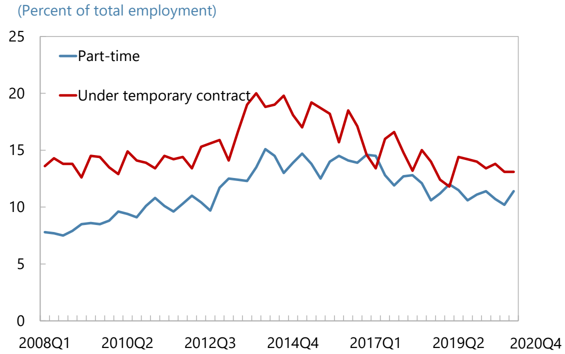
Long-Term and Short-Term Unemployment
(Percent)



Sources: Eurostat; and Haver Analytics.

The share of part-time employment and temporary workers have continued their declining trend.

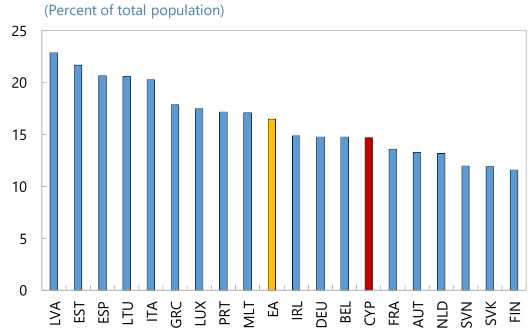
Part-Time and Temporary Contract
(Percent of total employment)



Sources: Eurostat; and Haver Analytics.

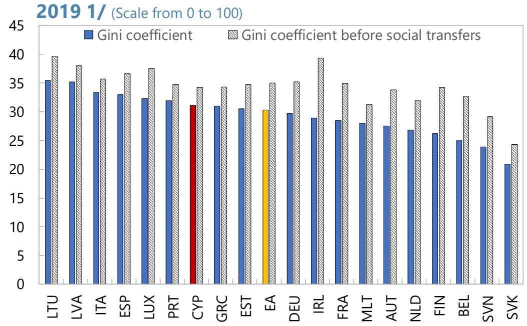
…with the poverty level in Cyprus remaining below euro area average.

At-Risk-Poverty Rate, 2019 1/
(Percent of total population)



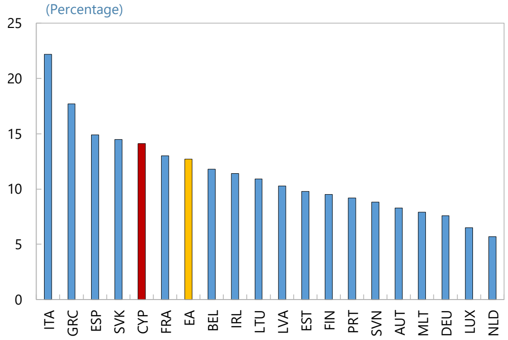
Income equality is comparable to European peers…

Gini Coefficient of Equivalized Disposable Income, 2019 1/ (Scale from 0 to 100)



but young population who are inactive are relatively large.

NEET Youth from 15 to 29 years, 2019
(Percentage)



Sources: Eurostat, Haver Analytics; and IMF staff calculations.
1/ Latest data in 2018 for France, Italy, Ireland, and Slovakia.

Table 3. Cyprus: Selected Economic Indicators, 2018–2026

(Percent change, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Real Economy									
Real GDP	5.2	3.1	-5.1	3.0	3.9	3.1	2.8	2.6	2.5
Domestic demand	2.6	5.1	0.8	1.2	3.4	2.5	2.1	1.9	1.8
Consumption	4.4	4.5	-0.3	1.1	3.6	2.5	2.1	1.9	1.8
Private consumption	4.7	1.8	-3.9	0.7	3.2	2.6	2.2	2.0	1.8
Public consumption	3.5	15.1	13.1	2.2	4.8	2.4	1.7	1.7	1.7
Gross capital formation 1/	-4.5	7.7	5.3	1.5	2.4	2.2	2.2	2.0	1.8
Foreign balance 2/	2.5	-1.8	-5.8	1.9	0.3	0.5	0.6	0.6	0.7
Exports of goods and services	8.0	-0.4	-12.4	3.8	7.8	7.4	6.7	5.9	5.9
Imports of goods and services 1/	4.5	2.0	-4.2	0.9	6.7	6.2	5.5	4.8	4.8
Potential GDP growth	2.0	2.1	1.2	2.4	3.3	3.0	2.5	2.5	2.5
Output gap (percent of potential GDP)	3.9	4.9	-1.6	-1.1	-0.5	-0.3	-0.1	0.0	0.0
HICP (period average)	0.8	0.6	-1.1	0.5	0.8	1.2	1.4	1.7	1.9
HICP (end of period)	1.0	0.7	-0.8	0.8	0.8	1.2	1.4	1.7	1.9
GDP deflator	1.2	0.9	-1.5	0.3	1.5	1.9	2.0	2.3	2.6
Unemployment rate (percent, period average)	8.4	7.1	7.6	7.5	7.0	6.5	6.0	5.5	5.1
Employment growth (percent, period average)	5.6	3.9	-1.5	2.0	1.4	1.4	1.4	1.4	1.4
Labor force	2.5	2.4	0.0	0.9	0.9	0.9	0.9	0.9	0.9
Public Finance									
General government balance	-3.5	1.5	-5.7	-4.8	-1.1	-0.4	0.1	0.6	0.8
Revenue	39.5	41.2	40.9	42.9	44.0	44.2	44.1	44.0	43.6
Expenditure	43.0	39.7	46.6	47.6	45.0	44.6	44.0	43.4	42.8
Primary Fiscal Balance	-1.1	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
General government debt	99.2	94.0	119.1	114.0	106.4	102.8	95.6	91.8	86.1
Balance of Payments									
Current account balance	-3.9	-6.3	-11.9	-8.1	-6.0	-5.1	-4.7	-4.0	-3.7
Trade Balance (goods and services)	1.5	-1.1	-6.2	-4.8	-4.3	-3.9	-3.4	-3.3	-2.2
Exports of goods and services	75.2	71.9	67.7	66.4	67.5	68.7	70.2	70.2	69.1
Imports of goods and services	73.7	72.9	73.9	71.3	71.9	72.7	73.5	73.5	71.3
Goods balance	-21.2	-20.8	-20.0	-23.1	-22.7	-23.9	-24.8	-25.2	-23.0
Services balance	22.7	19.7	13.8	18.2	18.4	20.0	21.4	21.8	20.8
Primary income, net	-3.8	-4.0	-4.2	-2.2	-0.8	-0.6	-0.4	0.4	-0.4
Secondary income, net	-1.6	-1.2	-1.5	-1.1	-0.9	-0.5	-1.0	-1.0	-1.1
Capital account, net	0.6	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Financial account, net	-3.7	-6.0	-10.4	-7.9	-5.8	-4.8	-4.5	-3.8	-3.6
Direct investment	-22.1	-23.8	-9.7	-10.6	-10.6	-10.7	-10.8	-10.8	-10.4
Portfolio investment	-13.8	9.5	-14.0	-5.2	-3.9	-3.2	-3.1	-5.7	-1.6
Other investment and financial derivatives	32.0	8.4	13.1	7.8	8.7	9.1	9.4	12.7	8.5
Reserves (+ accumulation)	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 3/	0.0	0.0	-3.4	0.0	0.0	0.0	0.0	-1.3	-3.6
Errors and omissions	-0.4	0.2	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	15.3	13.1	8.4	13.8	15.7	16.3	16.4	16.8	16.8
Government	6.7	5.9	-2.1	-0.9	3.1	3.8	4.2	4.6	4.6
Non-government	8.5	7.2	10.5	14.7	12.6	12.5	12.2	12.2	12.1
Gross capital formation	19.2	19.4	20.3	21.9	21.7	21.4	21.1	20.8	20.5
Government	10.2	4.5	3.7	3.8	4.2	4.2	4.1	4.0	3.8
Private	9.0	14.9	16.6	18.1	17.5	17.1	17.0	16.8	16.7
Foreign saving	-3.9	-6.3	-11.9	-8.1	-6.0	-5.1	-4.7	-4.0	-3.7
Memorandum Item:									
Nominal GDP (billions of euros)	21.4	22.3	20.8	21.5	22.7	23.9	25.0	26.3	27.6
Underlying primary fiscal balance 4/	6.3	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
Structural primary balance 5/	4.4	2.1	-3.2	-2.1	1.4	1.7	1.9	2.2	2.4
External debt	900.2	849.0	909.0	1018.6	984.2	956.0	931.7	903.0	872.3
Net IIP	-125.8	-122.3	-128.1	-131.8	-130.8	-129.4	-127.8	-125.7	-123.0

Sources: Statistical Service of the Republic of Cyprus, Eurostat, Central Bank of Cyprus, and IMF staff estimates.

1/ Estimated negative growth of gross capital formation in 2018 reflect the base effect of volatile special purpose entities (SPEs) activity.

2/ Contribution to real GDP growth.

3/ Program financing (+ purchases, - repurchases) is included under the Financial Account, with consistent sign conversion.

4/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction and state-owned AMC of 7.4 percent of GDP.

5/ Excludes the fiscal impact of the sale of the CCB transaction and state-owned AMC of 7.4 percent of GDP.

Table 4. Cyprus: Fiscal Development and Projections, 2018–2026 [1/]

(Percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Revenue	39.5	41.2	40.9	42.9	44.0	44.2	44.1	44.0	43.7
Current revenue	38.5	40.8	40.4	42.3	43.5	43.7	43.6	43.5	43.1
Tax revenue	24.7	24.6	23.9	24.3	24.8	25.0	25.2	25.2	25.2
Indirect taxes	15.1	14.9	13.8	14.3	14.7	14.9	15.0	15.0	15.0
Direct taxes	9.6	9.7	10.1	10.0	10.1	10.2	10.2	10.2	10.2
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	8.6	10.7	11.5	12.4	12.6	12.6	12.7	12.7	12.7
Other current revenue	5.2	5.5	5.0	5.7	6.1	6.1	5.7	5.5	5.3
Capital revenue	1.1	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Expenditure	43.0	39.7	46.6	47.6	45.3	44.8	44.2	43.5	42.8
Current expenditure	32.8	35.2	43.0	43.8	40.9	40.5	40.0	39.5	39.0
Wages and salaries	11.6	12.3	13.9	13.7	13.6	13.6	13.4	13.2	12.9
Goods and services	3.8	4.4	4.4	4.5	3.9	3.9	3.9	3.9	3.8
Social Transfers	12.6	13.5	17.0	17.9	18.1	18.1	18.1	18.1	18.1
Subsidies	0.3	0.3	2.8	2.8	0.9	0.8	0.7	0.5	0.4
Interest payments	2.4	2.3	2.2	2.4	2.3	1.9	1.7	1.6	1.4
Other current expenditure	2.2	2.5	2.7	2.5	2.2	2.2	2.2	2.2	2.2
Capital expenditure	10.2	4.5	3.7	3.8	4.3	4.3	4.2	4.1	3.8
Capital transfers, payable	5.3	1.9	0.7	0.7	0.7	0.7	0.7	0.7	0.6
Gross capital formation less NFA disposal	4.9	2.6	3.0	3.1	3.6	3.6	3.5	3.4	3.2
Overall balance	-3.5	1.5	-5.7	-4.8	-1.2	-0.6	0.0	0.5	0.9
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-3.5	1.5	-5.7	-4.8	-1.2	-0.6	0.0	0.5	0.9
Net financial transactions	-3.1	1.4	-5.9	-4.8	-1.2	-0.6	0.0	0.5	0.9
Net acquisition of financial assets	9.0	-0.3	13.9	-6.0	-3.0	0.9	-2.5	1.2	-0.3
Currency and deposits	9.0	-0.3	13.9	-6.0	-3.0	0.9	-2.5	1.2	-0.3
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	12.1	-1.7	19.9	-1.3	-1.7	1.5	-2.4	0.7	-1.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	19.3	7.0	22.0	-2.6	-2.0	1.3	-2.7	2.4	3.1
Loans	-7.3	-8.8	-2.1	1.3	0.3	0.2	0.2	-1.7	-4.3
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Underlying expenditure 2/	35.5	38.4	42.6	42.2	39.6	39.1	38.5	37.8	37.1
Output Gap	3.8	4.8	-1.8	-1.0	-0.5	-0.4	-0.2	-0.1	-0.1
Underlying overall balance 3/	3.8	1.5	-5.7	-4.8	-1.2	-0.6	0.0	0.5	0.9
Primary balance	-1.1	3.8	-3.6	-2.4	1.0	1.3	1.7	2.1	2.3
Primary balance (ESA2010)	-1.1	3.8	-3.6	-2.4	1.0	1.3	1.7	2.1	2.3
Underlying primary balance 3/	6.2	3.8	-3.6	-2.4	1.0	1.3	1.7	2.1	2.3
Structural overall balance 3/	2.1	-0.2	-5.3	-4.5	-1.1	-0.4	0.0	0.5	0.9
Structural primary balance 3/	4.4	2.1	-3.1	-2.2	1.2	1.5	1.8	2.1	2.3
Public debt	99.2	94.0	119.1	114.0	106.4	102.8	95.6	91.8	86.1
Public debt net of cash holding	96.8	89.8	101.8	103.3	99.0	94.6	90.1	85.3	80.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

2/ Expenditure excluding fiscal impact of the Cyprus Cooperative Bank (CCB) transaction, state-owned AMC, and NHS related expenditure.

3/ All the three series exclude the fiscal impact of the sale of the CCB transaction and state-owned AMC of 7.4 percent of GDP. Structural overall balance and primary balance also exclude the impact of the cyclical components.

Table 5. Cyprus: General Government Financing Requirements and Sources, 2020–2026

(Millions of Euros, unless otherwise indicated)

	2020	2021	2022	2023	2024	2025	2026
		Projections					
Gross borrowing needs	3,645	3,227	2,484	1,781	2,626	1,904	2,454
Overall deficit	1,238	1,026	239	95	-31	-160	-226
Primary surplus	742	511	-275	-365	-471	-592	-650
Interest payments	496	515	514	460	441	432	425
Amortization	2,407	2,201	2,245	1,687	2,657	2,064	2,679
Medium- and long-term	1,403	901	1,945	1,387	2,357	1,414	1,379
Foreign	541	90	1,091	1,092	1,942	1,242	1,088
Eurobonds	458	0	1,000	1,000	1,850	1,000	1,000
Russia	0	0	0	0	0	0	0
Other	83	90	91	92	92	242	88
Domestic	862	811	854	295	415	173	291
Short-term	300	1,300	300	300	300	300	300
EU and IMF	705	0	0	0	0	350	1,000
Stock-flow adjustment 1/	0	0	0	0	0	0	0
Gross financing sources	3,881	3,227	2,484	1,781	2,626	1,904	2,454
Privatization receipts	0	0	0	0	0	0	1
Market access	6,550	1,929	1,850	2,050	2,050	2,250	2,350
Medium- and long-term	5,250	1,629	1,550	1,750	1,750	1,950	2,050
Foreign	4,850	1,629	1,450	1,650	1,650	1,850	1,950
Domestic	400	0	100	100	100	100	100
Short-term	1,300	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0	0
Use of deposits 2/	-2,669	1,298	634	-269	576	-346	104
Net placement	4,143	-272	-395	363	-607	186	-329
Medium and Long Term Debt	3,847	728	-395	363	-607	536	671
Domestic Securities	-462	-811	-754	-195	-315	-73	59
Eurobonds	4,042	1,250	300	500	-350	700	800
Domestic Loans	0	0	0	0	0	0	-250
Foreign Loans	267	289	59	58	58	-92	62
Short term (Net increase)	1,000	-1,000	0	0	0	0	0
EU and IMF	-705	0	0	0	0	-350	-1,000
Memorandum item:							
Cash holding (eop)	3,616	2,318	1,684	1,952	1,376	1,722	1,618
General government debt (eop)	24,829	24,557	24,162	24,525	23,918	24,104	23,774
General government debt (eop, percent of GDP)	119.1	114.0	106.4	102.8	95.6	91.8	86.1
General government net debt (eop, percent of GDP) 3/	101.8	103.3	99.0	94.6	90.1	85.3	80.2

1/ Adjustments for consistency between estimated cash basis fiscal balance and debt data.

2/ Minus (-) sign represents accumulation of deposits.

3/ General government debt minus cash holding.

Table 6. Cyprus: Balance of Payments, 2018–2026

(Percent of GDP, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				(Percent of GDP)					
Current Account Balance	-3.9	-6.3	-11.9	-8.1	-6.0	-5.1	-4.7	-4.0	-3.7
Trade Balance (Goods and Services)	1.5	-1.1	-6.2	-4.8	-4.3	-3.9	-3.4	-3.3	-2.2
Goods Balance	-21.2	-20.8	-20.0	-23.1	-22.7	-23.9	-24.8	-25.2	-23.0
Exports	17.2	13.9	14.2	13.7	14.3	13.7	13.5	13.1	14.7
Imports	38.4	34.7	34.3	36.8	37.0	37.7	38.3	38.3	37.7
Services Balance	22.7	19.7	13.8	18.2	18.4	20.0	21.4	21.8	20.8
Exports	58.0	57.9	53.4	52.7	53.2	55.0	56.6	57.1	54.3
Imports	35.3	38.2	39.6	34.4	34.8	35.0	35.2	35.3	33.6
Primary Income	-3.8	-4.0	-4.2	-2.2	-0.8	-0.6	-0.4	0.4	-0.4
Secondary Income	-1.6	-1.2	-1.5	-1.1	-0.9	-0.5	-1.0	-1.0	-1.1
Capital Account	0.6	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Financial Account (- financing)	-3.7	-6.0	-10.4	-7.9	-5.8	-4.8	-4.5	-3.8	-3.6
Direct Investment	-22.1	-23.8	-9.7	-10.6	-10.6	-10.7	-10.8	-10.8	-10.4
Portfolio Investment	-13.8	9.5	-14.0	-5.2	-3.9	-3.2	-3.1	-5.7	-1.6
Financial Derivatives	3.6	0.9	-1.1	-1.1	-1.0	-1.0	-0.9	-0.9	-0.8
Other Investment	28.3	7.5	14.2	8.9	9.7	10.1	10.3	13.6	9.3
Reserves (+ accumulation)	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	-0.4	0.2	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current Account Balance adjusted for SPEs 1/	-3.0	-6.8	-11.6	...	...	...	...	...	...
Program Financing 2/	0.0	0.0	-3.4	0.0	0.0	0.0	0.0	-1.3	-3.6
Private Net Capital Flows 3/	-5.8	-6.4	8.2	...	...	...	...	...	...
o/w Portfolio Investment	-9.1	21.7	6.8	...	...	...	...	...	...
o/w Other Investment	21.7	-5.2	12.2	...	...	...	...	...	...
o/w MFIs	C	C	C	...	...	...	...	...	...
o/w Non-MFIs	C	C	C	...	...	...	...	...	...
Gross External Debt	900.2	849.0	908.4	1018.6	984.2	956.0	931.7	903.0	872.3
o/w Short-term Debt	158.6	151.6	157.4	168.3	168.1	169.0	174.2	173.8	173.3

Sources: Central Bank of Cyprus; Eurostat; and IMF staff estimates.

1/ Treating Special Purpose Entities (SPEs) as non-residents.

2/ Program financing (+ purchases, - repurchases) is included under the Financial Account, with consistent sign conversion.

3/ Private net capital flows (- inflows, + outflows) are defined to exclude the public-sector flows (the central-bank flows and part of the general-government flows). It is not possible to exclude all general government-related flows from “other investment” in the published data because of secondary confidentiality issues (i.e., these data are suppressed to preserve the confidentiality of data pertaining to other sectors that could otherwise be indirectly deduced).

Table 7. Cyprus: External Financing Requirements and Sources, 2018–2026

(Millions of Euros)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
GROSS FINANCING REQUIREMENTS	**54,760**	**47,797**	**45,795**	**48,326**	**50,590**	**52,572**	**55,729**	**58,743**	**61,393**
Current account deficit ("-" = CA surplus)	842	1,406	2,476	1,754	1,367	1,208	1,181	1,048	1,030
Medium- and long-term debt amortization	11,829	12,403	8,822	11,828	12,978	13,183	14,231	13,765	13,746
Public sector	697	2,158	541	90	1,091	1,092	1,942	1,242	1,088
Banks	636	424	341	502	496	494	491	493	496
Other private	10,496	9,822	7,941	11,236	11,391	11,598	11,798	12,029	12,162
Short-term debt amortization	42,089	33,988	33,792	34,744	36,245	38,180	40,317	43,581	45,618
Public sector	313	398	399	224	115	62	33	18	10
Central Bank	296	381	399	214	115	62	33	18	10
General government and SOEs	17	16	0	10	0	0	0	0	0
Banks	17,175	13,407	10,641	10,510	10,196	9,993	9,892	10,283	10,690
Other private	24,601	20,183	22,752	24,010	25,933	28,126	30,391	33,279	34,918
EU and IMF	0	0	705	0	0	0	0	350	1,000
SOURCES OF FINANCING	**54,760**	**47,797**	**45,795**	**48,326**	**50,590**	**52,572**	**55,729**	**58,743**	**61,393**
Capital account (net)	130	24	17	46	53	59	55	42	45
Foreign direct investment (net)	4,734	5,312	2,020	2,274	2,412	2,556	2,705	2,839	2,880
Cypriot investment abroad	-9,812	17,745	724	735	787	842	901	946	979
Foreign investment in Cyprus	-5,078	23,057	2,744	3,009	3,200	3,398	3,606	3,786	3,859
New borrowing and debt rollover	52,646	43,215	48,435	50,361	52,542	55,051	58,685	60,663	60,942
Medium and long-term borrowing	18,658	9,423	13,691	14,116	14,361	14,734	15,104	15,045	15,324
General government	1,500	2,600	4,850	1,629	1,450	1,650	1,650	1,850	1,950
Banks	213	346	305	476	486	484	501	503	506
Other private	16,945	6,477	8,537	12,011	12,425	12,600	12,954	12,692	12,868
Short-term borrowing	33,988	33,792	34,744	36,245	38,180	40,317	43,581	45,618	45,618
Public sector	398	399	224	115	62	33	18	10	10
Central Bank	381	399	214	115	62	33	18	10	10
General government and SOEs	16	0	10	0	0	0	0	0	0
Banks	13,407	10,641	10,510	10,196	9,993	9,892	10,283	10,690	10,690
Other private	20,183	22,752	24,010	25,933	28,126	30,391	33,279	34,918	34,918
Other	-2,750	-754	-4,678	-4,355	-4,417	-5,094	-5,716	-4,802	-2,474
Of which: Net errors and omissions	-87	47	286	0	0	0	0	0	0
FINANCING GAP	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
ESM	0	0	0	0	0	0	0	0	0
IMF	0	0	0	0	0	0	0	0	0
ROLLOVER RATES									
General government	212%	120%	899%	1637%	133%	151%	85%	149%	179%
Central bank	129%	105%	54%	54%	54%	54%	54%	54%	100%
Private	96%	92%	104%	105%	106%	106%	108%	105%	101%
Banks	76%	79%	98%	97%	98%	99%	104%	104%	100%
Non-financial corporates	106%	97%	106%	108%	109%	108%	110%	105%	102%

Sources: Eurostat; Central Bank of Cyprus; and IMF staff estimates.

Table 8. Cyprus: Financial Soundness Indicators, 2012–2020 [1/]

(Percent, unless otherwise specified)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Capital Adequacy									
Total capital ratio	7.3	13.5	15.3	16.6	16.8	16.3	17.5	19.9	20.1
Tier I capital ratio	6.3	12.3	14.6	16.0	16.4	15.4	16.5	19.0	19.0
Asset Quality									
Non-performing loans (NPLs) to total gross loans 2/	27.1	44.4	47.5	45.3	46.4	42.5	30.5	28.0	17.7
Non-performing loans (NPLs) to total gross loans (local operations) 3/	22.6	44.4	47.8	45.8	47.2	43.7	30.3	27.9	17.7
Provisions to NPLs	...	...	33.9	38.3	42.1	47.2	51.6	55.2	49.7
Restructured loans classified as NPLs to total NPLs	...	28.0	33.9	40.1	40.8	40.9	44.8	44.6	43.7
Earnings and Profitability									
Return on assets 4/	-3.4	-4.3	-0.6	-0.6	-0.3	-1.1	0.2	0.4	0.0
Return on equity 4/	-69.5	-69.5	-8.1	-7.4	1.7	-11.2	6.4	4.3	-1.5
Net interest income to gross income ratio	78.9	86.2	78.4	81.2	75.3	70.7	67.1	68.5	69.7
Net fees and commissions income to gross income ratio	16.0	13.4	11.6	13.8	14.6	16.4	19.6	20.5	19.9
Net interest margin	2.3	2.4	2.9	2.8	2.6	2.3	1.8	1.9	1.8
Liquidity									
Cash, trading and available-for-sale assets to total assets ratio	8.6	7.0	14.4	19.8	22.9	27.9	27.6	29.3	27.6
Others									
Total loans and advances to total assets ratio	82.9	83.6	73.4	73.6	69.1	64.1	54.6	53.8	51.4
Total deposits (other than from credit institutions) to total assets ratio	71.7	63.8	63.0	65.1	74.9	75.6	79.2	82.8	80.2

Source: Central Bank of Cyprus.

1/ Unless otherwise specified, these FSIs cover consolidated accounts of domestic and foreign banks operating in Cyprus up to 2020Q3. The data on asset quality ratios is up to 2020Q4.

2/ Based on the European Banking Association's definition of NPLs. As of end-2014, banks report NPLs as per the EU's regulation on reporting NPLs and forborne exposures. The main changes with respect to the previous definition are that the minimum probation period for forborne loans remaining classified as NPLs has increased from 6 to 12 months.

3/ Local operations are confined to banks active in the local market, excluding overseas branches and subsidiaries of Cyprus-based banks.

4/ Annual return. The last observation is the year-to-date return.

Annex I. Status of Article IV Recommendations

Past Policy Recommendation	Policy Actions
Strengthen Financial Sector Policies	
Reduce private sector debt and high NPLs, including by: (i) addressing impediments in the foreclosure and insolvency frameworks and asset sales legislation; (ii) relying on a broad set of tools that includes burden sharing and keeps banks well provisioned and capitalized; and (iii) strengthening supervisory and governance framework for credit-acquiring companies (CACs), including the government-owned CAMC.	The amendments to the foreclosure and insolvency legislation and the sales of loans law as well as the adoption of a law on securitization have enhanced the toolkit to address NPLs (2018). Banks have made significant progress in offloading NPLs. However, their successful workout outside of the banking system is still needed, Parliament recently made further amendments to foreclosure law to weaken the effectiveness of its framework. A subsidy scheme aimed at encouraging vulnerable borrowers to start servicing their loans through burden sharing is about to be implemented, but its coverage is rather broad. CAMC has yet to become fully operational.
Ensure Fiscal Sustainability and Avoid Procyclicality	
Cap fiscal spending and wage bill by medium term GDP growth and nominal GDP growth, respectively, to avoid procyclical policies, prevent structural loosening and mitigate risks stemming from the high level of public debt.	The authorities have contained fiscal spending and wage bill within medium term GDP growth and nominal GDP growth, respectively. Some fiscal loosening took place during 2017–2019. A more durable mechanism to keep the public-sector wage bill in check has not been adopted by Parliament. The government has decided to reverse crisis-era public wage cuts gradually starting in 2018.
Mitigate fiscal risks from the introduction of a public health insurance system.	Reforms are ongoing to make the public health sector more competitive.
Focus on implementing key reforms in public financial management (PFM) and revenue administration (RA); pass the law on creation and functioning of SOEs.	PFM and RA reforms are being implemented, supported by Fund technical assistance. Legislative reform of SOEs, however, has stalled.
Implement Structural Reforms	
Strengthen judicial efficiency and commercial claims enforcement.	The legislation for the establishment of a commercial court is [currently undergoing legal vetting]. An action plan is being drawn based on issues identified in a functional review of the Cyprus's Court System prepared by the Irish Institute of Public Administration.
Strengthen central bank governance and undertake Local government and civil service reforms.	The amending legislation to strengthen the governance and autonomy of the CBC is [undergoing legal vetting]. A draft law on local government reform is currently being prepared [under discussion in Parliament]. Civil service reform has largely stalled.
Continue to improve the AML/CFT framework, including by ensuring effectively mitigating inherent AML/CFT risks.	A cap on the number of citizenships granted under the CIP has been introduced and the required period for holding investment lengthened; The CIP scheme has been terminated from end-Nov 2020.

Annex II. External Sector Assessment

Overall Assessment: *The external position of Cyprus in 2020 was weaker than the level implied by fundamentals and desirable policies.* The current account (CA) deficit widened in 2020 mainly due to collapsed services exports in the wake of the pandemic. Over the medium term, the current account deficit is set to recover and gradually narrow while the NIIP is projected to increase temporarily and gradually decline over the medium term.

Potential Policy Responses: *Short-term policies should focus on containing the COVID-19 outbreak and its economic consequences and provide relief to households and firms to reduce scarring from the crisis. The COVID-crisis initiatives both at the national and EU-levels will support these efforts and potentially help reduce imbalances. Maintaining financial stability through continued efforts to unwind the credit gap would be essential for external rebalancing by raising the current account and lowering net IIP liabilities. Polices to boost travel and enhance exports diversification would help the recovery of service exports. Structural reforms to raise productivity and enhance competitiveness will help to improve the external position.*

Foreign Assets and Liabilities: Position and Trajectory

Background. In 2020, the net international investment position (NIIP) declined to -141.3percent of GDP, as lower direct investment liabilities were offset by higher portfolio and other investment liabilities. Excluding the contribution of SPEs' foreign financial positions, the underlying NIIP improved from -78 percent of GDP in 2014 to -52 percent in 2020. Gross liabilities increased to 2543 percent of GDP in 2020, with around one third in the form of external debt. Under the IMF staff's baseline scenario, the NIIP is projected to decline further temporarily and then gradually improve through the medium term on the back of lower CA deficits.

Assessment. External vulnerabilities have been reduced with the strengthening of the NIIP in recent years, although it increased somewhat with the larger size of the NIIP since the pandemic in 2020. The significant size of NIIP reflects Cyprus's role as a financial center and the effects of SPEs. The NIIP remains broadly sustainable when excluding SPEs. Projections of improvements in CA deficits suggest that the NIIP-to-GDP ratio will improve at a moderate pace in the medium term.

2020 (% GDP)	NIIP: -141.3 (underlying -52)	Gross Assets: 2402 (underlying 402)	Debt Assets: 539	Gross Liab.: 2543 (underlying 459)	Debt Liabilities.: 909)

Capital and Financial Accounts: Flows and Policy Measures

Background. Compared to net inflows of previous years, net capital flows for the private sector recorded outflows of 8 percent of GDP in 2020, reflecting the decline in net FDI inflows and outflows in net private portfolio and other investment. Net public inflows for the central bank were 4 percent of GDP in 2020, compared to outflows of 2 percent in 2019, with TARGET2 balance slightly declining to 37 percent of GDP. Total financial inflows reached 10 percent of GDP in 2020, mainly reflecting higher public portfolio inflows. Adjusting for SPEs, the underlying net private flows changed from net inflows in 2019 (-6 percent of GDP) to net outflows in 2020 (10 percent of GDP), mainly due to significant declines in FDI inflows to 10 percent of GDP in 2020 compared to a peak of 36 percent of GDP in 2019.

Assessment. With sizable external debt of the public and private sectors, Cyprus remains exposed to financial market risks. The prolonged pandemic and sustained financial market volatility could increase vulnerability, although partly mitigated by the ECB's policies of maintaining favorable liquidity conditions.

Current Account

Background. The overall CA deficit widened to 11.9 percent of GDP (underlying 11.6) in 2020 mainly due to a collapse in services exports in the wake of the pandemic and a larger deficit in primary income, compared to 6.3 percent of GDP (underlying 6.8) in 2019. Services balance worsened reflecting significantly lower travel exports, which was partly offset by increase in transport and financial exports. The primary income deficit increased slightly mainly due to the lower direct investment income.

Cyprus: Results from EBA-Lite Model for 2020
(in percent of GDP)

	CA model	REER model	ES model
CA-Actual	**-11.9**		
Cyclical contributions (from model) (-)	-0.6		
COVID-19 adjustor (+) 1/	4.4		
Additional temporary/statistical factors (+)	1.3		
Natural disasters and conflicts (-)	0.0		
Adjusted CA	**-5.6**		
CA Norm (from model) 2/	**-1.7**		
Adjustments to the norm (+)	0.0		
Adjusted CA Norm	**-1.7**		
CA Gap	**-3.8**	**2.0**	**0.1**
o/w Relative policy gap	3.1		
Elasticity	-0.51		
REER Gap (in percent)	**7.6**	**-3.9**	**-0.2**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on oil trade balances (0.2 percent of GDP) and on tourism (4.1 percent of GDP), and on remittances (0.01 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

Assessment. The EBA model estimates a CA norm of -1.7 percent of GDP, against an adjusted CA of -5.6 percent of GDP after adjusting for cyclical contributions, SPE effects, and additional adjustor to account for the effects of oil balance, tourism, and remittance changes due to the pandemic. Policy gaps, reflecting deviations of current policy settings in Cyprus and the rest of the world (ROW) from their desired settings, contribute 3.1 percentage point. Based on the CA model, IMF staff assesses the CA gap to be -3.8 percent for 2020, which corresponds to an assessment that the external position was weaker than the level warranted by fundamentals and desirable policy settings in 2020.

2020 (% GDP)	Actual CA: -11.9	Cycl. Adj. CA: -11.3	EBA-lite CA Norm: -1.7	Staff Adj. CA: -5.6	Staff CA Gap: -3.8

Real Exchange Rate

Background. In 2020, the CPI-based REER depreciated by 0.9 percent relative to its 2019 average. The real effective exchange rate stayed at post-crisis low in 2020.

Assessment. The EBA-lite REER model estimates an undervaluation of 3.9 percent in 2020. The REER gap derived from the IMF staff's CA gap assessment, with an estimated elasticity of -0.52, implies that the real exchange rate was overvalued by 7.6 percent in 2020. The external sustainability (ES) model suggests a small REER undervaluation of 0.2 percent. Considering all estimates and the uncertainties around them, staff's assessment is based on the EBA-lite CA model and estimates the REER gap to be in the range of -3.9 to 7.6 percent in 2020.

FX Intervention and Reserves Level

Background. The euro has the status of a global reserve currency.

Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.

Annex III. Debt Sustainability Analysis

The Public Debt Sustainability Analysis for Market-Access Countries indicates that, in the baseline, public debt is on a steady downward path after a sharp increase in 2020 due to the COVID-19 pandemic. Risks to debt sustainability are high and have increased through the impact of the pandemic, although extremely low financing costs—which are expected to persist—will provide considerable cushion for some time. Debt levels remain above risk thresholds over the forecast horizon, and debt reduction could be temporarily halted by an adverse short-term growth shock or a fiscal shock, including from contingent liabilities. If a combination of macro-fiscal shocks and a contingent liability were to materialize, public debt would rise and remain at a very high level. Gross public financing needs have recently increased and could rise further under macro-fiscal and contingent liability shocks but are expected to remain below high vulnerability thresholds.

A. Baseline Scenario

1. Public debt rose sharply in 2020, reflecting the negative output growth and the discretionary fiscal response to the pandemic.[1] In addition, the government issued Eurobonds of €1.75 billion in April 2020 to pre-finance anticipated spending needs and started accessing EC's SURE funds, building up a large cash buffer of around 20 percent of GDP.[2] As a result, the debt-to-GDP ratio increased by 25 percentage points to above 119 percent at end-2020. In February 2020, Cyprus repaid early the remaining balance of the Extended Fund Facility credit to the IMF.

2. Public debt is projected to resume a steady decline from 2021. Projected improvements in primary balances and a negative interest-economic growth differential going forward will support a durable decline in public debt to around 86 percent of GDP by 2026.

3. The gross public financing needs (GPFN) are expected to remain below the benchmark. The debt issuance to the Cyprus Cooperative Bank (CCB) was implemented through a private off-market placement of domestic bonds, which are being redeemed gradually over a five- year period beginning 2018. The gross financing needs of the government increased to 17.3 percent of GDP in 2020 from 13.3 percent of GDP in 2019 but will remain well below the benchmark for advanced economies (20 percent of GDP) over the projection horizon[3]. Looking forward, the authorities plan to issue medium- or long-term Eurobonds each year to maintain a cash buffer sufficient to cover gross financing needs on a nine-month forward rolling basis.

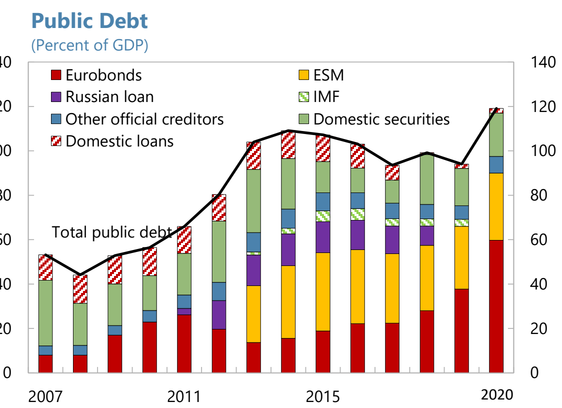
[1] The coverage of the public DSA is the general government. Debt guaranteed by the government is not included in the baseline DSA, but debt of public entities guaranteed by the general government as well as deficits of public entities is included in the calculation of the DSA contingent liabilities scenario.

[2] In April 2020, the government issued a seven-year bond of 1.25 billion euros at a yield of 1.56 percent and a 30-year bond of 0.5 billion euros at 2.34 percent. Cyprus has already received as a loan amounts to 479 million euros under SURE. Cyprus received the first disbursement of 250 million euros in 2020 and the second disbursement of 229 million euros in 2021.

[3] The projection assumes interest rates of 1.4 percent for 7-year Eurobond and 1.8 percent for 15-year Eurobond.

B. Risk Assessment

4. **High NPLs pose a risk to the sustainability of public debt.** As part of the CCB sale, the government agreed to an Asset Protection Scheme (APS) covering the loan portfolio (€2.6 billion) transferred to Hellenic Bank (HB), although the eventual loss to which the government is exposed will likely be much smaller.[4] In addition, broader risk from NPLs at other systemic banks could spill over to the government's balance sheet if higher provisioning and recapitalization needs cannot be met through private financing. On the other hand, the baseline scenario conservatively assumes zero recovery from the NPLs in the public asset management company (AMC).



Sources: Ministry of Finance and IMF staff estimates.

5. **Cyprus's current high level of public debt also leaves it vulnerable to macro-fiscal shocks.** Under the baseline, Cyprus's public debt ratio is projected to decline to around the benchmark level for advanced economies (85 percent of GDP) only in 2026. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 100 percent until 2026 with a probability of 40 percent (fan chart in Annex Figure 1).[5]

6. **Gross public financing needs are susceptible to a range of shocks.** In the event of short- duration individual macro-fiscal shocks or a sustained scenario corresponding to historical adverse episodes for growth and the primary balance, the GPFN would jump several percentage points of GDP, although it remains well below the 20 percent benchmark.

7. **The profile of Cyprus's public debt points to vulnerabilities as well as mitigating factors:**

- Given Cyprus's role as a financial center and business hub, private sector short-term foreign liabilities are very large, reflecting mainly nonresident deposits in Cypriot banks and foreign debts of nonfinancial corporates, although they are estimated to have declined in 2020 due to ongoing reductions in non-resident deposits at Cypriot banks. The private sector GFN may create pressure if liabilities are not rolled over or flows reverse, although gross liabilities are to a considerable extent matched by gross assets of a similar duration.

- Around 80 percent of public debt is owed to non-residents. However, about 40 percent of this debt reflects official financing from the ESM, and loans from the European Investment Bank and

[4] The fiscal cost is estimated at around €150 million (0.7 percent of GDP).

[5] In the asymmetric distribution, upside shocks to growth and the primary surplus are limited to 1 percentage point and 2 percentage points, respectively.

the Council of Europe Development Bank. Cyprus also issued 7- and 30-year Eurobonds in 2020, lengthening the average maturity of the stock of Eurobonds. The relatively low and/or fixed interest rate on official liabilities, combined with long maturities and the back-loaded repayment schedule on a significant share of debt, mitigates interest rate and financing risks.[6]

- Cyprus's sovereign credit has maintained investment grade. The 10-year sovereign bond spread relative to German bonds—an indicator of market perception of sovereign risk—was around 84 basis points on average in the past three months, below the lower risk-assessment benchmark.

- Reliance on short-term debt is limited and considered low risk.

C. Realism of Baseline Assumptions

8. GDP growth and fiscal outturns have surpassed staff's forecasts in recent years, in contrast to previous excessive optimism. Recent GDP growth and the fiscal balance have been stronger than expected, due in part to robust external demand and private financial inflows that have substituted for new bank lending. This over-performance occurred despite the sizable structural fiscal consolidation during the program. The forecast error for primary balance in 2018 mainly reflects the fiscal impact of the Cyprus Cooperative Bank (CCB) transaction and state-owned AMC. In contrast, projection errors during 2012–13 indicate excessive optimism although these errors reflect difficult-to-foresee events (damage to the sole power plant in 2011 and the write-down of banks' holdings of Greek public debt in 2012). The relatively high 3-year average level of projected cyclically-adjusted primary balance is underpinned by consistent overperformance of tax revenue in recent years and the authorities' commitment to expenditure restraint.

D. Stress Tests and Alternative Scenarios

Given Cyprus's high debt-to-GDP ratio and contingent liabilities from the banking sector, debt reduction is highly susceptible to the growth shock and realization of contingent liabilities.

9. Various macro-fiscal and contingent liability shocks would postpone debt reduction:

- **Growth shock.** A one standard deviation (4.7 percentage points) decrease in growth during 2022–23, accompanied by (i) a 63 and 130 basis points (bps) rise in interest rates in 2022 and 2023 respectively (corresponding to 25 bps rise per one percentage point reduction in primary balance), and (ii) a decrease in inflation by 0.25 percentage points per percentage point

[6] The weighted average maturity of total debt increased from 7.4 to 8 years from end-2019 to end 2020. The shares of debt that falls due within 1 year and 5 years are 9.7 percent and 40 percent, respectively.

reduction in GDP growth, would raise public debt by 20 percentage points relative the baseline to 123 percent of GDP by 2023, before declining to 105 percent of GDP by 2026.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.7 percent of GDP during 2022–23, accompanied by 40 bps rise in interest rates (corresponding to 25 bps rise per one percentage point reduction in primary balance) and an increase in the real interest rate by 486 bps during 2022–26 would raise public debt marginally to 89.4 percent and 89.1 percent of GDP, respectively.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 126 percent of GDP in 2023 before declining to 112.6 percent of GDP by 2026. Gross financing needs would peak at 16.2 of GDP in 2023 before falling back.

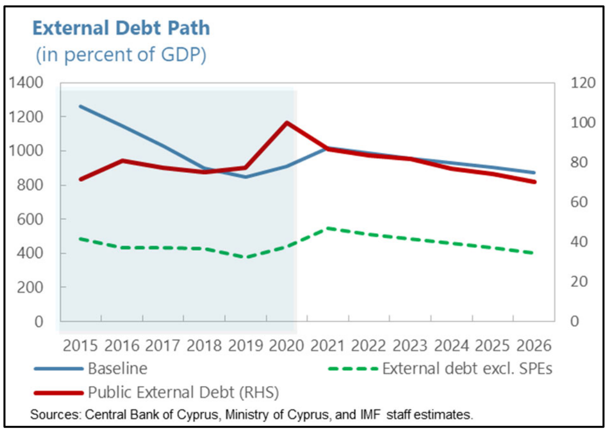
10. Under a scenario with a lower fiscal balance and realization of contingent liabilities from government guarantees, the public debt-to-GDP ratio declines very slowly. The primary fiscal balance is assumed to be permanently lower than in the baseline by ½ standard deviation, which could materialize from the reversal of expenditure measures implemented during the adjustment program or the higher-than-expected fiscal cost of the forthcoming National Health System (NHS) implementation. Further realization of contingent liabilities from government guarantees to public entities and pension deficits of public entities is also assumed. As risk premiums rise, interest rate is higher than under the baseline by 285 basis points in 2022 and 42– 64 basis points thereafter. Under this scenario, public debt would rise to 117.7 percent of GDP in 2022 and thereafter decline to 105.4 percent in 2026. Gross financing needs would spike to 22.3 percent of GDP in 2022 before declining to 12.4 percent in 2026.

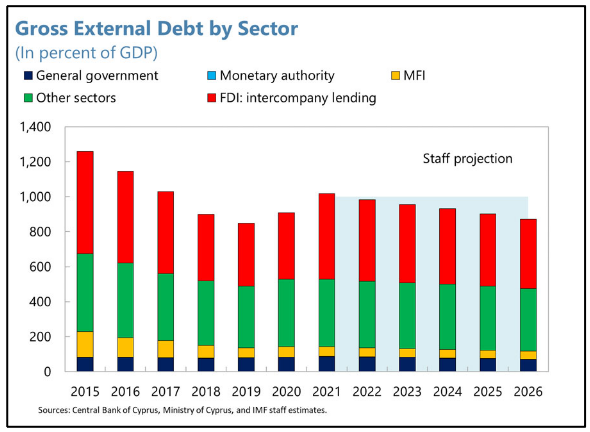
11. Under an alternative adverse scenario of lower economic growth and primary fiscal balances combined with a further realization of contingent liabilities from the banking sector (adverse macro-fiscal-contingent liability (CL) scenario), public debt and gross financing needs remain high. Real GDP growth and the primary fiscal balance are assumed to be permanently lower than in the baseline by ½ standard deviation which could materialize from a productivity slowdown, an unforeseen fiscal loosening, and lower-than-expected recovery after the pandemic. These shocks are assumed to be accompanied by a decrease in inflation and a rise in interest rates. Further realization of contingent liabilities from the banking sector (6 percent of GDP from the existing NPLs and 1.5 percent of GDP from 10 percent further increase in NPLs) in 2022, on top of the support already provided to the CCB, is also assumed.[7] Under this adverse scenario, public debt would rise to 123 percent of GDP in 2023 and would decline only slowly to 121 percent of GDP in 2026. Gross financing needs would also spike to 23.7 percent of GDP in 2022 before declining to 13.6 percent of GDP over the medium term.

[7] Contingent liabilities from the banking sector comprise three components: (i) 50 percent default rate for loans covered by the APS and 50 percent loss-given-default rate; (ii) 75 percent loss from gross book value of NPLs minus provisions of the banking system; and (iii) capital needs of 1.5 percent of GDP from 10 percent increase in NPLs.

E. External Debt Sustainability Analysis

12. Under the baseline scenario, the external debt-to-GDP ratio is projected to increase in 2021 reflecting the pandemic shock, then decline gradually over the medium term. In 2020, Cyprus's external debt increased to 908 percent of GDP (287 percent of GDP excluding SPEs) as a result of growth decline and wider external deficit due to the pandemic. The high external debt level reflects its role as a financial center and the presence of SPEs[8]. In 2020, government external debt increased slightly to 100 percent of GDP mainly due to the denominator effect. Net debt was much lower than gross debt at 369percent of GDP for the economy and even negative after excluding SPEs (-4 percent of GDP). Gross external debt is projected to increase to around 1019 percent of GDP in 2021 as a result of higher government borrowing and FDI, then gradually decline to 872 percent of GDP by 2026. Government external debt is projected to be 86 percent of GDP in 2021, then decline over the medium-term to around 70 percent of GDP, supported by GDP growth.





13. The projected increases of external debt from an already high level in the near term due to the pandemic leaves Cyprus vulnerable to a variety of risks. Shocks to interest rates and economic growth would significantly impede debt reduction, as the large size of external debt would markedly increase debt service costs while reducing the denominator effect on the debt-to-GDP ratio. Standardized current account deficit shocks would have a more limited impact on the debt ratio.

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[8] Cyprus is a regional financial center and its external assets and liabilities are very large. The external DSA focuses on gross external debt and associated gross interest payments. However, changes in gross external debt may be accompanied by changes in gross external assets, which—in a financial center—could be large and volatile if SPEs engage in operations to expand or shrink their balance sheets, even though net positions may be unchanged. Large historical residuals in the external DSA suggest that indeed past increases in external debt were accompanied by increases in external assets. This notwithstanding, the DSA provides a tool for assessing risks emanating from macro-financial shocks in the presence of large gross external debt.

14. The Cypriot economy remains exposed to liquidity and other risks as a result of continued large gross financing needs. Gross financing needs have declined from the peak levels of over 400 percent of GDP in 2012 and 2013 to 216 percent of GDP in 2020. While gross external financing needs are projected to increase in the near term then decline, it would remain elevated (over 200 percent of GDP) through the projection period, reflecting sizable stock of short-term debt of the private sector. Sound financial sector policies and structural reforms targeting a more diversified economy would help to ensure balanced and sustainable growth. Maintaining prudent fiscal policy post-pandemic that avoids procyclicality would help safeguard the downward path of external public debt and create space to absorb possible contingent fiscal shocks. It also will remain important to closely align the maturity and currency of external assets and liabilities.

15. In conclusion, Cyprus's public debt and external debt remain at high levels and debt sustainability risks have increased through the impact of the pandemic, although extremely low financing costs—which are expected to persist—will provide considerable cushion for some time. Ensuring strong underlying fiscal surpluses, reducing risks to financial stability and strengthening structural reforms to support the recovery are needed to maintain debt sustainability. Debt reduction is susceptible to the growth shock and realization of contingent liabilities, As recommended in the main text of the staff report, when a firm recovery is underway, the policy focus should gradually shift to maintaining fiscal sustainability. Sound financial sector policies and structural reforms could contain the risks from the banking sector and support a more diversified economy, which would help improve the sustainability of the public debt and external debt.

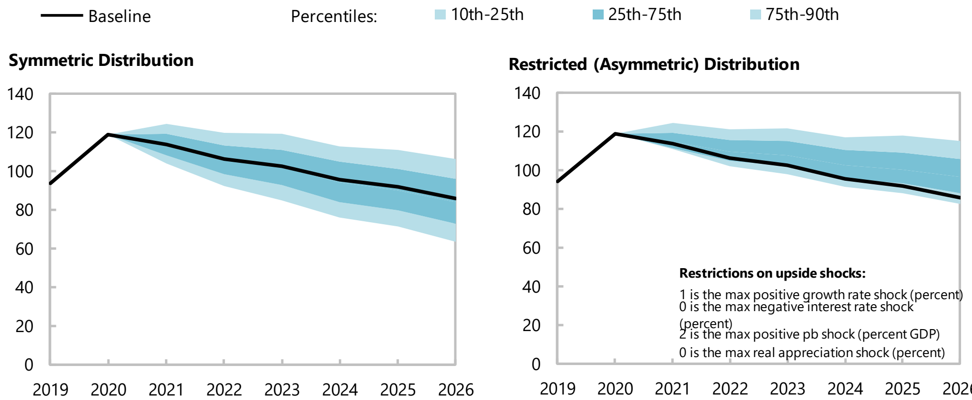
Figure 1. Cyprus Public Risk DSA Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

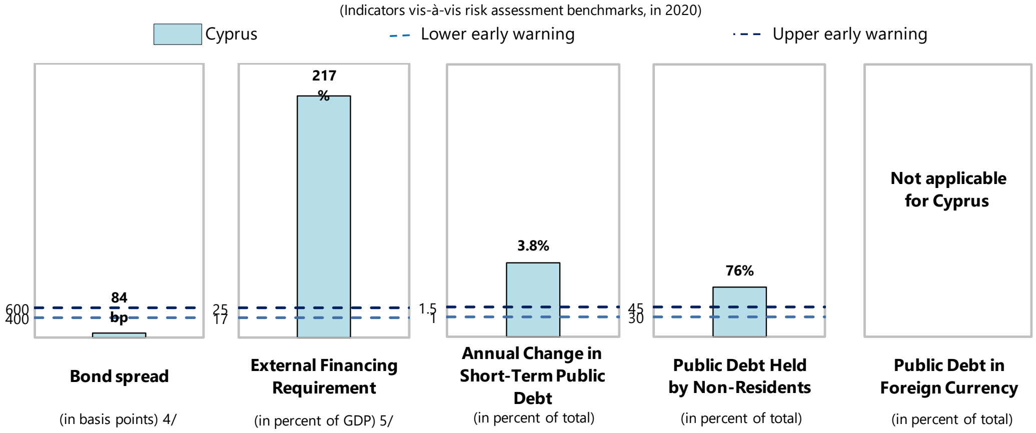
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

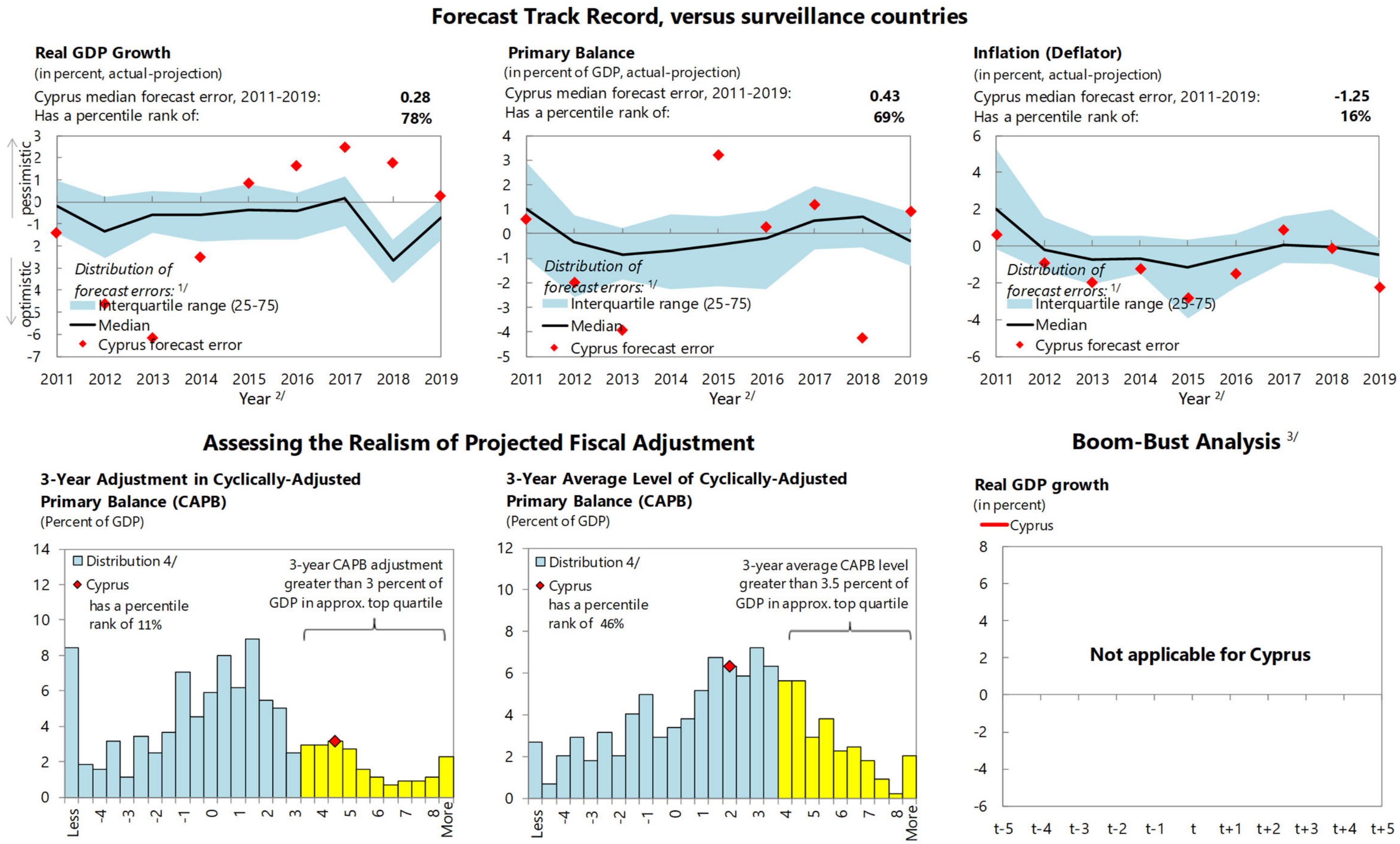
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, December 25, 2020 through March 25, 2021.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Cyprus: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Cyprus, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Cyprus: Public Sector Debt Sustainability Analysis (DSA) - Basic Scenario

(in percent of GDP unless otherwise indicated)

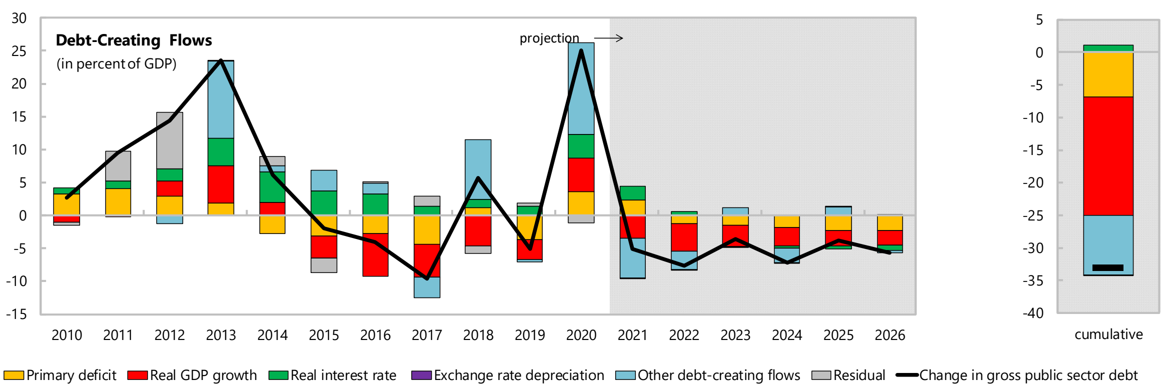
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	90.5	94.0	119.1	114.0	106.4	102.8	95.6	91.8	86.1
Public gross financing needs	12.0	13.3	17.3	15.0	10.9	7.5	10.5	7.3	8.9
Real GDP growth (in percent)	1.2	3.1	-5.1	3.0	3.9	3.1	2.8	2.6	2.5
Inflation (GDP deflator, in percent)	0.4	0.9	-1.5	0.3	1.5	1.9	2.0	2.3	2.6
Nominal GDP growth (in percent)	1.6	4.0	-6.5	3.3	5.4	5.0	4.9	4.9	5.2
Effective interest rate (in percent) [4/]	3.3	2.4	2.2	2.1	2.1	1.9	1.8	1.8	1.8

As of March 25, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		87
5Y CDS (bp)		102
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	5.2	-5.1	25.1	-5.1	-7.6	-3.6	-7.2	-3.8	-5.7	-33.0	
Identified debt-creating flows	3.8	-5.6	26.2	-5.1	-7.6	-3.6	-7.2	-3.8	-5.7	-33.0	
Primary deficit	0.0	-3.8	3.6	2.4	-1.2	-1.5	-1.9	-2.3	-2.4	-6.9	-3.4
Primary (noninterest) revenue and grants	37.9	41.2	40.9	42.9	44.0	44.2	44.1	44.0	43.6	262.8	
Primary (noninterest) expenditure	37.9	37.4	44.5	45.2	42.7	42.7	42.3	41.7	41.3	256.0	
Automatic debt dynamics [5/]	1.3	-1.5	8.7	-1.5	-3.6	-3.2	-3.0	-2.8	-3.0	-17.1	
Interest rate/growth differential [6/]	1.3	-1.5	8.7	-1.5	-3.6	-3.2	-3.0	-2.8	-3.0	-17.1	
Of which: real interest rate	2.5	1.4	3.6	2.0	0.6	0.0	-0.3	-0.5	-0.8	1.1	
Of which: real GDP growth	-1.2	-2.9	5.1	-3.5	-4.2	-3.2	-2.8	-2.4	-2.2	-18.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	2.4	-0.3	13.9	-6.0	-2.8	1.1	-2.3	1.3	-0.4	-9.1	
Privatization/Drawdown of Deposits (+ reduces financing need) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	2.4	-0.3	13.9	-6.0	-2.8	1.1	-2.3	1.3	-0.4	-9.1	
Residual, including asset changes [8/]	1.4	0.5	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

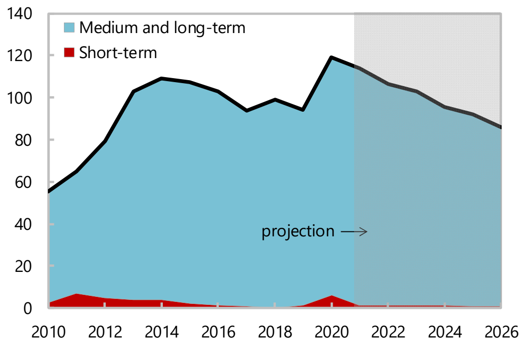
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Cyprus: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

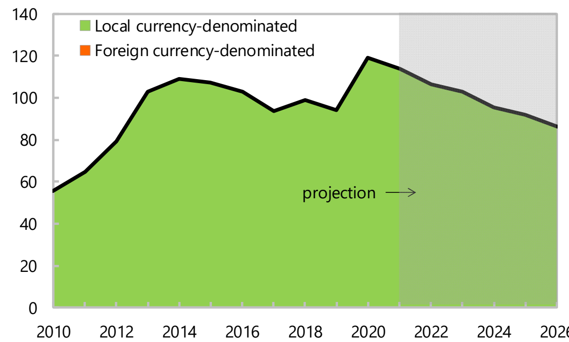
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

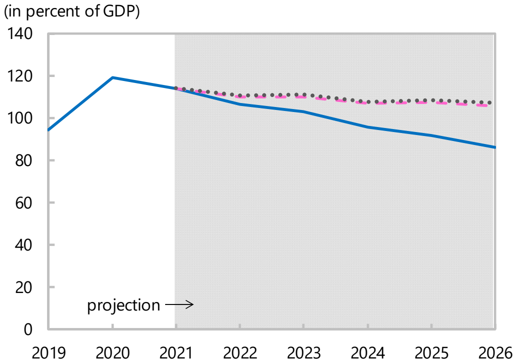


Alternative Scenarios

Baseline Historical Constant Primary Balance

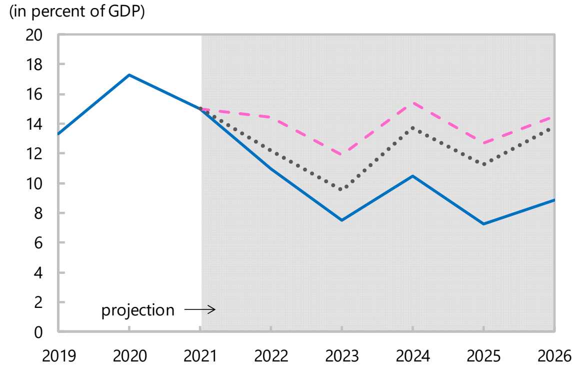
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

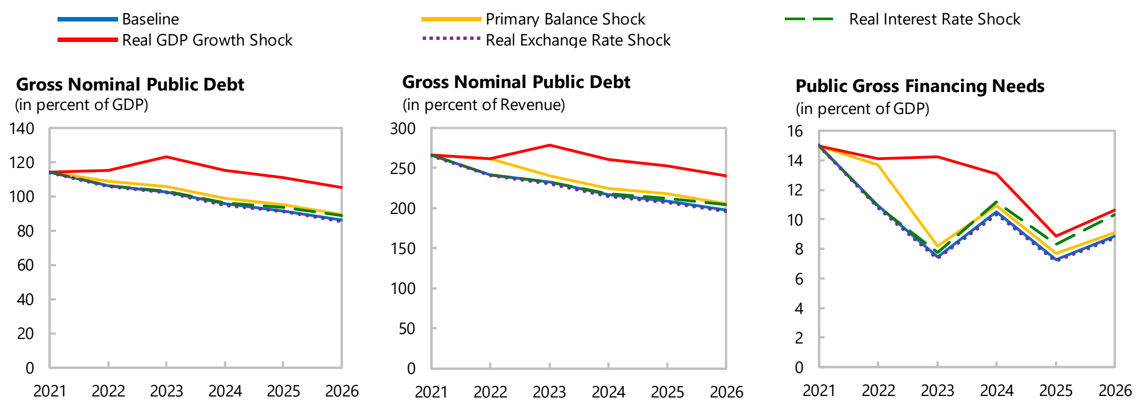
Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary Balance	-2.4	1.2	1.5	1.9	2.3	2.4
Effective interest rate	2.1	2.1	1.9	1.8	1.8	1.8
Constant Primary Balance Scenario						
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	2.1	2.0	1.8	1.7	1.7	1.7

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.0	0.7	0.7	0.7	0.7	0.7
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary Balance	-2.4	0.3	0.3	0.3	0.3	0.3
Effective interest rate	2.1	2.0	2.0	2.2	2.4	2.7

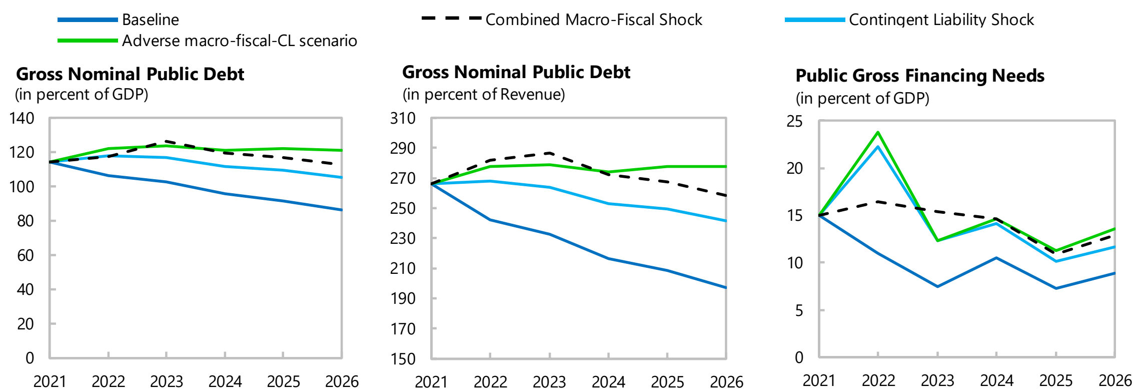
Source: IMF staff.

Figure 5. Cyprus: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary balance	-2.4	-1.7	1.3	1.6	2.0	2.3
Effective interest rate	2.1	2.0	1.9	1.8	1.8	1.8
Real Interest Rate Shock						
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary balance	-2.4	1.2	1.5	1.9	2.3	2.4
Effective interest rate	2.1	2.0	2.2	2.4	2.9	3.2
Combined Shock						
Real GDP growth	3.0	-0.8	-1.5	2.8	2.6	2.5
Inflation	0.3	0.3	0.7	2.0	2.3	2.6
Primary balance	-2.4	-3.6	-3.9	1.6	2.0	2.3
Effective interest rate	2.1	2.0	2.3	2.7	3.2	3.5

	2021	2022	2023	2024	2025	2026
Real GDP Growth Shock						
Real GDP growth	3.0	-0.8	-1.5	2.8	2.6	2.5
Inflation	0.3	0.3	0.7	2.0	2.3	2.6
Primary balance	-2.4	-1.3	-3.7	1.9	2.3	2.4
Effective interest rate	2.1	2.0	1.9	1.9	1.9	1.9
Real Exchange Rate Shock						
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.9	1.9	2.0	2.3	2.6
Primary balance	-2.4	1.2	1.5	1.9	2.3	2.4
Effective interest rate	2.1	2.0	1.8	1.7	1.8	1.7
Contingent Liability Shock						
Real GDP growth	3.0	3.9	3.1	2.8	2.6	2.5
Inflation	0.3	1.5	1.9	2.0	2.3	2.6
Primary balance	-2.4	-10.2	-1.0	-0.5	0.6	0.7
Effective interest rate	2.1	2.0	2.2	2.1	2.2	2.2

Source: IMF staff.

Figure 6. Cyprus: External Debt Sustainability Framework

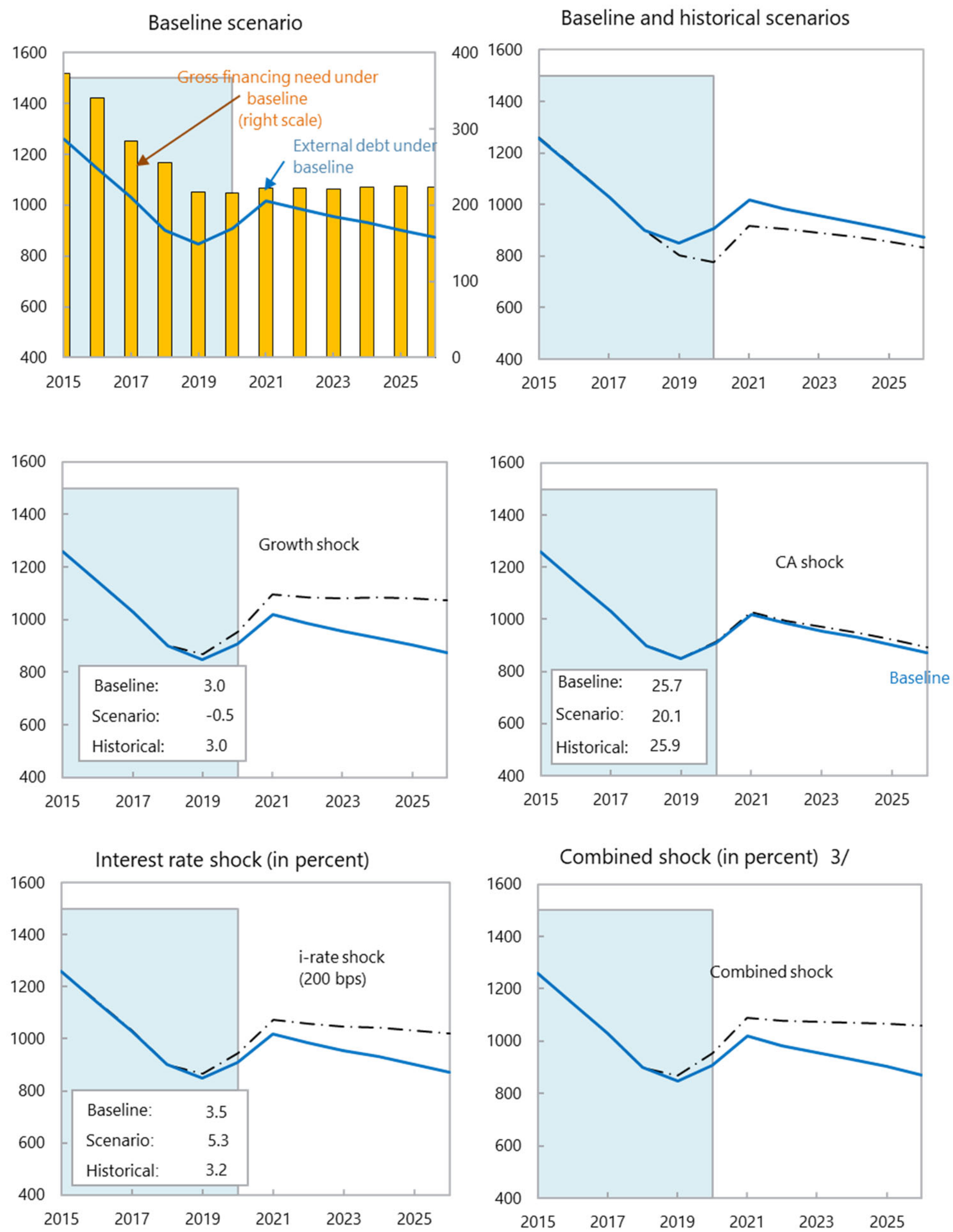
(Percent of GDP, unless otherwise indicated)

	Actual								Projections						
	2015	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	Debt-stabilizing non-interest current account 5/
Baseline: External debt	1259	1144	1030	900	849	908			**1019**	**984**	**956**	**932**	**903**	**872**	**-1.8**
Change in external debt	110.8	-114.4	-114.0	-130.2	-51.2	60.0			109.6	-34.3	-28.2	-24.4	-28.7	-30.7	
Identified external debt-creating flows (4+9+14)	203.6	-112.7	-66.9	-130.5	30.5	68.3			89.4	-37.8	-27.9	-24.2	-28.5	-30.6	
Current account deficit, excluding interest payments	-41.3	-32.8	-29.0	-27.3	-23.0	-17.7			-21.5	-24.4	-25.1	-26.4	-27.9	-28.7	
Deficit in balance of goods and services	-2.6	-1.7	0.4	-1.5	1.1	6.2			4.8	4.3	3.9	3.4	3.3	2.2	
Exports	70.1	70.5	73.5	75.2	71.9	67.7			66.4	67.5	68.7	70.2	70.2	69.1	
Imports	67.5	68.8	73.9	73.7	72.9	73.9			71.3	71.9	72.7	73.5	73.5	71.3	
Interest receipts (negative)	-16.5	-14.7	-12.7	-13.1	-12.3	-12.2			-11.6	-11.6	-12.1	-13.3	-14.4	-15.3	
Net non-debt creating capital inflows (negative)	125.2	-49.0	6.0	-50.7	35.5	4.7			131.1	12.4	14.3	15.7	11.2	10.2	
Net foreign direct investment, equity	158.9	-39.8	8.4	-37.5	31.8	-2.3			110.9	-7.0	-7.1	-7.1	-7.1	-6.8	
Net portfolio investment, equity	-12.7	3.6	16.6	-15.5	3.7	5.0			1.4	-1.1	0.0	-2.8	-1.9	1.7	
Net sales of assets under other investment	-13.2	-13.6	-20.1	1.3	-1.1	2.2			16.5	18.1	18.5	22.6	17.8	13.1	
Financial derivatives, net	-4.4	1.7	1.4	3.1	0.8	-1.0			-0.9	-0.9	-0.8	-0.8	-0.7	-0.7	
Automatic debt dynamics 1/	119.7	-31.0	-43.9	-52.5	17.9	81.3			-20.2	-25.9	-17.1	-13.5	-11.8	-12.0	
Contribution from nominal interest rate	41.8	37.0	34.3	31.2	29.3	29.6			29.6	30.4	30.2	31.1	31.9	32.5	
Contribution from real GDP growth	-43.1	-76.8	-54.4	-48.5	-28.1	45.6			-25.2	-37.3	-29.2	-25.7	-23.1	-21.5	
Contribution from price and exchange rate changes 2/	121.1	8.8	-23.8	-35.3	16.7	6.1			-24.6	-19.0	-18.1	-18.9	-20.5	-23.0	
Residual (2-3 or 19+20+21+22)	-92.9	-1.6	-47.1	0.3	-81.7	-8.3			20.2	3.5	-0.2	-0.2	-0.2	-0.2	
Net accumulation of official reserve assets	0.0	-0.1	0.0	0.2	0.0	0.1			0.0	0.0	0.0	0.0	0.0	0.0	
Captial account flows, net (negative)	0.0	-0.1	-0.4	-0.5	-0.1	-0.1			-0.2	-0.2	-0.2	-0.2	-0.1	-0.1	
Errors and omissions, net (negative)	-2.0	-2.0	-2.2	0.3	-0.2	-1.2			0.0	0.0	0.0	0.0	0.0	0.0	
Changes in debt stock without flow transactions, incl. valuation changes, write-offs, and reclassifications	14.8	-15.5	-48.4	-17.3	-52.0	-12.5			-0.1	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	1796	1622	1402	1197	1181	1342			1534	1458	1391	1328	1286	1263	
Gross external financing need (in billions of euros) 3/	74	71	64	65	54	51			57	61	63	67	71	74	
in percent of GDP	372	340	284	256	217	216			223	222	221	224	225	224	
Scenario with key variables at their historical averages 4/							5-Year Historical Average	5-Year Standard Deviation	**917**	**906**	**889**	**874**	**855**	**835**	Projected Average
Key Macroeconomic Assumptions Underlying Baseline															
Nominal GDP (in billions of euros)	19.8	20.9	22.7	25.3	25.0	23.7			25.8	27.4	28.8	30.2	31.7	33.3	
Real GDP growth (in percent)	3.2	6.4	5.2	5.2	3.1	-5.1	3.0	4.7	3.0	3.9	3.1	2.8	2.6	2.5	3.0
GDP deflator in euros (change in percent)	-17.0	-0.8	3.2	5.9	-4.4	0.2	0.8	3.9	5.4	2.3	1.9	2.0	2.3	2.6	2.7
Nominal external interest rate (in percent)	3.1	3.1	3.2	3.4	3.2	3.3	3.2	0.1	3.5	3.2	3.2	3.4	3.6	3.8	3.5
Growth of exports (euro terms, in percent)	-9.0	6.2	13.0	14.1	-5.9	-10.5	3.4	11.1	6.6	8.0	6.9	7.1	5.0	3.5	6.2
Growth of imports (euro terms, in percent)	-11.2	7.7	16.4	11.2	-2.5	-3.7	5.8	8.7	4.7	7.2	6.2	6.1	5.0	2.0	5.2
Current account balance, excluding interest payments	41.3	32.8	29.0	27.3	23.0	17.7	25.9	5.8	21.5	24.4	25.1	26.4	27.9	28.7	25.7
Net non-debt creating capital inflows	-125.2	49.0	-6.0	50.7	-35.5	-4.7	10.7	37.8	-131.1	-12.4	-14.3	-15.7	-11.2	-10.2	-32.5

Source: IMF staff estimates.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in euro terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and non-interest current account in percent of GDP.
5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 7. Cyprus: External Debt Sustainability—Bound Tests 1/ 2/
(In percent of GDP)



Sources: Ministry of Finance; Central Bank of Cyprus; and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Five-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the five-year period, and the information is used to project debt dynamics five years ahead. Unlike the default settings, the path of non-debt creating flow is set to be the same as the baseline, because its historical average is influenced by exceptional flows during the crisis period and seems too optimistic.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Annex IV. Labor Market Developments During COVID-19

1. **After a five-year decline, the unemployment rate rose in the aftermath of the COVID outbreak.** At the outset, The LFS-based unemployment rate rose marginally to 6.8 percent in 2020:Q2 from a low of 6.4 percent in 2019:Q4, cushioned by sizable take-up of the job retention support policies[1] that were rapidly deployed with the aim to preserve the employee relationships. As these measures were phased out in 2020:Q3 and 2020:Q4, the unemployment rate jumped by 1.5 percentage points and 1.7 percentage points compared to 2019:Q3 and 2019:Q4, above both EU and euro area averages, reaching 8.2 percent and 8.0 percent, respectively. While job losses have been relatively modest, total hours worked in 2020:Q2, declined by 10.5 percent, due to lower hours worked per worker, recovering slightly to reach -7.2 percent (yoy) in 2020:Q4.

2. **The sectoral and distributional impact has been uneven.** The travel and mobility restrictions disproportionately impacted employment in contact-intensive sectors such as trade and hospitality sectors, while the construction sector, where restrictions were lifted early, held up well. Job losses were concentrated among temporary workers with more flexible contracts. Job losses were more significant for the youth (15-24 years old), broadly in line with European averages. The young population also exited the labor market to a larger extent but has reentered in 2020:Q3. These declines are in keeping with international trends where the young and lower-skilled workers are concentrated in contact-intensive sectors. The unemployment rate for women has not changed significantly compared to last year. However, they have tended to drop out of the labor force at a faster pace as they shoulder a disproportionately larger burden of school closings and childcare.

3. **There remains considerable labor market slack despite a modest recovery.** Job vacancy postings declined by 19 percent in 2020:Q2 compared to the same period last year in a fairly broad-based manner. Compensation for employees in the private sector has also dropped by 12 percent in 2020:Q2, and 8 percent in 2020:Q4 (yoy).

4. **The recovery of the labor market will depend crucially on the magnitude and duration of the shock and the resilience of the labor market to adjust to new growth sectors.** Vulnerability to COVID19 shock is very high given nearly a third of the workforce are concentrated in tourism-related sectors (accommodation, food services, transport, and trade). The longer the period of demand recovery in these sectors—tourism sector is not expected to recover to pre-pandemic levels until 2024 (Annex VII)—the higher the likelihood of permanent scarring in the economy. In recent years, Cyprus has seen rapid growth in other (non-tourism) services sectors such as professional and administrative services, education, and ICT sectors. Based on CEDEFOP Skills Forecast (2020), the sectors with the fastest employment growth are in transport, business and other (professional and administrative) services, followed by non-market services such as health and

[1] As part of a job retention scheme, in the first phase (March-June), the government provided 70 percent wage subsidy for businesses that lost turnover by over [80] percent and required workers to be retained at least for the additional same duration as the period when the benefits were utilized. Subsequently, the scheme was extended in a more targeted basis to tourism sectors through October 2021. With the advent of the second wave, another wage subsidy scheme has been introduced though March 2021.

education. To mitigate such scarring effects, flexibility of the labor market to reallocate resources across sectors will be essential.

5. Labor market institutional rigidities in Cyprus are relatively low as also evidenced by Cyprus's cost competitiveness. The ILO's Employment Flexibility Indicator places its rank at 16 out of 41 EU and OECD countries, and 11 out of 27 EU countries. Tax wedge on labor is relatively low, reducing disincentives to work. Cyprus currently does not have a statutory minimum wage, although it is required for certain occupations. Wage-setting mechanism is relatively more flexible. While the share of part-time and temporary workers is relatively low, a significant share (23 percent) of the labor force comprise more mobile foreign nationals and seasonal workers. Until 2019, Cyprus unit labor cost has remained low: while labor productivity level and growth has been relatively weak, wages have also been contained (2019 A4). Long term unemployed declined rapidly from a peak of over 7 percent following the financial crisis to around 2 percent of active population in 2020:Q2, at a faster pace than the euro area average.

6. However, the ability to reallocate resources will depend crucially on the ability to address skills gap. Based on CEDEFOP's European Skills Index 2020, Cyprus ranks 28th out of 31 countries. This ranking is attributed to low performance in skills development, particularly in vocational educational and training, recent training, and reading math and science scores. Spending on active labor market policies is low. Skills matching is also problematic given overqualification and under-employed part-timers. According to the EC's Digital Economy and Society Index Report, Cyprus ranks 23rd out of 28 EU countries in digital skills which reflect weakness in both basic digital skills as well as advanced ICT specialized skills. The risk of increasing skills mismatch is high as economic transformation gets underway.

7. Policies should be geared to ensure inclusive recovery that eventually moves away from protecting jobs to protecting people and fostering reallocation of resources.

- **Reskilling:** A large share (nearly 3/4) of labor market interventions are directed towards passive labor market policies that support income replacement for the unemployed. Spending on active labor market policies such as training, private sector employment incentives and public employment services are currently relatively limited. In addition, given the changing landscape of work opportunities that is more geared towards a digital world, opportunities for reskilling and upskilling training to retool themselves and become more employable with more digital skills or vocational skills for a more green economy that achieves energy efficiency will be needed.

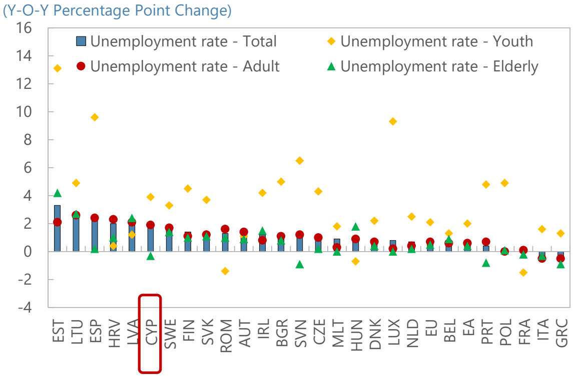
- **Inclusive policies:** More targeted policies for the youth will be needed especially given the evidence of long-term persistent impact of those entering the job market. For youth, policies should aim towards job search assistance, incentives for part-time work, and payroll subsidies for newly-hired staff. Providing opportunities for entrepreneurship such as through start-up incentives (grants and advisory support) would help. To facilitate women to re-enter the labor force, policies should support childcare and balance in work and family responsibilities. To avoid people falling into the low-wage, low security trap in an informal economy or the gig-economy, policies should ensure sufficient safety net for the vulnerable.

Figure 1. Cyprus: Impact of COVID on the Labor Market

The unemployment rate jumped, especially among the youth

Unemployment Rate in EU Countries by Age Group, 2020Q4

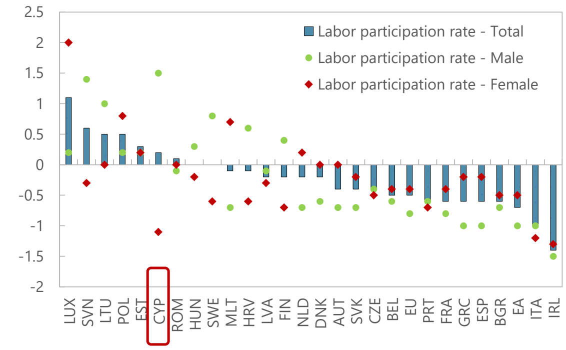
(Y-O-Y Percentage Point Change)



More women exited the labor market.

Labor participation rate in EU Countries by Gender, 2020Q4

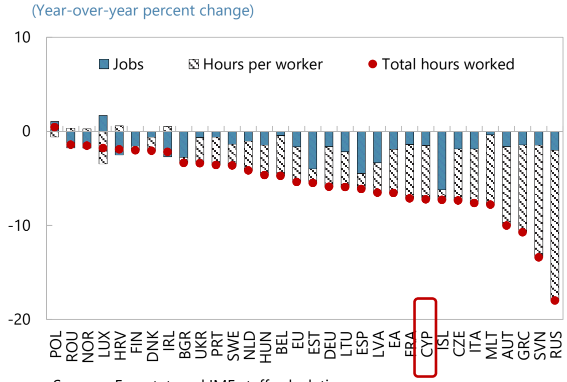
(Y-O-Y Percentage Point Change)



While job losses were contained, hours worked per person dropped more significantly.

Working Hours Growth Decomposition, 2020Q4

(Year-over-year percent change)

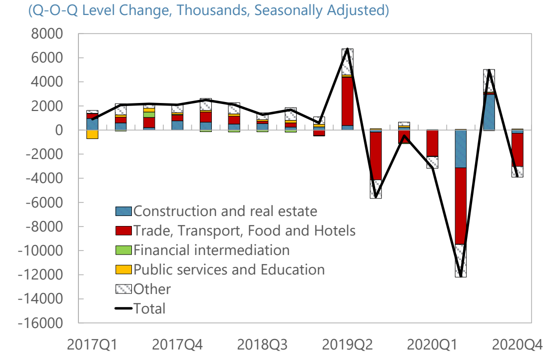


Sources: Eurostat; and IMF staff calculations.

Contact-intensive sectors have been more severely impacted.

Cyprus: Total Working Hours by Sector

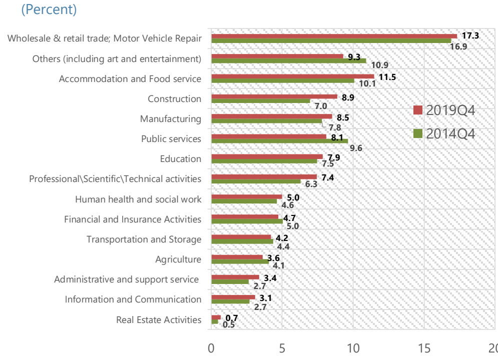
(Q-O-Q Level Change, Thousands, Seasonally Adjusted)



Since these sectors account for nearly a third of the workforce, the risk of scarring is high if the COVID shock persists.

Share of Employment by Sectors: 2014Q4 vs 2019Q4

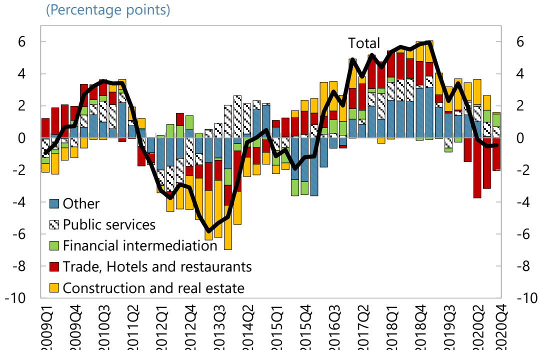
(Percent)



The ability to reallocate resources to other services sectors, where Cyprus has shown significant growth in recent years, will be crucial to mitigate scarring effects.

Contribution of Sectors to Employment Growth

(Percentage points)



Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IMF and IMF staff calculations.

Annex V. Risk Assessment Matrix[1]

Sources of Risks	Likelihood of Risk	Expected Impact of Risk	Policy Responses
External Risks			
Unexpected shifts in the Covid-19 pandemic	Medium **Asynchronous progress.** Limited access to, and longer-than-expected deployment of, vaccines in some countries prompt a reassessment of their growth prospects. **Prolonged pandemic.** The disease proves harder to eradicate, requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable. For countries with policy space, prolonged support exacerbates stretched asset valuations, fueling financial vulnerabilities. **Faster containment.** Pandemic is contained faster than expected due to the rapid production and distribution of vaccines, boosting confidence and economic activity.	High The recovery is delayed with scarring effects, unmasking vulnerabilities in the private sector. The needed containment measures would negatively affect economic activity, especially the tourism sector with reduced demand. More layoffs could lead to a considerable increase in unemployment, which will weigh on productivity growth. Reassessing real economy risks would lead to a repricing of risk assets, unmasking of debt-related vulnerabilities, and weakening banks and nonbank financial intermediaries–forcing them to reduce credit.	• Develop comprehensive strategies for containment to lower the risk of infection. Provide further support to the healthcare sector. • Further support the recovery by preventing liquidity problems and enhance private debt resolution system. • Regulatory forbearance and broader policy support from the ECB would help banks withstand this shock. • Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence. • Continue strengthening the financial sector and its capacity to support growth.
Widespread social discontent and political instability	High Social tensions erupt as the pandemic and inadequate policy response cause economic hardship and exacerbate preexisting socioeconomic inequities. Economic activity is disrupted, or due to unequal access to vaccines. Growing political polarization and instability weaken policymaking and confidence, especially for decisions at the European level.	Medium Social tensions cause economic disruptions and erode trust in policy makers. The resulting political instability complicates reaching political consensus on policies to address the pandemic. Public protests may also lead to an increased COVID-19 infection rate.	• Policies need to target the vulnerable population by ensuring adequate access to healthcare and social assistance including unemployment benefits. • Active labor market policies should be used to facilitate reallocation of workers toward expanding sectors and limit labor market hysteresis.
Accelerating deglobalization	Medium Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	High Additional tariff and nontariff barriers imposed by trading partners or within the European Union reduce the trade flows, confidence effects, and growth. Disruptions in trade of vaccines or medical supplies due to national protectionist policies	• Work with trading partner countries to address the policies that distort trade flows and investment decisions. • Strengthen collaboration within the EU on medical supplies • Accelerate structural reforms to strengthen competitiveness.

[1] The Risk Assessment Matrix shows events that could materially alter the baseline path. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. ("Low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more.) The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Sources of Risks	Likelihood of Risk	Expected Impact of Risk	Policy Responses
Sharp rise in global risk premia exposes financial and fiscal vulnerabilities	Medium A reassessment of market fundamentals triggers a widespread risk-off event. Risk asset prices fall sharply and volatility spikes, leading to significant losses in major non-bank financial institutions. Higher risk premia generate financing difficulties for leveraged firms and households, and a wave of bankruptcies erode banks' capital buffers. Financing difficulties extend to sovereigns with excessive public debt, leading to cascading debt defaults.	High Sharp increases in funding costs further strain leveraged corporates and households, and result in sizable insolvencies and a rapid deterioration of bank balance sheets and profitability with adverse effects on the credit channel. High-debt countries may face potential downgrades, further undermining their ability to service their debt.	• EU financing support could be expanded both in size and scope to restore confidence. • Work on credible medium-term fiscal plans.
Uncertainties related to post-Brexit	Medium Despite of the UK-EU trade agreement, there could be delays in business to fully comply with the new trade agreement could add risks to trade activities. Risks could associate with delays in reaching decisions on data sharing and on financial services.	Low Delays in business to comply with new paperwork and new procedures at ports could lead to some trade disruptions; delays on remaining decisions on data sharing and on financial services could undermine service trade of information sector and financial sector.	• Accelerate compliance with the new paperwork and procedures for business that trade with UK • Collaborate with UK and other EU countries on services trade, especially the financial services.
		Domestic Risks	
Low NPL workouts	High The persistently low efficiency of the court has impeded timely resolution of legacy NPLs, hindering banks' profitability and ability to supply new credit. A weaker foreclosure framework due to policy reversals undermines NPL sales market and weakens payment discipline.	Medium Weaker collateral recovery increases provision and capital needs. Perceived loan forbearance leads to further increase in strategic default and moral hazard, with negative implications for banks' ability to extend new credit, as well as higher direct and contingent liabilities for the state.	• Encourage banks to remain adequately provisioned and capitalized, implement the framework for insolvency and foreclosure. • Strengthen bank profitability by addressing inefficient cost structure, diversifying income sources while maintaining underwriting standards. • Appropriate NPL strategies are crucial to ensure swift balance sheet repair, support intermediation and avoid long-term scarring due to high private indebtedness.
Sharp decline of investment inflows	High Sudden and significant declines in investment inflows as a result of the pandemic and the cancellation of CIP scheme.	Medium Declines in investment inflows could affect economic activities, especially the construction sector, which was closely related to the CIP scheme in recent years. GDP growth slows down sharply weighing adversely on employment, tax revenue and banks' asset quality.	• Enact a comprehensive reform agenda to improve prospects for more diversified growth and reduce reliance on the construction sector. • Accommodative policies to facilitate private sector growth.
Higher-than-expected increase in fiscal spending	Medium Healthcare demand could increase rapidly and progress in public hospital reforms could be slower-than-expected. Wage bill growth could be higher than expected. A sharp increase in the structural deficit and higher debt could undermine market confidence.	Medium Higher-than-expected cost of the NHS or higher wage bill growth could put pressure on the government expenditure, weaken the underlying fiscal position, and increase risk premiums.	• Enhance the competitiveness of public hospitals. • Contain cost for healthcare services. • Control the growth of the public sector wage bill.

Annex VI. Solutions for Legacy Non-Performing Loans in Cyprus

1. **NPLs in Cyprus remain sizable, with an aged portfolio split among households and SMEs.** While the NPLs have declined significantly, the stock remains large (23.5 percent of GDP, 17.7 percent of loans) at end-December 2020. NPLs of households (HHs) account for 54 percent of total NPLs, while that of SMEs (predominantly construction, tourism, and trade sectors) account for 34½ percent. Although the portfolio is estimated to be largely secured, the share of NPLs more than 5 years past due stood at 45 percent at end-2020, underscoring potential difficulties with loan recovery. Provisions for NPLs has declined to 46.3 percent in December 2020. Provisioning is lower for NPLs to households at 42.1 percent.

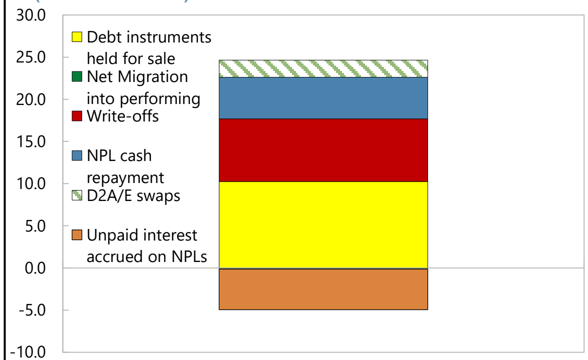
Cyprus: Non-Performing Loans in the Banking System
(Billions of euro)

	2014Q4	2015	2016	2017	2018	2019	2020	2020
		Change						
Total NPLs	28.4	-1.1	-3.0	-3.4	-10.5	-1.3	-3.9	5.1
HHs	12.8	-0.1	-0.7	-1.1	-5.8	-0.5	-1.9	2.8
NFCs	14.4	-0.5	-2.2	-2.2	-4.6	-0.8	-1.9	2.2
Large enterprises	5.3	-0.7	-3.1	-0.5	-0.3	-0.2	-0.2	0.4
SMEs	9.0	0.1	0.9	-1.7	-4.3	-0.7	-1.7	1.8
NFCs								
Tourism and trade	4.0	-0.1	-0.3	-0.6	-0.9	-0.2	-0.9	0.8
Construction	5.1	-0.2	-1.1	-0.7	-1.8	-0.3	-0.5	0.5
Real estate	2.4	0.0	-0.3	-0.5	-0.9	-0.2	-0.2	0.3
Manufacturing	0.9	0.0	-0.1	-0.1	-0.3	-0.1	-0.1	0.2
Others	2.0	-0.1	-0.3	-0.3	-0.6	-0.1	-0.2	0.3
Other financial corporates and government	1.2	-0.5	-0.2	-0.1	-0.2	0.0	-0.1	0.2

Source: Central Bank of Cyprus and IMF staff calculations.
Note: Non-performing loans are defined as in Commission Implementing Regulation (EU) 227/2015 on Supervisory reporting on forbearance and non-performing exposures.

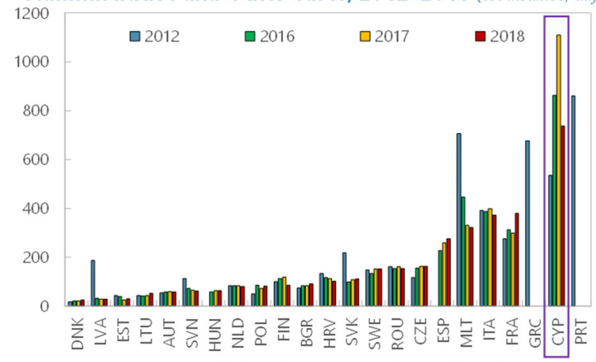
2. **The disposal of NPLs have relied mainly on write-offs and sales to third parties.** Of the cumulative NPL outflows between 2016 and 2020, around 55 percent are attributed to NPL sales and write-offs. Banks also relied on onboarding of properties, either through Debt to Asset swaps or foreclosure processes. Auction data, however, suggest a persistent below-market recovery rate, indicating potential overvaluation of collateral values. The impact of loan restructuring on net NPL migration into performing status has been modest, with high redefault rates. A key challenge to viable restructuring has been the uneven progress with claims enforcement and collateral recovery due to lengthy judicial processes and lack of a credible threat of foreclosure. Following the 2018 legal amendments to the foreclosure framework, the threat of foreclosure has incentivized greater cooperation for cash repayments and bilateral restructurings. However, the COVID crisis has delayed the foreclosure process, and the 2019 amendments to the foreclosure legislation have introduced uncertainties. The value of property recovered through foreclosures remains low.

Cyprus: Cumulative Outflows from NPLs, 2016–2020
(Billions of euro)



Sources: Central Bank of Cyprus; and IMF staff calculations.

Estimated Time Needed to Resolve Civil, Commercial, Administrative and Other Cases, 2012–2018 (1st instance, days)



Source: European Commission, The 2020 EU Justice Scoreboard.

3. The current strategy for NPL reduction consists of three key pillars. The NPL resolution would be achieved largely through NPL sales to third parties. Another pillar of the strategy is the state subsidy scheme (Estia) for NPL portfolios collateralized by primary homes. However, the applications for this subsidy scheme represent only half of the potentially eligible amount, partly reflecting strategic default behavior and indicating its ability to solve only a small share of the NPL portfolio. For ineligible and vulnerable applicants to the Estia, a different burden sharing agreement between state, creditors, and debtors is likely to be offered. In addition, further organic reduction is planned for highly collateralized but sub-performing portfolio through restructuring and Debt to Asset swaps, but a large share of the portfolio represents legacy/terminated loans with limited prospect for restructuring and consensual agreements, unless there are larger write-downs.

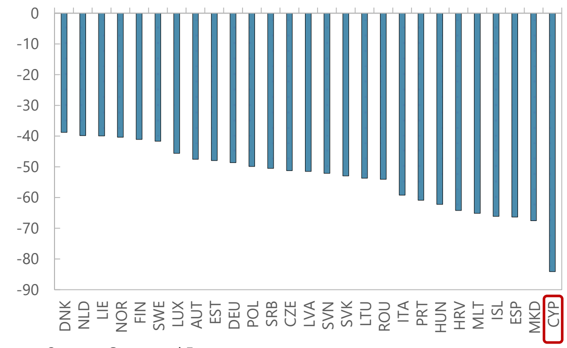
4. The NPL resolution strategy will depend crucially on the viability of borrowers and the recoverable value of collateral. Given the aged portfolio, adequate provisioning is key to facilitate this process. EC's prudential (Pillar 1) backstop and SSM's Pillar 2 approach are welcome steps in this regard. Supervisors should ensure Pillar 2 bank-specific phase-in paths to be sufficiently ambitious, yet credible. Given the large share of secured housing loans, efforts should be focused on determining the viability of the borrower, the present recoverable value of the collaterals and finalizing loan modification/restructuring options. If borrowers are deemed unviable or uncooperative, efforts towards collateral execution should be stepped up. For non-performing loans to viable SME borrowers, banks should be encouraged to make greater use of existing resolution tools or additional restructuring modalities (e.g. "pre-packaged" restructuring plans and out-of-court procedures) to finalize loan modification. For non-performing loans to SMEs where the recovery prospects are minimum, supervisors should increasingly force loss recognition on banks through write downs/write offs. Finally, to address real estate risks, a cap on the overall stock of onboarded assets should be maintained and ensuring proper collateral valuation is crucial.

Annex VII. Tourism Sector in Cyprus[1]

1. **Tourism in Cyprus has taken a hard hit by the Covid-19 shock, among the most severe in Europe.** Tourist arrivals experienced an unprecedented collapse since the pandemic, declining by 84 percent (yoy) in 2020. The spillover to the broader economy was substantial since tourism is a key sector for Cyprus. The decline in employment has been largely contained thanks to the job retention scheme, but hours worked contracted more severely than during the previous crises.

Growth of Tourist Arrivals, 2020

(Y-O-Y Percent Growth Relative to 2019)



Sources: Cystat; and Eurostat.

2. **Overall economic vulnerability to tourism is high in Cyprus.** Tourism receipts accounted for more than 18 percent of total exports in 2019. Tourism and related industries provide a large contribution to total employment and GDP. High bank exposure to the tourism sector also indicate high risks of macro-financial feedback loop, as more than 90 percent of borrowers in the sectors of accommodation and food services were under loan repayment moratorium. Based on a heatmap analysis using macroeconomic indicators, Cyprus is in the top quintile of overall economic vulnerability to tourism among European countries.

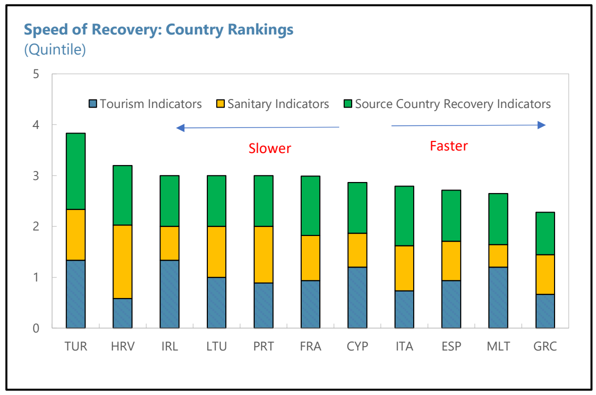
Macroeconomic Indicators

	Share of tourism in total output	Share of tourism (direct and indirect) in total employment	Share of travel services in total exports	Private consumption WEO forecast (2020-2021)	Bank Lending to Accommodation & Food Services Sector	Average quintile
Austria						4.2
Belgium						2.2
Bulgaria						3.4
Croatia						4.3
Cyprus						4.0
Czechia						2.5
Denmark						2.0
Estonia						3.0
Finland						1.8
France						3.2
Germany						2.8
Greece						4.8
Hungary						2.8
Iceland						4.5
Ireland						2.8
Italy						4.4
Latvia						3.2
Lithuania						1.0
Luxembourg						2.4
Malta						4.0
Netherlands						3.4
Norway						2.8
Poland						1.8
Portugal						4.8
Romania						2.0
Slovakia						1.3
Slovenia						3.4
Spain						5.0
Sweden						2.6
Switzerland						2.7
Turkey						3.0
United Kingdom						3.6

3. **The prospect for tourism recovery will depend on a range of factors**. Cyprus is in a less favorable position given its high reliance on foreign tourism and hotel accommodations, while the type of travel and sanitary indicators are more favorable for the outlook**.** The tourism sector in Cyprus is dominated by foreign tourism compared to other European countries as the arrivals of foreign tourists reached around 5 times of domestic tourists in 2019. In addition, tourist accommodation in Cyprus rely exclusively on hotels and similar accommodations which have raised more sanitary concerns during the pandemic than other types of accommodations such as Airbnb. On the positive side, established travelers' preference presents a more favorable outlook, with a higher ratio of personal travel and the concentration of stays away from cities. More importantly, Cyprus ranks

[1] This annex is based on Staff Selected Issues Paper, "*Tourism Sector in Cyprus*."

relatively well in terms of health conditions, with relatively fewer reported COVID cases and more tests and faster vaccination than most other EU countries.



4. Cyprus also fares relatively well in terms of recovery prospects of its tourists' source countries, with expectation of a full recovery to the pre-pandemic levels in the medium term. The UNWTO scenarios show are bound in the international tourism from 2021:Q3 and a return to 2019 levels in 2.5 to 4 years. The Eurocontrol forecasts that the air traffic in Europe will fully recover by 2024 in the most optimistic scenario. Based on our estimates using the indicators for tourism characteristics, sanitary indicators and recovery indicators of the tourist source markets, Cyprus should have a relatively faster recovery rate compared with other European countries. However, the outlook is highly uncertain, and the recovery of tourism will be determined by the pace of the vaccination rollout, the coordination among countries on travel procedures, and the economic situation.

5. Continued targeted support measures to the tourism sector are warranted in the near term, while longer-term policies should aim to enhance the tourism sustainability. Considering the tourism sector's systemic importance to the economy and its prospect of a slow recovery, liquidity-type support, such as guaranteed loans or lending rate subsidies, etc. could be considered to mitigate long-term scarring, which would allow public support to benefit from a viability assessment by banks. Increased access to SME restructuring tools, with possible public support would help to avoid costly bankruptcies. For larger, strategic businesses, equity-type support could provide potential upside for the government down the road. In the longer-term, policy priorities should shift towards building sustainable tourism, with a focus on smaller-scale, regionally more diverse, and higher-end tourism more strongly based on environmental sustainability, quality of services, and non-price competitiveness.

Annex VIII. Restructuring Tools to Address Corporate Financial Difficulties Arising from the COVID-19 Pandemic[1]

1. **This year is a critical juncture to prepare for potential new financial difficulties.** While a large-scale public moratorium of loan repayment was taken in response to the onset of the COVID-19 pandemic, it ended in December 2020.[2] The take-up of this moratorium was high at nearly half of performing bank loans. Repayment performance has been encouraging as of March 2021, but the scheduled due dates have not yet come for many borrowers in the affected business sectors while cash buffers and government measures have also supported the repayments. As the pandemic and uncertainties continue, and support measures taper off, some borrowers could face financial difficulties going forward. New delinquencies could potentially emerge among borrowers who have been severely affected, such as tourism-related sectors and small-and-medium enterprises (SMEs) (Figure 1).

2. **Loans with potential new delinquencies are distinct from legacy NPLs.** Even if some borrowers would face financial difficulties arising from the COVID-19 pandemic, they were performing until recently (top-left panel of Figure 1). This implies that they would have higher potential for viable businesses that could be saved with reorganization and restructuring tools. This is a stark difference from the legacy NPLs from the 2012–13 crisis.

3. **Against this backdrop, having appropriate tools supporting the timely restructuring of potentially viable businesses will be key in avoiding unnecessary insolvencies.** As debt collection activities start to resume, the objective must be to restructure as many potentially viable companies as possible and swiftly liquidate those unable to regain viability.[3]

Taking Stock of Existing Tools and Preparing for Challenges Ahead

4. **To support the reorganization of viable companies, Cyprus introduced the examinership procedure as part of the new insolvency framework enacted in 2015.**[4] Examinership is a corporate reorganization procedure modeled after Irish law. In the process, the company, its creditors, or shareholders can petition the court to appoint an independent expert examiner, for a fixed period, to prepare a restructuring plan for the company. Once the plan is

[1] Prepared by Machiko Narita (MCM) and Amira Rasekh (LEG).

[2] The nine-month moratorium was launched in April 2020 for all borrowers who had no arrears over 30 days on February 29, 2020 (i.e., prior to the COVID-19 pandemic). While another public moratorium was issued on January 14, 2021 for six months, it is not applicable for most loans that already benefitted from the 2020 moratorium for 9 months, along with the EBA guidelines on December 2, 2020.

[3] "Flattening the Insolvency Curve: Promoting Corporate restructuring in Asia and the Pacific in the Post-C19 Recovery" (2021), IMF WP/21/16.

[4] See "Reforming the Legal Framework to Support Private Debt Restructuring" in Selected Issues Papers (2017), IMF Country Report No. 17/376.

approved by the required majority of creditors and confirmed by the court, it becomes binding on all creditors.[5]

5. Since its introduction, the use of the examinership procedure has been very limited (Table 3), and this seems to be attributable to a number of different factors. One is the *complexity* of the procedure, which involves many steps and deadlines, and is thus not very accessible and also costly to users. Another is the *duration*; while the law foresees that the procedure would conclude within four to six months, in practice, the process is often not commenced within this period as courts are unable to process the applications sufficiently quickly. *Debtor and creditor behaviors and perceptions* of the process also partially explain its limited use. Debtors often do not seek help early on and concerns about being perceived as insolvent dissuade them from tapping the procedure. Some debtor applications also appear motivated by halting an ongoing receivership/liquidation rather than achieving a reorganization.[6] At the same time, creditors often lack the necessary financial information needed to initiate the process, and perceive the process as a tool for debtors to forestall other ongoing procedures. Secured creditors generally find it more effective and efficient to resort to receivership or foreclosure than to initiate an examinership process. A number of legal provisions seem to also pose *procedural impediments* to the use of the process (e.g. notice periods, viability assessments by independent expert).[7] The implementation of the process has also been beset by *institutional challenges:* apart from the procedural complexity mentioned above, the limited number of cases initiated has not allowed the development of sufficient expertise and familiarity with the process among judges and insolvency professionals. And lack of clarity on the agency responsible for monitoring the process (Registrar of Companies and Official Receiver or Insolvency Service) limited data availability and stock-taking.[8]

6. The implementation of the EU Directive on Preventive Restructuring and Second Chance provides a good opportunity to look at these issues and reform the examinership process. In this respect, an issue that merits closer examination is the interplay between examinership and the receivership; receivership remains the more significant debt enforcement tool for secured credit, and this is a typical tension, as no reorganization is possible unless the rights of secured creditors are limited, provided they are adequately safeguarded.[9] Consideration should therefore be given more to the balance between receivership as a tool for individual enforcement

[5] Companies (Amending) Law (No 2) of 2015. A special mechanism was also established to allow the coordination of a personal and micro-SME debt restructuring under a joint personal repayment plan and examinership procedure.

[6] The law allows a petition for the appointment of an examiner to be filed within 30 days from the appointment of a receiver. Although the initiation of the examinership suspends the receivership process until the examinership process is concluded, the receiver remains in place alongside the examiner (unless the court orders otherwise).

[7] The law provides that all interested parties must be given notice of the application within 3 days from the filing of a petition (publication does not suffice). All interested parties, in turn, have the right to file objections to the petition, which further adds to the length and delay. Creditor challenges to the viability assessment done by the independent expert reportedly often last up to months and end up consuming the entire four months protection period.

[8] The recent clarification of the delegation of responsibilities and transfer of the Official Receiver to the Insolvency Service (which will oversee examinership, liquidation and receivership) provides an excellent opportunity to step up monitoring and data collection efforts to inform the reform process.

[9] "Orderly & Effective Insolvency Procedures - Key Issues" (1999), Legal Department, IMF.

and the examinership as a collective procedure. Additionally, consideration could also be given to complementing the toolkit by introducing an out-of-court or hybrid restructuring procedure with the view to reducing complexity, duration and cost.[10] [11] In this regard, company voluntary arrangements may present a useful model to examine.[12] In designing any such process, however, it is crucial that the procedure take account of, and be well suited and adapted to the national characteristics of Cyprus. The Directive offers many possibilities for the design of the restructuring procedure, however, its implementation requires careful analysis of its multiple options and the tradeoffs involved.[13]

7. Alongside these efforts on the development of the restructuring toolbox, prudential policies should continue supporting banks' engagement while preserving financial stability.[14] Macroprudential policies should support banks to constructively engage with borrowers, by ensuring capital buffers available to continue lending to restructured businesses and absorb associated losses. In this regard, the guidance to encourage the use of capital buffers and to limit dividend distributions should be maintained until uncertainties from the pandemic dissipate sufficiently. Enhanced supervisory monitoring and analyses also continue to be crucial in ensuring timely and accurate provisioning by banks and reliable collateral valuation to avoid abrupt capital losses.

[10] Pre-insolvency procedures and formal reorganization procedures have separate spaces in an insolvency system. The Directive seeks to complement formal insolvency frameworks (reorganization and liquidation). It can be implemented by introducing a restructuring procedure which would then stand side by side with the existing procedures under national insolvency law. If countries implement the Directive by just adapting their reorganization procedures to its requirements, they will miss the space between informal out of court and formal reorganization procedures. See "Restructuring and Insolvency in Europe: Policy Options in the Implementation of the EU Directive" (2021), IMF WP (*forthcoming*).

[11] It is worth noting that Ireland is currently in the process of introducing a new restructuring procedure, separate from the examinership, for the rescue of small enterprises that meet certain criteria. The use of the examinership in Ireland by small enterprises has been limited despite past reforms. It is expected that the process will involve no/minimal court intervention and thus be significantly less expensive than the examinership.

[12] The UK has recently introduced significant reforms to its insolvency framework, which include the possibility for a company (that meets certain requirements) to apply to the court for a moratorium to give it a statutory breathing space from creditor action within which to formulate a rescue plan. Amongst others, the moratorium could give a breathing space while a company voluntary arrangement is considered, and is automatically extended until the proposal is implemented, rejected, or withdrawn.

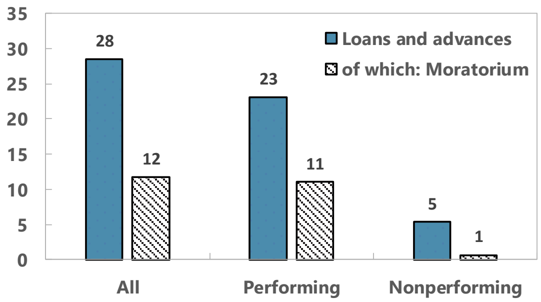
[13] For a discussion of such options and tradeoffs, see "Restructuring and Insolvency in Europe: Policy Options in the Implementation of the EU Directive" (2021), IMF WP (*forthcoming*).

[14] "Special Series on COVID-19: Main Operational Aspects for Macroprudential Policy Relaxation"; "Special Series on COVID-19: Unwinding COVID-19 Policy Interventions for Banking Systems" (forthcoming); and "Special Series on COVID-19: Private Debt Resolution Measures in the Wake of the Pandemic".

Figure 1. Loans Granted the Public Moratorium in 2020

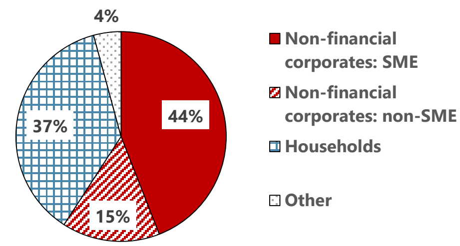
The take-up rate was high among performing loans at 48 percent.

Bank Loans granted the Moratorium
(in Euro Billions, as of September 2020)



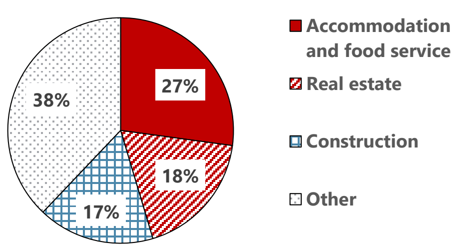
SMEs took the largest share (44 percent) of the bank loans granted the 2020 moratorium.

Moratorium: Sector Share
(percent, as of September 2020)



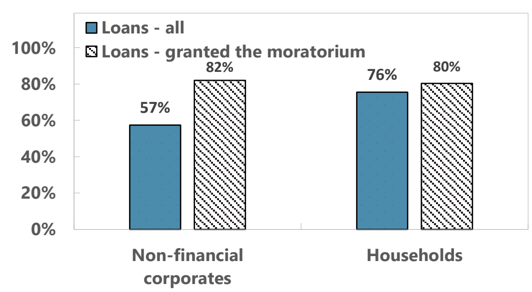
Looking by industry, the tourism sector took the largest share (27 percent) of the NFC loans granted the moratorium.

Moratorium: Industry Share
(percent, as of September 2020)



The share of collateralized loans is slightly higher among the loans granted the moratorium, especially for NFC loans.

Share of Collateralised Bank Loans
(as of September 2020)



Sources: The Central Bank of Cyprus and IMF staff calculation.
Notes: The figures are based on the data of all banks, excluding foreign branches in Cyprus. While the 2020 moratorium was also applicable to loans held by Credit Acquiring Companies (CACs), the amount of such loans is small because CACs are mostly handling legacy NPLs.

Table 1. Examinership Applications in Cyprus

Year	Total Examinership Applications[1]
Up to June 2017	3
Up to September 2018	17
Up to August 2019	18
Up to March 2021	19

Source: Department of Insolvency.

1 To date, no examiner has been appointed in any examinership case, which means in no case has the procedure been completed from beginning to end. For the joint personal repayment plan/micro-SME examinership, there have been no applications initiated to date.

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 30, 2021

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2021)

Membership Status: Joined December 21, 1961; Article VIII

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	303.80	100.00
IMF's Holdings of Currency	218.75	72.00
Reserve Tranche Position	85.06	28.00
Lending to the Fund		
New Arrangements to Borrow	9.72	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	132.80	100.00
Holdings	48.10	36.22

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
EFF	May 15, 2013	Mar 6, 2016	891.0	792.00
Stand-By	Jul 16, 1980	Jul 15, 1981	8.5	8.5

Projected Payments to the Fund (SDR millions; Projected from 2021)

	Principal	**Charges/Interest**	**Total**
2021	0	0.04	0.04
2022	0	0.04	0.04
2023	0	0.04	0.04
2024	0	0.04	0.04
2025	0	0.04	0.04

Exchange Rate Arrangement and Exchange Restrictions:

Cyprus is a member of the euro area, and its currency—the euro—floats freely and independently against other currencies. Cyprus has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions except for restrictions in place for security reasons notified to the Fund pursuant to Decision No. 144-(52/51).

Last Article IV consultation, Post-Program Monitoring discussions, and program relations:

Article IV. Cyprus is currently on a standard 12-month consultation cycle. The last Article IV consultation was concluded on November 27, 2019 (IMF Country Report No. 19/362).

EFF. Cyprus's three-year, SDR 891 million (293 percent of current quota) Extended Arrangement under the Extended Fund Facility (EFF) was approved by the IMF Executive Board on May 15, 2013. The total amount drawn was SDR 792 million (260.7 percent of quota). The EFF arrangement was coordinated with the European Stability Mechanism (ESM), which disbursed €6.3 billion. The ninth (and penultimate planned) review was completed on January 23, 2016 (IMF Country Report No. 16/26). The EFF arrangement was cancelled by the authorities on March 7, 2016, about two months before it was scheduled to expire. The cancellation coincided with the expiration of the three-year ESM program.

PPM and repurchases. The Fund initiated PPM on March 18, 2016. Board consideration of the Third Post-Program Monitoring (PPM) discussions was concluded on June 3, 2019 (IMF Country Report No. 19/151). An early repurchase on July 11, 2017 reduced outstanding Fund credit to Cyprus to SDR 570 million (187.5 percent of quota), which is below standard PPM-eligibility thresholds. The Board approved a one-year PPM extension on August 2, 2017, June 4, 2018, and June 3, 2019. Cyprus repaid early its remaining balance of EFF credit in February 2020, and successfully exited the Fund's PPM.

Safeguards. A safeguards assessment was finalized in August 2013 in the context of an EFF arrangement approved in May 2013. The assessment found a weak governance framework at the CBC and a strained balance sheet given the large ELA exposure. The CBC addressed most of the recommendations made in the areas of audit and control oversight, financial reporting transparency, and internal audit. The CBC continues to publish its audited financial statements in a timely manner. Legislative efforts currently underway are expected to address the remaining safeguards recommendations to strengthen the central bank's governance and financial autonomy.

Technical Assistance:

Department	**Purpose**	**Date**
FAD	Revenue administration	October–November 2014
FAD	Revenue administration	January–February 2015
FAD	Functional review of Ministry of Finance	February 2015
FAD	Government guarantees	February 2015
MCM	Cooperative credit sector restructuring	February–March 2015
FAD	Public financial management	March 2015
STA	Balance of payments	March–April 2015
FAD	Public financial management	August 2015
MCM	NPL management	August–September 2015
MCM	Macro-financial modeling	September 2015

MCM	NPL management	September 2015
FAD	Public financial management	September–October 2015
MCM	Financial aspects of reunification	November 2015
FAD	Revenue administration	November–December 2015
MCM	Central bank governance	December 2015
STA	Statistical aspects of reunification	December 2015
FAD	Fiscal aspects of reunification	December 2015
MCM	Financial aspects of reunification	December 2015
MCM	Financial aspects of reunification	January 2016
MCM	Financial aspects of reunification	February 2016
STA	Statistical aspects of reunification	February 2016
FAD	Fiscal federalism workshop	February 2016
FAD	Fiscal aspects of reunification	February–March 2016
MCM	Debt management	March 2016
FAD	Public financial management	March–April 2016
MCM	Financial aspects of reunification	April 2016
FAD	Revenue administration	April–May 2016
STA	Statistical aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	May 2016
MCM	Financial aspects of reunification	May 2016
MCM	Cooperative credit sector restructuring	June–July 2016
MCM	Financial aspects of reunification	June–July 2016
FAD	Revenue administration	October 2016
FAD	Spending review	October 2016
FAD	Fiscal aspects of reunification	November 2016
STA	Sectoral Accounts and Balance Sheets	January 2017
FAD	Revenue administration	March 2017
FAD	Spending review	April–May 2017
MCM	Financial stability	July 2017
MCM	NPL management	July 2017
MCM	Macro-prudential policy	September 2017
LEG	Insolvency legal framework workshop	September 2017
FAD	Spending review	September–October 2017
FAD	Revenue administration	October 2017
MCM	NPL management	November 2017
MCM	Financial stability	December 2017
FAD	Revenue administration	December 2017
FAD	Spending review	February 2018
LEG	Legal framework for NPL resolution	March 2018
FAD	Spending review and public financial management	September 2018
MCM	Debt Portfolio Risk Management	November 2018

FAD	Policy Based Budget	September 2019
LEG	Judicial Training Workshop on Insolvency	December 2019
MCM	Stress Testing	December 2020
MCM	Debt and Cash Management	December 2020

Two FAD long-term resident advisors provided technical assistance on public financial management (from February 2014 to October 2016) and on revenue administration (from July 2015 to December 2016).

STATISTICAL ISSUES

(As of April 19, 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is adequate for surveillance purposes.
National accounts and real sector data: Since September 2014, the Statistical Service of Cyprus (CYSTAT) publishes a full set of national accounts based on the European System of National and Regional Accounts (ESA 2010) methodology, including quarterly GDP estimates. The data are available from the first quarter of 1995; the quarterly and annual data are consistent, although the timing of revisions to annual and quarterly statistics may not coincide. CYSTAT publishes the Consumer Price Index, and the Harmonized Index of Consumer Prices (HICP) according to the methodology of EU member states. Control and quality assessment are ensured through the supervision of Eurostat. The Central Bank of Cyprus publishes a Residential Property Price Index based on property valuation data collected since 2006. The agency is in the process of enhancing the index and is assessing the potential for using transactions data, rather than valuations. It is also finalizing the unpublished Commercial Property Price Index and Land Price Index.
Fiscal sector data: Ministry of Finance publishes monthly cash budget data based on ESA 2010 for the general government and its breakdown into central government, local government, and social security fund.
External sector data: The Central Bank of Cyprus (CBC) compiles and disseminates online the statistics of the balance of payments and the international investment position on a quarterly and annual basis, according to the IMF's sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6). The data are released with roughly a one-quarter lag. The data have included special purpose entities (SPEs) as residents since July 2014, and the treatment of SPEs is fully in line with the international standards including the BPM6. Full data coverage of SPEs was achieved in September 2019. Some historical statistics on SPEs have been published since November 2017. Cyprus participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).
Monetary and financial sector data: Data on central bank balance sheet, key aggregate financial indicators for other monetary financial institutions, and financial positions of domestic institutional sectors are available from the CBC website and comply with European standards. The CBC also provides monthly monetary statistics to the IMF through the ECB. A structural break exists for some financial sector data due to the migration to Basel III (in 2014:Q1) and adoption of the European Banking Authorities definition of non-performing loans (in 2014:Q4). Cyprus reports data on several series indicators of the Financial Access Survey (FAS) including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial sector surveillance: Cyprus reported all twelve core financial soundness indicators (FSIs) and all thirteen encouraged FSIs for the deposit takers on quarterly basis up to 2016:Q1. However, some FSIs have been missing or only partly reported since then. In addition, encouraged FSIs for the other sectors are not available.
II. Data Standards and Quality
Cyprus subscribes to the IMF's Special Data Dissemination Standard (SDDS) since December 2009, and the relevant metadata have been posted on the Dissemination Standards Bulletin Board. Data are provided to the Fund in a comprehensive manner (see attached table). Cyprus's economic database is comprehensive and of generally good quality. The authorities regularly publish a wide range of economic and financial data, as well as a calendar of dates for the main statistical releases. Cyprus is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted ESA 2010. No data ROSC is available.

Cyprus: Table of Common Indicators Required for Surveillance as of April 21, 2021					
	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting 7/	Frequency of Publication
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Mar. 2021	Apr. 2021	M	M	M
Reserve/Base Money	Feb. 2021	Mar. 2021	M	M	M
Broad Money	Feb. 2021	Mar. 2021	M	M	M
Central Bank Balance Sheet	Feb. 2021	Mar. 2021	M	M	M
Consolidated Balance Sheet of the Banking System	2020:Q4	Apr. 2021	Q	Q	Q
Interest Rates 2/	Current	Current	D	D	D
Consumer Price Index	Mar. 2021	April. 2021	M	M	M
Revenues, Expenditure, Balance and Composition of Financing 3/ - Central Government	Feb. 2021	Apr. 2021	M	M	M
Revenues, Expenditure, Balance and Composition of Financing 3/ - General Government 4/	Feb. 2021	Apr. 2021	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Feb. 2021	Apr. 2021	M	M	M
External Current Account Balance	2020: Q4	Mar. 2021	Q	Q	Q
Exports and Imports of Goods and Services	2020: Q4	Mar. 2021	Q	Q	Q
GDP/GNP	2020:Q4	Mar. 2021	Q	Q	Q
Gross External Debt	2020: Q4	Mar. 2021	Q	Q	Q
International investment position 6/	2020: Q4	Mar. 2021	Q	Q	Q

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government, social security funds and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial assets and liability positions vis-à-vis nonresidents.
7/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).