IMF Country Report No. 22/151

CYPRUS

June 2022

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR CYPRUS

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 2022 Article IV consultation with Cyprus, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 25, 2022 consideration of the staff report that concluded the Article IV consultation with Cyprus.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 25, 2022, following discussions that ended on March 28, 2022, with the officials of Cyprus on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 10, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Cyprus.

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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PR22/178

IMF Executive Board Concludes 2022 Article IV Consultation with Cyprus

FOR IMMEDIATE RELEASE

Washington, DC – June 1, 2022: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Cyprus on May 25, 2022.

Cyprus staged a strong recovery last year on the back of its successful management of the pandemic and sizeable policy support. Output returned to its pre-pandemic level and unemployment declined. The current account deficit has remained elevated but narrowed to 7¼ percent of GDP with a recovery in exports. Inflation edged up, driven mainly by higher energy prices. The fiscal deficit dropped to around 2 percent of GDP on the back of a cyclical revenue recovery. The public debt ratio has stayed high but declined to 104 percent. The liquidity in the banking sector has remained high and capital ratios broadly stable. Banks have made progress in offloading legacy non-performing loans and the effects of the pandemic on credit quality have been limited.

Growth this year will be set back by the fallout from the war in Ukraine and, with a partial recovery in exports and private consumption, is forecast at around 2 percent. It will also be supported by investment spending under the Cyprus's Recovery and Resilience Plan, which, combined with structural reforms, improves medium-term growth prospects. The current account is projected to temporarily worsen with a deterioration in the terms-of-trade and higher imports. Inflation will increase further before declining in the medium term. The slower recovery will stymie fiscal consolidation this year, but the fiscal deficit is still expected to narrow after the phase-out of Covid-related support, and the public debt ratio is set to remain on a firmly declining path.

The outlook remains highly uncertain with risks from an escalation and prolonged duration of the war and sanctions, de-anchoring of inflation expectations in advanced economies, and uncontrolled and more severe Covid outbreaks.

Executive Board Assessment[2]

Executive Directors commended the authorities for their policy response to the pandemic, which supported the recovery of output and employment. Directors noted that the pace of the recovery is expected to slow down in the near-term—mainly due to the war in Ukraine—but should regain momentum over the medium-term. However, the outlook is subject to risks, stemming from a prolonged war in Ukraine, uncontrolled COVID outbreaks, and abrupt monetary tightening in advanced economies. Directors stressed the need to calibrate a policy

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[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.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

response to manage the pandemic and war-related shocks in the near-term, while pressing ahead with financial sector and structural reforms to reduce vulnerabilities and improve growth prospects and resilience over the medium-term.

Directors concurred that fiscal policy should continue providing support but aim to gradually rebuild buffers. They supported a gradual fiscal adjustment and emphasized that additional discretionary measures, if needed, should be temporary and well-targeted, and not hinder labor reallocation. Directors underscored the importance of fiscal discipline over the medium-term to place the public debt on a firmly declining path. They encouraged further efforts to control public sector wage growth, address risks from the National Health System, and monitor the financial sector's contingent liabilities.

Directors noted that the financial system has stayed resilient. They agreed that the authorities should enhance monitoring and address asset quality given the worsened outlook. Directors emphasized that resolving legacy non-performing loans requires more forceful implementation of existing tools, including by further improving the working environment of credit acquiring companies and credit servicing companies. They underscored the criticality of an effective foreclosure framework for addressing strategic defaulters and providing incentives for borrowers to engage in restructurings and recommended enhancing the implementation of the 2019 amendments to the framework. Directors also stressed that the planned Mortgage-to-Rent scheme should be well-targeted to minimize the fiscal cost and to ensure transparency and accountability.

Directors emphasized that structural reforms are key to raise medium-term growth potential. They welcomed the progress in implementing the Recovery and Resilience Plan, including passing legislation on corruption and on civil service and local government reforms. Directors encouraged the authorities to continue to make progress in strengthening 2 the AML-CFT and governance frameworks, and in tackling the skills, digital, and infrastructure gaps. Reforms of the judicial system are also a priority.

Directors agreed that achieving the national climate goals can help Cyprus transition to a more resilient and sustainable growth model. They recommended continued efforts to address the challenges to implement the green agenda, including the planned green tax reform. Additional measures, including feebates, to enhance the emissions reduction could also be considered.

Cyprus: Selected Economic Indicators, 2019–23

	2019	2020	2021	Projections 2022	Projections 2023
Output/Demand					
Real GDP	5.3	-5.0	5.5	2.0	3.5
Domestic demand	6.0	-2.9	2.7	2.6	3.0
Consumption	4.9	-0.7	4.9	2.0	2.6
Private consumption	3.0	-5.0	3.7	2.3	2.5
Public consumption	12.7	15.0	8.4	1.0	2.8
Gross capital formation	10.6	-11.5	-6.6	5.8	5.1
Foreign balance 1/	-0.7	-1.9	2.7	-0.4	0.5
Exports of goods and services	7.5	-5.1	13.4	5.1	4.5
Imports of goods and services	8.3	-2.5	9.5	5.5	3.9
Potential GDP growth	4.6	-1.3	4.3	2.5	3.1
Output gap (percent of potential GDP)	2.5	-1.3	-0.2	-0.6	-0.2
Prices					
HICP (period average, percent)	0.5	-1.1	2.3	5.3	2.3
HICP (end of period, percent)	0.7	-0.8	4.8	3.0	2.5
Employment					
Unemployment rate (EU standard, percent)	7.1	7.6	7.5	7.9	7.5
Employment growth (percent)	3.9	0.2	3.4	0.0	1.5
Public Finance					
General government balance	1.3	-5.7	-2.1	-1.3	-0.1
Revenue	39.7	39.3	42.1	41.0	41.2
Expenditure	38.4	45.0	44.2	42.3	41.3
Primary Fiscal Balance	3.5	-3.6	-0.3	0.5	1.4
General government debt	91.1	115.0	103.9	97.7	94.1
Balance of Payments					
Current account balance	-5.7	-10.1	-7.3	-8.2	-6.8
Trade Balance (goods and services)	0.2	-2.5	1.1	-1.1	0.3
Nominal GDP (billions of euros)	23.0	21.6	23.4	24.7	26.4

Sources: Statistical Service of the Republic of Cyprus, Central Bank of Cyprus, and IMF staff estimates.
1/ Contribution to growth (percentage points).

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

May 10, 2022

KEY ISSUES

Context and outlook: Cyprus is highly exposed to the fallout from the war in Ukraine through trade with Russia. This new challenge comes against the background of the lingering effects of the pandemic and financial vulnerabilities dating from the 2012–13 crisis. Growth is projected to slow from 5½ percent in 2021 to around 2 percent this year. Recovery will regain momentum in 2023, and is projected to continue in the medium term, supported by investments and structural reforms in the Recovery and Resilience Plan.

Fiscal policy: With automatic stabilizers allowed to operate, the 2022 budget provides sufficient support in the baseline, but policies may need to be adjusted when there is more clarity on the size of the war-related shocks. Any additional discretionary support should be temporary, targeted and not hinder the process of labor reallocation to expanding sectors. A gradual fiscal adjustment in the medium-term—placing the public debt ratio of a firmly declining path—will help secure fiscal sustainability in light of risks from large contingent liabilities and macro and fiscal shocks.

Financial policy: The pandemic has had a limited impact on private balance sheets overall but appears to have weakened the financial position of some debtors. Banks have been actively restructuring problem loans but restructuring tools would further help viable business in financial difficulties. The pandemic has also added to political pressures to weaken the foreclosure framework, negatively affecting the resolution of still-high NPLs. A more forceful implementation of the existing deleveraging strategy is called for, removing uncertainties in the implementation of the foreclosure framework and improving the working environment for credit acquiring companies. The planned expansion of the public asset management company to resolve NPLs backed by primary residences should be well targeted and include safeguards to avoid weakening credit discipline.

Structural policies: The reforms in the Recovery and Resilience Plan rightly aim at strengthening governance, addressing skill mismatches, and closing the digital infrastructure gap, but they could be helpfully accelerated. Cyprus's climate goals are ambitious but their achievement, including through green investment and the planned introduction of a carbon tax, will be challenging.

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

Virtual discussions were held during March 11–28, 2022. The mission team comprised Mr. Wojciech Maliszewski (head), Ms. Estelle Xue Liu and Mr. Ruifeng Zhang (all EUR), Mmes. Zihan Cheng (MCM), and Chanda DeLong (LEG). Mr. Boyang Sun and Ms. Erika Paola Espinoza (EUR) supported the mission from headquarters. Messrs. Luc Dresse and Michalis Ghalanos (office of the Executive Director) joined some of the meetings.

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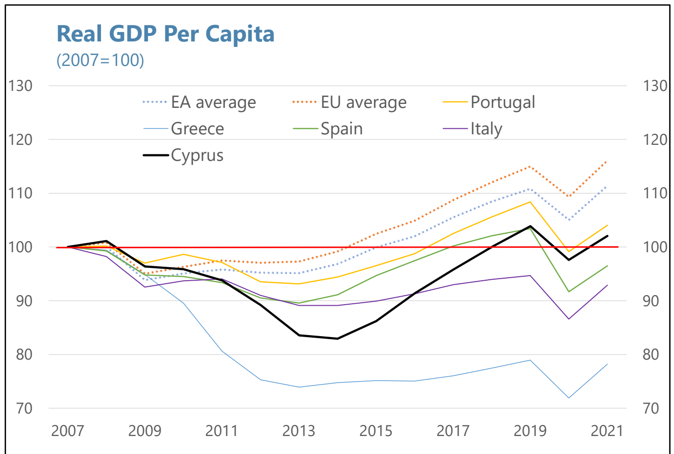
ANNEXES

CONTEXT[1]

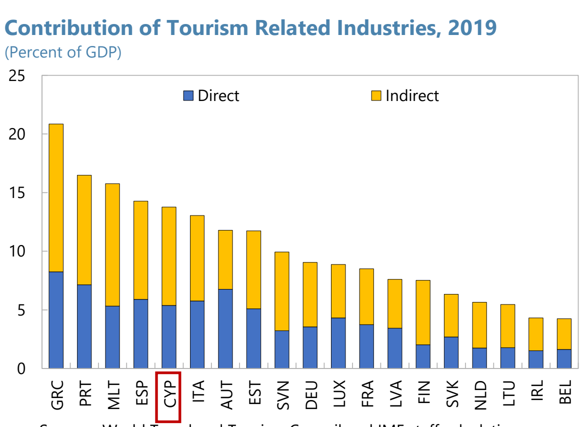
1. Before the Covid pandemic, Cyprus was fast recovering from the 2012–13 financial crisis. The recovery was supported by a rebound in tourism, but also growth in new, higher value-added sectors such as information and communication technologies (ICT), maritime shipping, non-bank financial services, and education. Consumption and investments grew strongly, even though the latter was largely in residential real estate, partly in response to the Cyprus Investment Program (CIP), which offered Cypriot citizenship to foreign nationals in exchange for investment and was terminated following corruption allegations.



Source: Statistical Office of the European Communities.

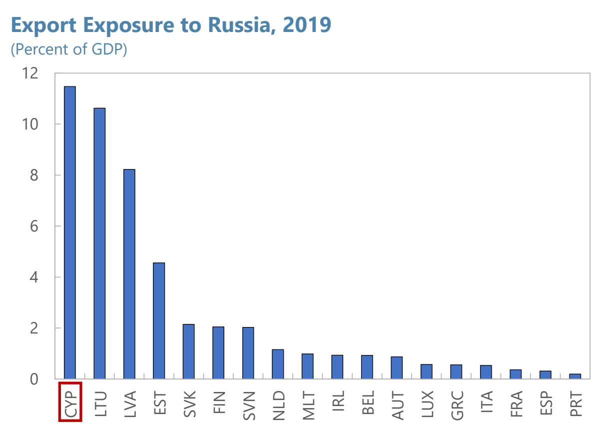
2. But the economy has been susceptible to recent shocks—both the pandemic and more recently the war in Ukraine. The large tourism sector and other contact-intensive activities were affected by Covid-related mobility restrictions. Financial linkages to Russia have been reduced since the financial crisis, but exposures through trade in services—mainly tourism and professional services—is very high. Exports to Russia account for about 10 percent of GDP, which is the highest level in the euro area.

Cyprus is dependent on tourism…



Sources: World Travel and Tourism Council and IMF staff calculations.

…and exposed to Russia through export.



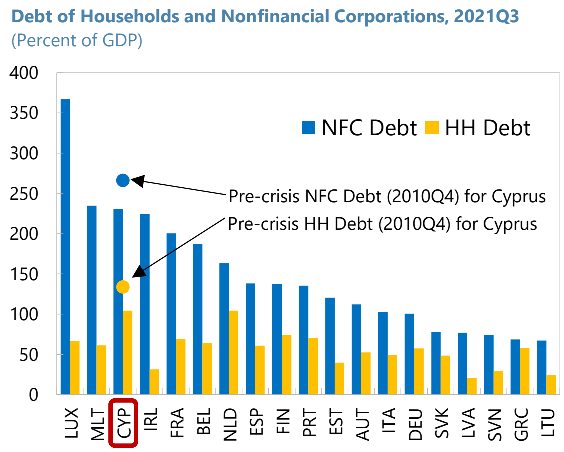
Source: Eurostat.

3. These recent challenges come while Cyprus continues to address the fallout from the country's financial crisis, namely high indebtedness and NPLs. Historically high household and corporate debt levels became excessive before culminating in the financial crisis. There has been progress in deleveraging and banks have made significant progress in reducing NPLs by offloading them to credit acquiring companies (CACs) and the public Asset Management Company (KEDIPES),

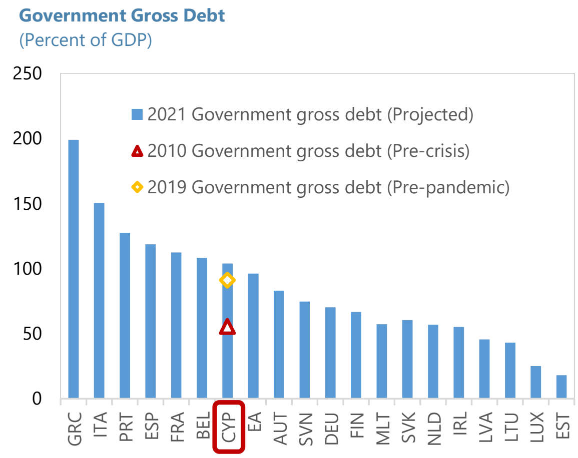
[1] This report does not cover areas of Cyprus not under the effective control of the Republic of Cyprus and assumes no change in status quo.

but the ultimate resolution of NPLs has been slow. The public sector helped cushion the impact of the financial crisis and subsequently that of the Covid pandemic, and Cyprus's public debt is now also relatively high.

Despite deleveraging, private debt remains among the highest in Europe.



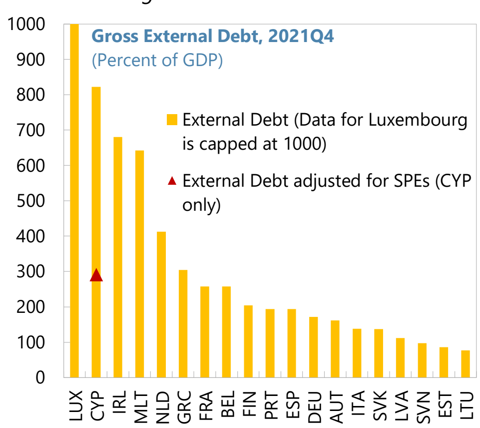
Public debt is significantly higher than before the financial crisis.



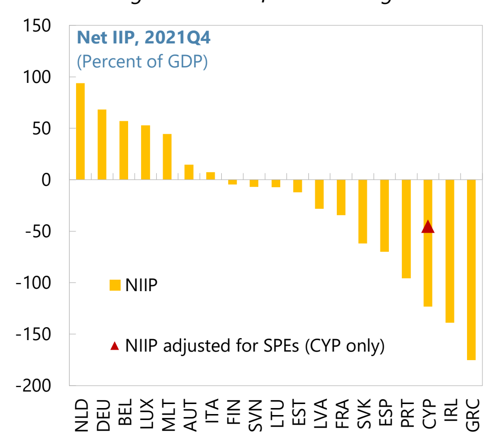
Sources: Central Bank of Cyprus; IMF WEO; Eurostat; Haver Analytics; and IMF staff calculations.

4. High indebtedness is partly a reflection of low savings rates, which have also contributed to a buildup of external debt. Reflecting Cyprus's role as a financial center, a significant portion of the external debt is due to operations of special purpose entities (SPEs), which have no or little employment, physical presence, or production in the country. But external debt is high and net international investment position (NIIP) negative even after excluding SPEs.

External debt is high...



...and NIIP negative even after excluding SPEs

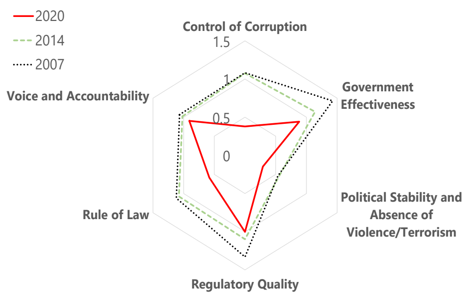


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

5. Cyprus also needs to grapple with the legacy of weak governance and structural bottlenecks. Despite government efforts, governance indicators point to persistent weaknesses. Inefficiencies in the legal system, in particular, hinder NPL workouts. Other structural bottlenecks include gaps in infrastructure and ICT adoption, and skills gap and mismatches.

Governance has deteriorated sharply since 2014.

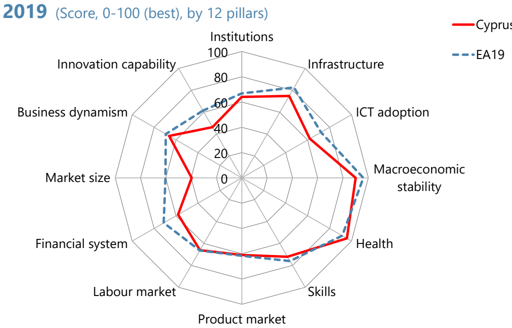
World Governance Indicator: Cyprus
(Estimates)



Sources: World Bank, and IMF staff.

Cyprus lags behind in infrastructure and ICT adoption, and skills.

World Economic Forum: Global Competitiveness Index, 2019 (Score, 0-100 (best), by 12 pillars)

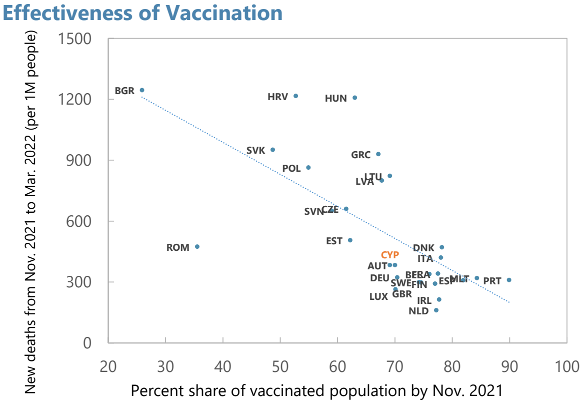


Sources: World Economic Forum; and IMF staff calculations.

RECENT DEVELOPMENTS: RECOVERY FROM COVID

6. Cyprus has managed the new Covid waves well. The infection rate surged during the Omicron outbreak. But the high vaccination rate—around 70 percent of the population has been fully vaccinated and around 40 percent has received a booster—has contributed to low hospitalization and mortality rates. The authorities further eased Covid restrictions in March, including shortening quarantines and eliminating testing requirements on arrival for vaccinated tourists.

Effectiveness of Vaccination



Source: Our World in Data.

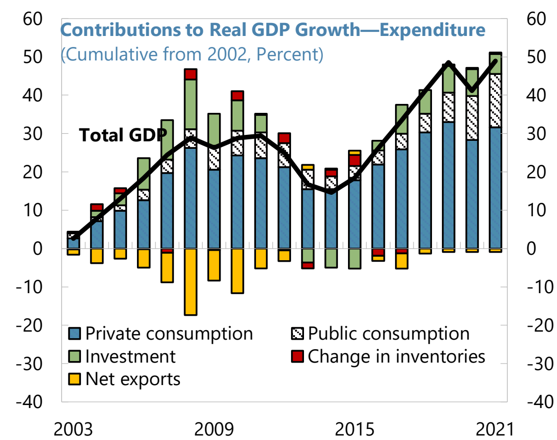
7. Still sizeable Covid-related support in 2021 has by now largely been withdrawn (Annex II). COVID-related fiscal support measures were equivalent to around 3 percent of GDP in 2021, but most expired in December, except for interest subsidy schemes and a new loan guarantee scheme. Most financial support (including debt payment moratoria, where the take up, especially by tourism-related businesses, was high) has also expired.

8. Limited mobility disruption and strong policy support have engendered a rapid recovery (Figure 1). Output returned to its pre-crisis level after GDP grew by an estimated 5½ percent last year. Public consumption remained a large contributor, while exports rebounded with the partial recovery of international tourism. Private consumption also started to recover, supported by the markedly stronger labor market. The unemployment rate declined sharply, to 6.3 percent by 2021Q4, which is around the pre-pandemic level. The labor force participation rate and employment reached all-time highs (even though this may partly reflect a transition of workers from informal to formal employment to benefit from Covid-related support schemes).

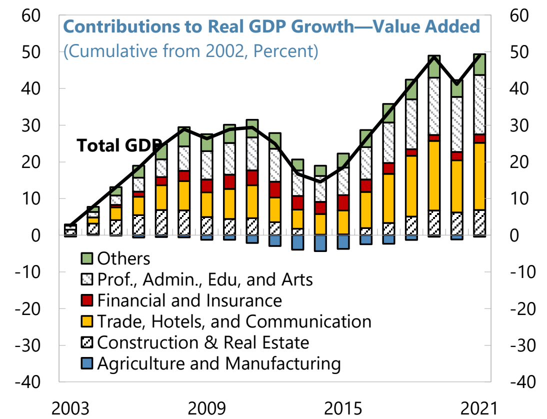
9. But slack remains as the recovery has lagged in tourism-related sectors. Value added, employment and hours worked in services dependent on international tourism are still below pre-pandemic levels. The underutilization of labor (lower hours worked) in tourism-related sectors contributed to the slack in the labor market and the output gap in 2021 is still negative at -½ percent.

Figure 1. Cyprus: Recent Developments

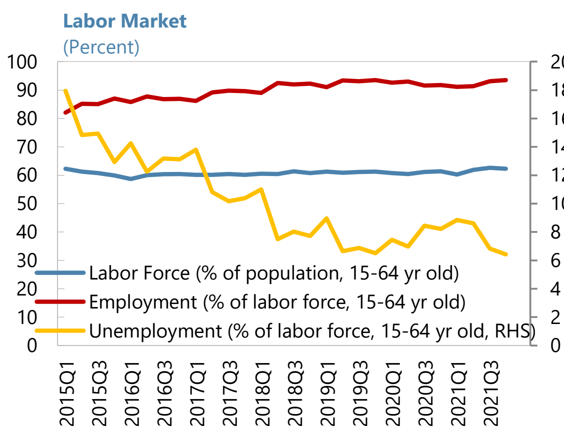
The strong growth in 2021 was mainly driven by exports and consumption.



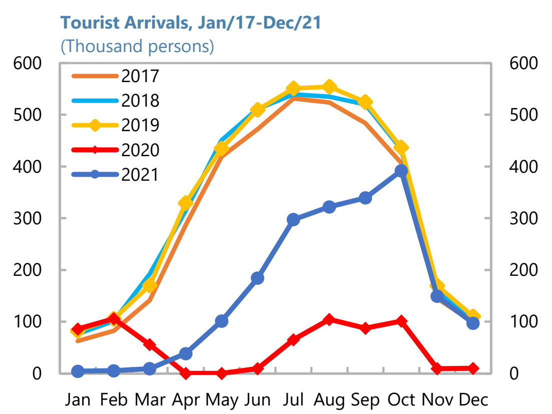
Service sectors such as retail trade and hotels rebounded strongly.



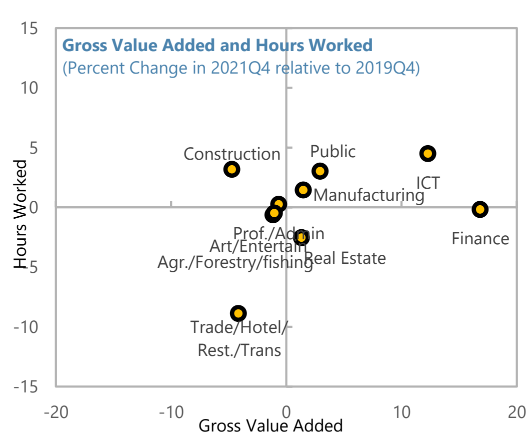
Labor market has improved markedly.



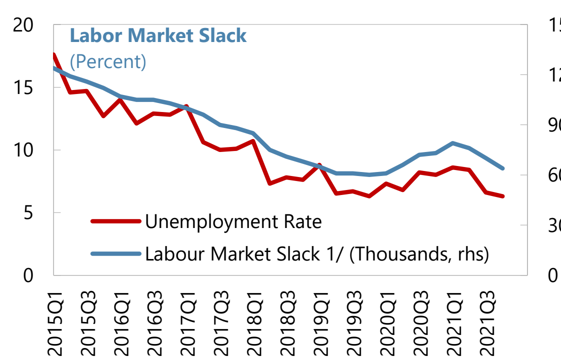
Tourist arrivals were still below pre-pandemic level...



...and there is still significant underutilization of labor in tourism-related sectors...



... contributing to the slack in the labor market.

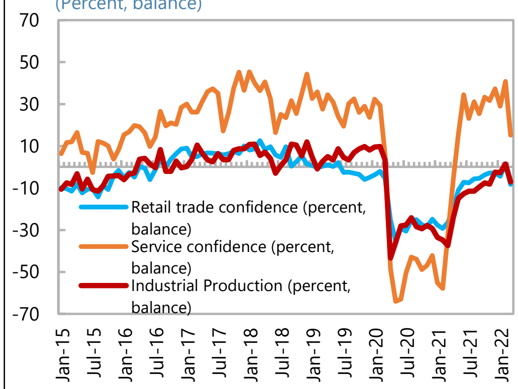


1/ Labor Market Slack includes unemployment, underemployed part-time workers, jobless persons seeking a job but not immediately available for work, and jobless persons available for work but not seeking.

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

10. Confidence weakened in the aftermath of the war in Ukraine. High-frequency consumer and business confidence indicators had been improving, but there has been a marked deterioration in the aftermath of the war in Ukraine (even though business confidence in the services sector was still in positive territory in March, pointing to an expansion).

Cyprus: Confidence Indicators, Jan.15 - Mar.22
(Percent, balance)



Source: European Commission.

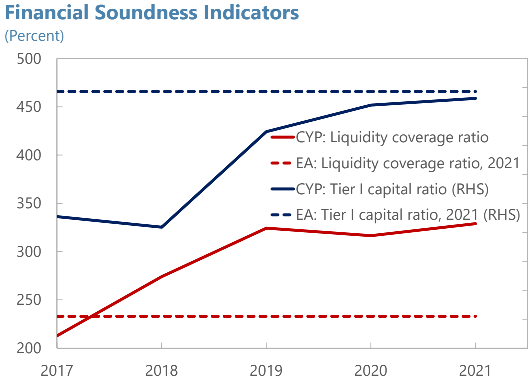
11. Higher inflation—largely driven by energy prices—prompted a revision in expectations (Figure 2). Headline and core inflation edged up sharply, to 5.8 and 2.8 percent (yoy) in February. Increases in utility and transportation prices reflected a pass through from imported energy prices, and households and businesses expect higher inflation. Wages started recovering (not fully in tourism-related services; but have continued increasing in public services).

12. Private balance sheets strengthened on the back of support measures (Figure 3). Support measures combined with subdued consumption and lower investments contributed to the strengthening of households' and NFCs' balance sheets. Households increased assets (mainly deposits) and NFCs reduced debt liabilities.

13. Banks have stayed resilient (Figure 3, Table 6). Liquidity has remained high and capital ratios broadly stable (the Tier1 capital ratio stands at 19.0 percent overall). The effects of the pandemic on NPLs have been minimal so far and banks have been actively restructuring problem loans. But stage 2 loans—performing exposures with significantly deteriorated credit quality—still accounted for 15 percent of total loans as of December 2021 (the EU average is 9 percent). The high take up of the debt repayment moratoria indicate these loans are concentrated in tourism-related sectors, which have not fully recovered from the pandemic and will likely be most affected by the war-related shocks. Moreover, margin pressures and high costs continue weighing on banks' profitability. Still, the European Banking Authority (EBA) stress test published in July 2021 (before the war) indicated that systemically important banks in Cyprus remain resilient.

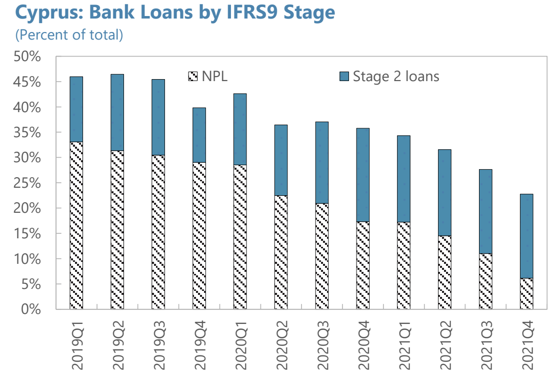
14. Banks have also made significant progress in offloading NPLs (Table 6)**.** The two largest banks have progressed with large NPLs sales, reducing the NPL ratio in the banking sector to around 10 percent in December 2021 (from 17.7 percent a year earlier). The CACs and KEDIPES already held 74 percent of the total NPLs in the economy before these transactions.

Banks are well-capitalized and highly liquid.



Source: EBA.

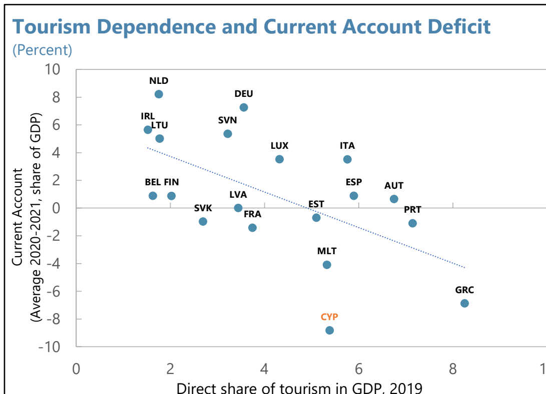
Banks have made progress in reducing NPLs, even though 'Stage 2' loans have risen after the pandemic.



Source: EBA.

15. After a sharp rise reflecting pandemic-related fiscal spending, public debt has started to decline (Figure 4, Table 2). The headline deficit dropped from 5.7 percent in 2020 to 2.1 percent of GDP last year on the back of a cyclical revenue recovery, an underutilization of Covid support measures, and a lower-than-budgeted wage bill. The sizable cash buffer from the 2020 Eurobond issuance covered the 2021 financing needs and allowed the redemption some debt. The debt ratio declined from 115 percent in 2020 to 104 percent last year (DSA Annex IV), also reflecting strong GDP growth. Sizeable deposits are still expected to be able to cover financing needs for the first 9–12 months of this year. Bond spreads have increased since November.

16. The current account deficit remains elevated (Figure 5). The current account deficit declined to -7.3 percent of GDP last year, compared to -10.1 percent of GDP in 2020, but was still higher than the 2019 level of -5.7 percent of GDP. The recovery in exports has been offset by a deterioration in the terms of trade, largely from higher energy prices. More fundamentally, domestic savings stayed relatively low despite the increase in private savings during the pandemic, and 2020-21 current account deficits in Cyprus were higher than in other tourism-dependent countries in Europe. The deficit was largely financed by Foreign Direct Investment (the termination of the CIP from end-Nov 2020 has not had a material impact). The Fund's EBA-lite Current Account model suggests the external positions is weaker than implied by fundamentals and desirable policy settings (Annex III. ESA and Annex IV. DSA).[2]



Sources: Eurostat; IMF WEO; and the WTTC.

[2] The Central Bank of Cyprus does not have a policy for active utilization of its SDR holdings (132.8mn), which is treated as a passive currency asset. However, being a participant in the Voluntary Trading Arrangement (VTA), the SDR holdings may fluctuate depending on VTA transactional activity.

OUTLOOK AND RISKS: FALLOUT FROM THE WAR

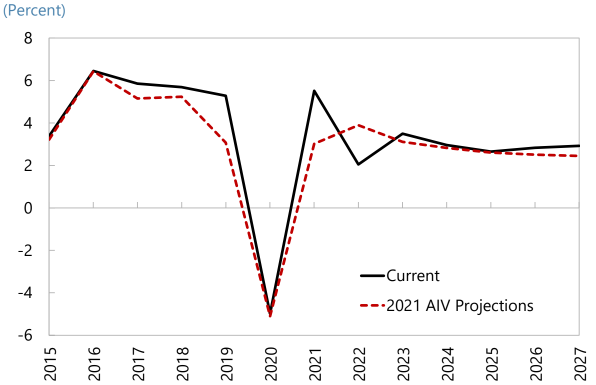
17. In the near term, recovery will be set back by the fallout from the war in Ukraine. Staff's baseline forecast assumes that the theater of conflict remains limited to Ukraine and that sanctions on Russia (along with European plans to become independent of Russian energy) do not tighten beyond those announced by end March and remain in place over the forecast horizon. Given Cyprus's exposures to Russia (Box 1), the impact will be on tourism arrivals and demand for professional services. GDP is projected to grow by around 2 percent this year, supported by a partial recovery in exports (with non-Russian tourist arrivals close to their 2019 level), private consumption (notwithstanding a negative terms-of-trade shock from higher energy prices), and investment (boosted by new spending under the Cyprus's Recovery and Resilience Plan (RRP)). Current account is projected to worsen on the account of a deterioration in the terms-of-trade and a recovery in imports. Inflation is expected to rise this year and then start declining but will remain elevated next year given the prolonged pass-through.

18. A stronger recovery will resume over the medium-term, supported by RRP spending and reforms. Recovery will be driven by external demand, with some lingering effects of the war-related shocks on tourism and on professional services (as some firms become unviable and resources are reallocated within and across the sectors). Additionally, growth will be supported by RRP investments and structural reforms, which, taken together, are expected to increase potential GDP growth by about ½ percentage point (to about 3 percent) by the end of the projection period. (Table 1, Annex VIII). This assumes progress on the reduction of NPLs, which would help strengthen the role of credit in financing private investment. Current account is expected to improve, albeit gradually, reflecting only a moderate increase in savings and higher investments.

19. Risks are tilted to the downside (Annex V).

Cyprus: Real GDP Growth

(Percent)



Source: IMF Staff estimates.

- **On the downside,** the key risk is an escalation and prolonged duration of the war and sanctions. Additionally, de-anchoring of inflation expectations in advanced economies could lead to unexpected and abrupt monetary tightening, flow reversals, rollover difficulties and higher risk premia. And uncontrolled and more severe Covid outbreaks remain a risk and could further disrupt the recovery of services and external demand. These shocks could lower growth, increase defaults, and strain banks' balance sheets. Given high public debt, lower growth and a materialization of contingent liabilities stemming from the financial sector could undermine fiscal sustainability, even though favorable debt profile mitigates financing risks (DSA Annex).

- **On the upside,** a higher-than-expected impact of the RRP—in particularly the productivity-enhancing reforms—would boost growth potential in the long-run.

Authorities' Views

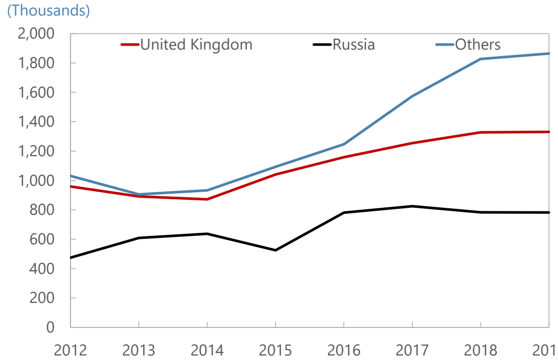
20. The authorities broadly shared the staff view on the outlook but pointed to mitigating factors giving rise to more optimism. They were of the view that the impact of the war in Ukraine would be mainly concentrated in the tourism sector, where there has been progress in finding alternative markets and enhancing the existing ones, and, to a lesser extent, in the professional services sector. They considered spillovers to other sectors and the direct exposure of the financial sector to the war as limited. They also saw a payout from structural reforms as being higher than projected by staff, leading to higher potential growth. Regarding the risks from tighter sanctions, they pointed out that Cyprus is not dependent on natural gas from Russia. Regarding the risks related to the pandemic, they felt that a new lockdown would be highly unlikely.

Box 1. Cyprus: Economic Fallout from the War in Ukraine

The impact of the war of the export of services—tourism in particular—will likely be significant. Prices and terms-of-trade are sensitive to oil prices. Financial exposures appear to have only a small real footprint in Cyprus.

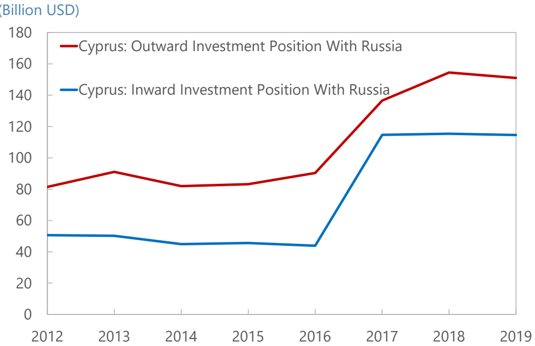
The impact on tourism industry will be significant, even if offset by arrivals from other countries. Tourists from Russia accounted for around 20 percent of total arrivals before the pandemic (arrivals from Ukraine were smaller; around 2½ percent of the total). Staff estimate that the corresponding revenues amounted to around 2½ percent of GDP in 2019. The war and the sanctions will likely reduce the arrivals to nearly zero, even though a partial substitution from other source countries is likely, facilitated by the relatively small size of the Cyprus market and promotion efforts by the industry and the government. But the shock may also be amplified by the weak financial situation in parts of the sector, already impacted by the pandemic.

Cyprus: Tourist Arrivals by Main Source Countries
(Thousands)



Source: Cystat.

Cyprus: Investment Position between Russia and Cyprus
(Billion USD)



Source: IMF CDIS database, latest published.

Large investment flowing to and from Russia also points to vulnerabilities; the main impact is likely to be on activity in professional services. Cyprus is the largest foreign investor in Russia, with the Cyprus-reported outward position of $161 billion in 2020 (over 850 percent of GDP). Russia, in turn, is the largest investor in Cyprus, with the Cyprus-reported inward position of $119 billion (625 percent of GDP). Most of these investments are through special-purpose entities or in the form of inter-company loans, with a limited real 'footprint' in Cyprus. But a reduction in these flows would have an impact on professional services (generating 11 percent of Cyprus's value added together with scientific and tech activities), where Russia-related activities account for about 10 percent of revenues. Additional (and more direct) impact could occur through reduced investments (or possibly a fire sale of assets) in the real estate sector: Russian citizens were the largest investors through the CIP between 2013 and 2020, with purchases of newly built real estate properties concentrated in the luxury segment.

Box 1. Cyprus: Economic Fallout from the War in Ukraine (concluded)

There could be additional fiscal impact from a reduction in investment flows. Foreign companies registered in Cyprus are subject to corporate taxes, and a reduction in their activities will have a fiscal impact, even though it is difficult to estimate due to paucity of data. In addition, the recent amendments to the double taxation treaty between Russia and Cyprus (all dividend and interest payments from Russia to Cyprus are subject to a 15 percent withholding tax since 2021) might reduce the Russian business presence in Cyprus due to the lowered tax advantage.

Higher oil prices will have an impact on terms-of-trade (ToT), purchasing power, and prices. Cyprus is heavily dependent on imported fossil fuels, mainly refined petroleum ($1.94 billion in 2019; 11.5 percent of total imports and 8.3 percent of GDP). It is used for both transport and electricity generation (which relies primarily on oil), making prices in Cyprus and its ToT highly sensitive to global crude oil prices. Cyprus, however, does not import natural gas, potentially shielding it from a direct impact of supply disruptions from Russia.

Direct financial sector linkages appear limited:

- **Russian depositors.** There has been a gradual decline in the share of Russian deposits in the banking system, which accounted for about 4 percent of total deposits at the end of 2021.
- **RCB bank.** The third largest Cypriot Systematic Institution has had significant Russian stake and business interests. VTB—a sanctioned Russian bank—held 46 percent stake in RCB Bank until February 24th, when it transferred its shares to two companies controlled by the bank's management. On March 24th, the bank announced its plan to phase out its banking operation in Cyprus. On the same day, the ECB restricted the RCB Bank's business and approved the sale of its domestic loan portfolio (up to around €560 million) to Hellenic Bank (the second largest bank in Cyprus). The first tranche of this transactions has been executed, and RCB Bank should now be capable of covering all its deposits. It will give up its banking license after the full payout of its depositors (excluding sanctioned individuals) and will continue to operate as a CAC upon approval from the Central Bank of Cyprus.

Refugees from Ukraine require government assistance but could have positive impact on the economy. By end-March, Cyprus has received around 10,000 Ukrainians and provided them a 12-month right to residence, food, education, health care, and employment. The fiscal impact from supporting refugees is expected to be small, while they could help alleviate the labor shortage in some economic sectors and bring entrepreneurship by reallocating their businesses.

POLICIES FOR SUSTAINABLE RECOVERY AND GROWTH

The key near-term challenge is to calibrate a policy response as the impact of the pandemic wanes, but the war-related shocks will likely take a toll on the economy. The cost of getting the policy package wrong is high in Cyprus: too restrictive policies may weaken private balance sheets already marred by the legacy NPLs; too much accommodation may leave fiscal buffers too low (given Cyprus's vulnerabilities) and undermine market confidence. In this context, a more forceful implementation of the strategy for NPL reduction is still paramount to reduce vulnerabilities. This, in turn, hinges on long-pending structural reforms to make the judicial system more efficient. More broadly, reforms to strengthen governance and address other bottlenecks—such as skills gaps and mismatches and infrastructure gaps—are key to improve growth prospects.

A. Gradually Rebuilding Fiscal Buffers

21. Fiscal policy should aim to rebuild buffers but remain flexible. The public sector absorbed the impact of the pandemic shock thanks to the improvements in the fiscal position registered since the financial crisis, which paid off in access to foreign financing at low cost (further bolstered by ECB policies). The stronger fiscal position also helped increase Cyprus's relatively low savings rate, creating more room for investment. A gradual fiscal adjustment should aim at restoring the buffers by maintaining the public debt ratio on a firmly declining path, but it should be allowed to absorb shocks and provide more discretionary support if needed. Cyprus still has fiscal space to do this, even though the reliance on external financing and the changing global environment—with possibly bouts of risk aversion—make the tradeoff between providing support and maintaining low-cost access to financing starker.

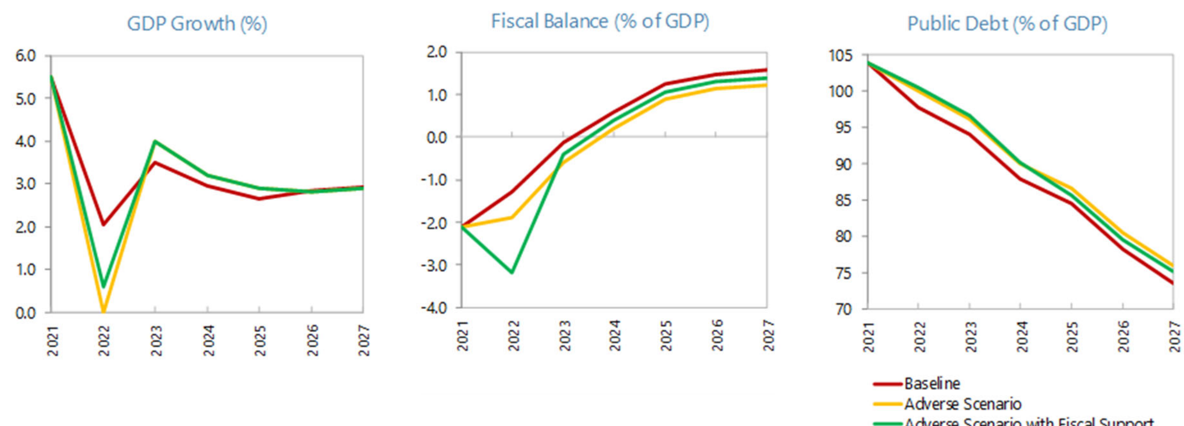
22. Fiscal policy in 2022 may need to be re-calibrated as more clarity emerges about the impact of the shocks:

- **Automatic stabilizers should be allowed to operate.** Based on the current budget, staff project a deficit of 1¼ percent of GDP this year. This is stronger than the deficit of 2 percent of GDP in 2021—reflecting the phase-out of Covid-related support—but still includes some cyclical weakening of fiscal position from the impact of the war and sanctions (Box 1). Given that Cyprus has a robust social safety net (Figure 7) based on a Guaranteed Minimum Income (GMI) scheme, automatic stabilizers will, by themselves, cushion the most vulnerable from the impact of the shock.

- **Cushioning the impact of higher energy prices should be affected through transfers supporting vulnerable households.** The authorities reduced VAT rates on electricity and excise duties on gasoline and diesel until June. The total cost of these measures is manageable (below 0.2 percent of GDP). However, if further rise in energy and food prices warrants additional measures to protect poor and vulnerable households, staff recommends stricter targeting through temporary transfers rather than lowering taxes or capping prices.

- **If the shock (or its impact) is larger or longer, additional support should be targeted, temporary, and not hinder reallocation of labor to expanding sectors.** Cyprus still has fiscal space to provide support: staff simulations suggest that in the adverse scenario of zero growth in 2022 (along the lines of a worst-case scenario considered by the authorities in their contingency planning), a 1½ percent of GDP higher deficit in 2022 (half of the size of Covid-related measures in 2021) would not jeopardize debt sustainability. To maximize supply response from such support and avoid adding to inflationary pressures, the measures should make it easier for expanding sectors to absorb laid-off workers. This could be achieved by extending unemployment benefits but tying them to activation requirements (such requirements are now very weak for both the GMI and unemployment benefits). Scaling up active labor market policies (which are limited in Cyprus) would also be helpful, even though the payoff would likely be small in the short run. In addition, there may be some rationale for providing temporary support to viable companies to prevent scarring and the authorities should draw on the experience with Covid support measures and ensure their transparency and accountability.[3]

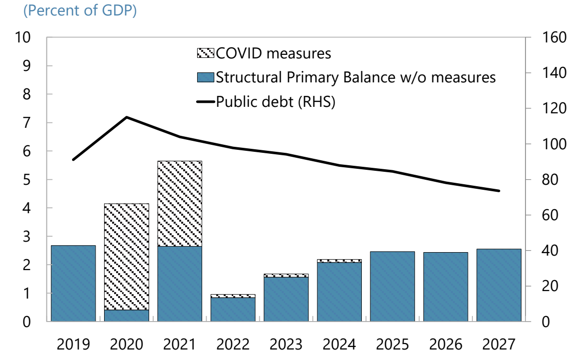
Cyprus: Baseline and Adverse Scenario Projections



Source: IMF staff calculations.

23. In the medium term, government plans are consistent with gradually rebuilding buffers, but will require maintaining strict fiscal discipline. The authorities' Stability Program 2022–25 targets a fiscal balance of 1¾ percent of GDP in 2025. Staff projects a slower adjustment— reflecting less optimistic growth projections bearing on tax revenues, and higher RRP-related capital spending—but still producing a small fiscal surplus in 2024. This would be sufficient to maintain the public debt ratio on a firmly declining path, helping to rebuild buffers. It would also be consistent with the national fiscal rule to keep the general government structural fiscal balance balanced or in surplus in the medium term (even though this objective may need to be adjusted based on how EU budget rules unfold). Achieving these targets, however, would require further action in some areas:

Cyprus: Gradual Fiscal Adjustment
(Percent of GDP)



Source: IMF Staff estimates.

- **Strengthening financial discipline in the National Health System (NHS).** The NHS consists of a National Health Insurance Fund (funded from contributions) paying for services from public (State Health Services Organization) and private providers. The system has safeguards to ensure

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[3] The authorities have implemented measures to ensure the transparency and accountability of Covid-related spending, including: i) assessing and disclosing their impact on public finances; ii) setting up and publishing the criteria for determining beneficiaries and actions eligible for support; iii) establishing application and information provision requirements; iv) conducting ex-post verification of the implementation of the support schemes. The authorities are in the process of hiring an external auditor to finish the ex-post verification.

its financial viability: a hard-cap global budget (prices per unit decrease with the volume of units to discipline providers); fully e-based operations (to promote efficiency and transparency); and co-payments. But it is facing financial stress as the pandemic reduced revenues from contributions and led to revenue losses for public hospitals as they needed to treat Covid cases. In addition, some irregularities have emerged on the expenditure side, including excess demand for medical services and false claims from service providers. The authorities are addressing them by introducing a performance-based reimbursement scheme and separate global budgets for specialties, utilizing the IT system for the detection and prevention of fraud, and intensifying audits. Beyond these pressures, public hospitals remain subsidized (until mid-2024) to allow them to prepare for competition with private providers. The authorities presented a plan for public hospitals to reach financial self-sufficiency by extending service hours and providing additional services, which should now be implemented

- **Controlling the wage bill.** The public wage bill remains relatively high relative to GDP. It has been declining since the financial crisis but increased during the pandemic (reflecting a lower denominator and pandemic-related employment needs). Controlling the wage bill is critical to safeguarding fiscal sustainability and can help contain inflation pressures. Staff projections assume that public wages and pensions will continue to follow a partial adjustment formula (50 percent of the increase in the COLA index, largely reflecting CPI changes) and the growth in public sector employment will be in line with overall employment growth in the economy.

24. Reinstating the immovable property tax could help offset the budgetary impact of spending pressure (if needed) and generate revenues for public investment. While controlling spending is first best and should be sufficient to reach a small budget surplus in 2024, reinstating the immovable property tax would increase revenue by about ½ percent of GDP and help offset spending pressures in case it proves larger than in the baseline. The additional tax revenues could alternatively be used to scale up public investment to address growth bottlenecks discussed below, including the need for financing climate adaptation measures and mitigation policies (see below and Annex VI on climate policies).

25. Rebuilding fiscal buffers is important given the high financial sector's contingent liabilities. Contingent liabilities arising from the banking system remain high due to the still-elevated legacy NPLs and potential new NPLs after the withdrawal of government support measures and given the impact of war-related shocks. The planned expansion of KEDIPES will also have a negative fiscal impact. Taken together, staff estimates contingent liabilities from the banking sector at around 8 percent of GDP (Annex IV DSA).

26. Funds from Next Generation EU (NGEU) should smooth the adjustment and support an economic transition. The total budget of Cyprus's RRP amounts to €1.2 billion (5.2 percent of 2021 GDP). The RRP is expected to play a key role in implementing pro-growth reforms and facilitating the transition towards a greener, digital, and more sustainable economy (41 percent of the total allocation to support climate objectives and 23 percent to support the digital transition). Cyprus received the first tranche of NGEU grants, in the amount of €157 million (0.7 percent of GDP), as pre-financing. A sizable share of the funds (around 30 percent) is expected to be used to support existing projects. The staff's baseline scenario assumes that the use of funds for new projects is paced gradually but concentrated over 2022–24. Absorption could be challenging, in part due to the wide range of ministries involved, but the paced spending could help. In this context, the authorities should continue to strengthen public investment management, including the investment planning through SOEs.

Cyprus: Fiscal Targets: 2019–27

	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Act.	Act.	Act.			Proj.			
	(Percent of GDP, unless otherwise noted)								
Stability Program 2022-2025									
Total revenue	39.7	39.3	42.1	41.7	41.3	41.3	40.6	...	...
Total expenditure	38.4	45.0	44.2	41.7	40.9	39.9	38.9	...	...
Overall balance	1.3	-5.7	-2.1	0.0	0.4	1.5	1.7	...	...
Primary balance	3.5	-3.6	-0.3	1.6	1.6	2.6	2.9	...	...
Gross public debt	91.1	115.0	103.9	93.9	88.2	81.0	76.7	...	...
Staff Projections									
Total revenue	39.7	39.3	42.1	41.0	41.2	41.1	40.8	40.1	39.8
Total expenditure	38.4	45.0	44.2	42.3	41.3	40.5	39.5	38.6	38.2
Overall balance	1.3	-5.7	-2.1	-1.3	-0.1	0.6	1.2	1.5	1.6
Primary balance	3.5	-3.6	-0.3	0.5	1.4	1.9	2.5	2.4	2.5
Gross public debt	91.1	115.0	103.9	97.7	94.1	87.8	84.5	78.2	73.6
	(Percent of potential GDP, unless otherwise noted)								
Primary balance	3.6	-3.5	-0.3	0.5	1.4	1.9	2.5	2.4	2.5
Cyclically-adjusted revenue	39.8	39.2	42.1	40.9	41.2	41.1	40.8	40.1	39.8
Primary expenditure	37.1	42.3	42.3	40.2	39.7	39.2	38.3	37.7	37.2
Structural primary balance	2.7	-3.3	-0.4	0.7	1.5	2.0	2.5	2.4	2.5
Structural primary balance excluding Covid-related measures 1/	2.7	0.2	1.9	0.8	1.5	2.1	2.5	2.4	2.5
Output gap	2.5	-1.3	-0.2	-0.6	-0.2	0.0	0.1	0.1	0.0

1/ For 2021, also excluding the EU grants that the government received in October and November 2021.

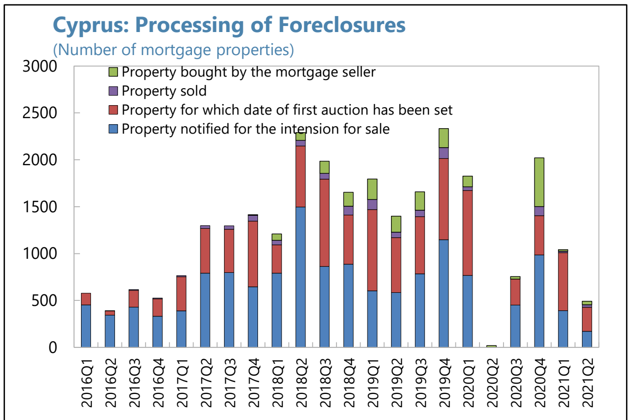
Authorities' Views

27. The authorities are committed to maintaining fiscal discipline and rebuilding fiscal buffers. They currently do not envisage the need for new schemes to support the economy, which would, at the current juncture, only increase inflationary pressures. If developments warrant additional support, they agreed that the measures should be temporary, targeted and promote rather than hinder labor reallocation (and such support is considered in their contingency plans). Regarding support to the tourism sector, they prefer a scheme providing hotel discounts for local tourists to avoid disincentives for restructuring which could arise if measures are also extended to loss-making parts of affected industries. The authorities shared the concerns about the financial sustainability of the NHS but emphasized that progress has been made to address the irregularities of the system. While recognizing the benefit of new revenue sources, they indicated that a re-introduction of an immovable property tax should only be considered in the context of a broader tax reform and considering the impact on the real estate sector.

B. Safeguarding Financial Stability and Rebuilding the Credit-Growth Nexus

28. Persistently high NPLs have limited the role of credit in supporting investment and growth. Stubbornly high NPLs impaired both credit demand and banks' ability to supply credit (IMF, 2018). NPL resolution has been slow, reflecting limited ability to pay by some debtors, but also strategic defaults. The pandemic has made impediments to the process worse, by negatively affecting the capacity of debtors to repay but also by adding to political pressures to weaken the foreclosure framework and thus undermining claims enforcement.

29. More forceful implementation of the NPL reduction strategy would speed it up and reduce economic costs:



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

- **Foreclosure framework.** Data on recent foreclosure activity (including e-auctions) indicates that it remains limited and stalled for primary residences. An effective foreclosure framework is critical for addressing strategic defaulters and providing incentives for borrowers to engage in restructurings. In this regard, staff recommend addressing any uncertainties arising from the implementation of the 2019 amendments to the framework.

- **CACs.** The CACs are critical to addressing high NPLs among households and NFCs. There has been progress in improving the working environment for CACs (and for credit servicing companies), but gaps remain, including their online access to the land registry database. Oversight of CACs needs to be strengthened and transparency should be enhanced through public disclosure of the aggregate statistics of the CACs.

30. Support measures to protect living conditions of vulnerable borrowers through the planned expansion of KEDIPES should be well targeted (Annex VII). As an alternative to foreclosure, the authorities plan to transfer primary residences and business premises with a market value below €350,000 used as collateral for NPLs (after a debt-to-asset swap) to KEDIPES. Once transferred, a mortgage-to-rent (MtR) scheme and rent subsidies would be introduced for vulnerable borrowers. House price statistics indicate that over half of primary residences could be eligible and, without targeting, staff estimates the upper bound of the fiscal cost of the expansion at about 3½ percent of 2022 GDP. To avoid further weakening credit discipline and to minimize fiscal impact, the scheme should be limited to the most vulnerable households on a strictly means-tested basis. Other safeguards should include making the support timebound; a robust transfer pricing mechanism to minimize fiscal costs and risks; and a strong governance framework with an emphasis on transparency and accountability (Annex VII).

31. Improved restructuring tools are needed to support timely restructuring of potentially viable businesses. Banks have been actively restructuring loans post-pandemic, but applications for bankruptcies/liquidations/examinerships remain relatively low. The use of insolvency tools will be key to enabling timely restructuring of viable businesses in financial difficulties. Staff welcomed progress toward improving these tools through amending the legislative framework to implement the EU Restructuring Directive on Preventive Insolvency Procedures (changes are undergoing review before submitting to Parliament); improving the examinership process and the institutional framework for insolvency (steps are being taken to set up a new Department of Insolvency and digitalize insolvency cases); and initial steps to develop a new hybrid/out-of-court restructuring procedure.

32. Macroprudential policy should strike a balance between containing the build-up of vulnerabilities and avoiding procyclicality. Staff welcomed the ongoing work on drafting a policy that will enable the CBC to set a positive neutral countercyclical capital buffer (CCyB). But, for now, a broad tightening of financial conditions should be avoided, as the credit gap remains negative and there appear to be no signs of overheating in the real estate market. To the contrary, planned sales of repossessed collateral properties by banks and CACs could potentially depress real estate prices, and the market (albeit in a different segment) could also be affected by the exit of Russian investors. Although such downward pressures have not been evident, supervisors should continue to monitor the development to limit the risk of excessive holding or sales of foreclosed properties.

33. The authorities should continue their efforts to address identified weaknesses in the anti-money laundering and countering-financing of terrorism (AML/CFT) framework. Cyprus continues to make progress in strengthening AML/CFT regulation and conducting on-site and off-site supervision. Cyprus also developed an interim solution system for the collection of data on beneficial owners, and a final solution system is expected to be implemented in 2022. In its recent follow-up report to the 2019 assessment, MONEYVAL noted that Cyprus had made some progress in improving its level of compliance with Financial Action Task Force (FATF) standards on AML/CFT, but Cyprus has not been re-rated on any of the recommendations. In this regard, Cyprus should continue to address identified weaknesses and strengthen the implementation of AML/CFT measures, in particular the supervision of banks and gatekeepers (e.g., lawyers, accountants, and trust and company service providers) and preventive measures (e.g., customer due diligence and measures for politically exposed persons). The authorities should also continue following-up on the potential misuse of the terminated CIP.

Authorities' Views

34. The authorities broadly agreed with staff's assessment. They highlighted major progress in the disposal of NPLs by the largest banks while acknowledging that the leading role for private deleveraging has been passed on to CACs. In this context, they agreed on the importance of a sound foreclosure framework for NPL resolution and financial stability. On the MtR scheme, although the key terms are still under study, they indicated that the planned wealth and income criteria would help target it to vulnerable groups. They agreed that timely implementation of the EU Directive and associated amendments would be helpful to strengthen examinership and resolution tools. Regarding macroprudential regulations, they explained that they are working on enhancing the flexibility for the CBC to set a positive CCyB rate, even though they are not considering imposing non-zero countercyclical buffers for now. The authorities emphasized progress in improving the AML/CFT framework and remain committed to addressing any remaining gaps.

C. Structural Reforms and Green Transition

35. The RRP offers an opportunity to press ahead with reforms to address impediments to growth (Annex VIII). Competitiveness indicators show that Cyprus has a relatively dynamic business sector, and flexible labor and product markets. But weaknesses in governance, skills gaps and mismatches, and digital and infrastructure gaps weigh on growth prospects. Reforms in the RRP aim to tackle these weaknesses, which underpins the projected improvement in growth prospects. The improvement is backloaded though, reflecting the timing of reforms and lags in the materialization of their effects (long in the case of reforms to address skills gaps and mismatches). In this context, the authorities could consider accelerating key reforms in the RRP:

- **Strengthening governance.** The reforms include measures to enhance the rule of law (by recruiting and training judges and improving processes with a view to gradually reducing the backlog of cases); control of corruption (including the recently passed legislation on whistle-blower protection and a new independent anti-corruption agency); and government efficiency (including the recently passed public service reform). Continued progress in strengthening the AML/CFT and governance frameworks could also help manage Cyprus's reputational risk related to the war in Ukraine, and the potential negative impact of Cyprus's financial sector being misused for sanctions evasion.

- **Addressing skills gap and mismatches and closing the digital infrastructure gap.** The measures include improving teaching quality, enhancing digital skills at all levels of education, and strengthening vocational education. The plan also includes public investments in digital infrastructure and steps to improve the functioning of the e-communications market.

36. Achieving the national climate targets is an important element of the country's development agenda (Annex VI). Cyprus has set a 2030 greenhouse gas reduction target of 32 percent (relative to 2005) for sectors not covered by the EU Emissions Trading Scheme (ETS). While significant on its own, moving toward this target would help diversify energy sources and improve energy security. To achieve the target, Cyprus aims to:

- **Reduce energy dependency and enhance energy efficiency.** The measures include promoting electricity generation from cleaner sources, improving electricity connectiveness, increasing energy efficiency in the residential sectors, and improving public transport. Total public funding needs for these initiatives are estimated at 25 percent of GDP. The authorities plan to finance the investment through a combination of national budgets and EU funding (including from the RRP).

- **Green tax reform.** The government plans to introduce a carbon tax on fuels used in the sectors that are not covered by the ETS in 2023. Staff simulations suggest that a carbon tax starting at €25 per metric ton of carbon emission in 2023 and gradually increasing to €100 by 2030 would reduce total emissions by 7½ percent relative to the baseline and reduce emissions of the non-

ETS sectors by 12 percent. The tax would generate a revenue of about ¾ percent of GDP, which could be used to address growth and distributional impacts of the reform.

37. But achieving the national climate targets will be challenging. The implementation of projects to reduce energy dependency and enhance efficiency may face financing and capacity constraints, and the current high energy prices may also pose implementation challenges for the green taxation policy. Staff's analysis suggests that additional measures would still be needed to achieve the targets, which could include feebates at the sectoral level.

Authorities' Views

38. The authorities agreed about the significance of structural reforms for achieving a more sustainable growth model. They noted significant progress, including the recently passed legislation on the public service reform, which is expected to improve the efficiency and overall performance of public services. They also emphasized that the recently passed anti-corruption legislation already created a strong legal framework against corruption, and they agreed that further reform of the judicial system would enhance the efficiency of NPL resolution. They will continue to implement climate-related projects and provide incentives to the private sector for the green transition but recognized the challenges in achieving the national climate targets.

STAFF APPRAISAL

39. Cyprus has been successful in handling the pandemic but is now exposed to the fallout from the war in Ukraine. Output and employment returned to pre-Covid levels last year. But tourism has not fully recovered, and the sector—together with professional services—is highly dependent on demand from Russia. The recovery is thus projected to stall in 2022 but should regain momentum in 2023. The recovery is projected to continue in the medium term with growth supported by investments and structural reforms in the RRP. Risks to the outlook stem mainly from an escalation and longer duration of the war in Ukraine, uncontrolled Covid outbreaks, and an abrupt monetary tightening in advanced economies.

40. Fiscal policy should continue providing support but aim to gradually rebuild buffers. Fiscal policy was able to support the economy during the pandemic thanks to buffers built since the financial crisis. But given the elevated public debt level post-pandemic, policy should aim at restoring buffers through a gradual fiscal adjustment. The government fiscal plan is consistent with achieving a small fiscal surplus in 2024 and placing public debt on a firmly declining path. This assumes that automatic stabilizers are allowed to operate, which, given Cyprus's robust social safety net, would cushion the most vulnerable from the impact of the shock.

41. Additional discretionary measures, if needed, should be temporary and well-targeted. Additional discretionary support may be needed if the shock (or its impact) is larger or longer-lasting than expected. Such support should be temporary, targeted to most affected groups, and not hinder reallocation of labor to expanding sectors. It could be provided by further strengthening the social safety net (e.g., by extending unemployment benefits but tying them to labor market activation and job search requirements), which could be accompanied by scaling up active labor market policies.

Measures to alleviate the impact of high energy and food prices should be strictly targeted through temporary transfers.

42. Strict fiscal discipline is needed to achieve medium-term fiscal adjustment. The authorities should continue their efforts to keep public sector wages under control, address irregularities emerging in the NHS, and continue with the plan to ensure financial self-sufficiency of public hospitals. While controlling spending should be sufficient to reach the budget targets, reinstating the immovable property tax would help offset spending pressures or alternatively scale up public investment to address growth bottlenecks. The authorities should also closely monitor the contingent liabilities arising from the banking system due to the still-elevated legacy NPLs and potential new NPLs.

43. The financial system has stayed resilient, but the authorities should enhance monitoring and address asset quality given the worsened outlook. The impact of the pandemic on banks has been contained, with liquidity staying high and capital ratios broadly stable. But despite recent declines, 'stage 2' loans—performing exposures with significantly deteriorated credit quality—have remained elevated post-pandemic. The problem loans appear to be concentrated in tourism-related sectors, which will likely be most affected by the war-related shocks. Banks have been actively restructuring these loans, but a broader use of insolvency tools—supported by a timely implementation of the EU Directive on Preventive Restructuring and Second Chance—would further help viable businesses in financial difficulties.

44. Resolving legacy NPLs requires more forceful implementation of the existing tools. Banks have made significant progress in offloading legacy NPLs but resolution of these NPLs—now residing mostly in CACs and KEDIPES—has been slow. An effective foreclosure framework remains critical for addressing strategic defaulters and providing incentives for borrowers to engage in restructurings. Any uncertainties arising from the implementation of the 2019 amendments of the Foreclosure Law should thus be addressed. The working environment for CACs and credit-servicing companies should also be improved, while their oversight should continue to be strengthened.

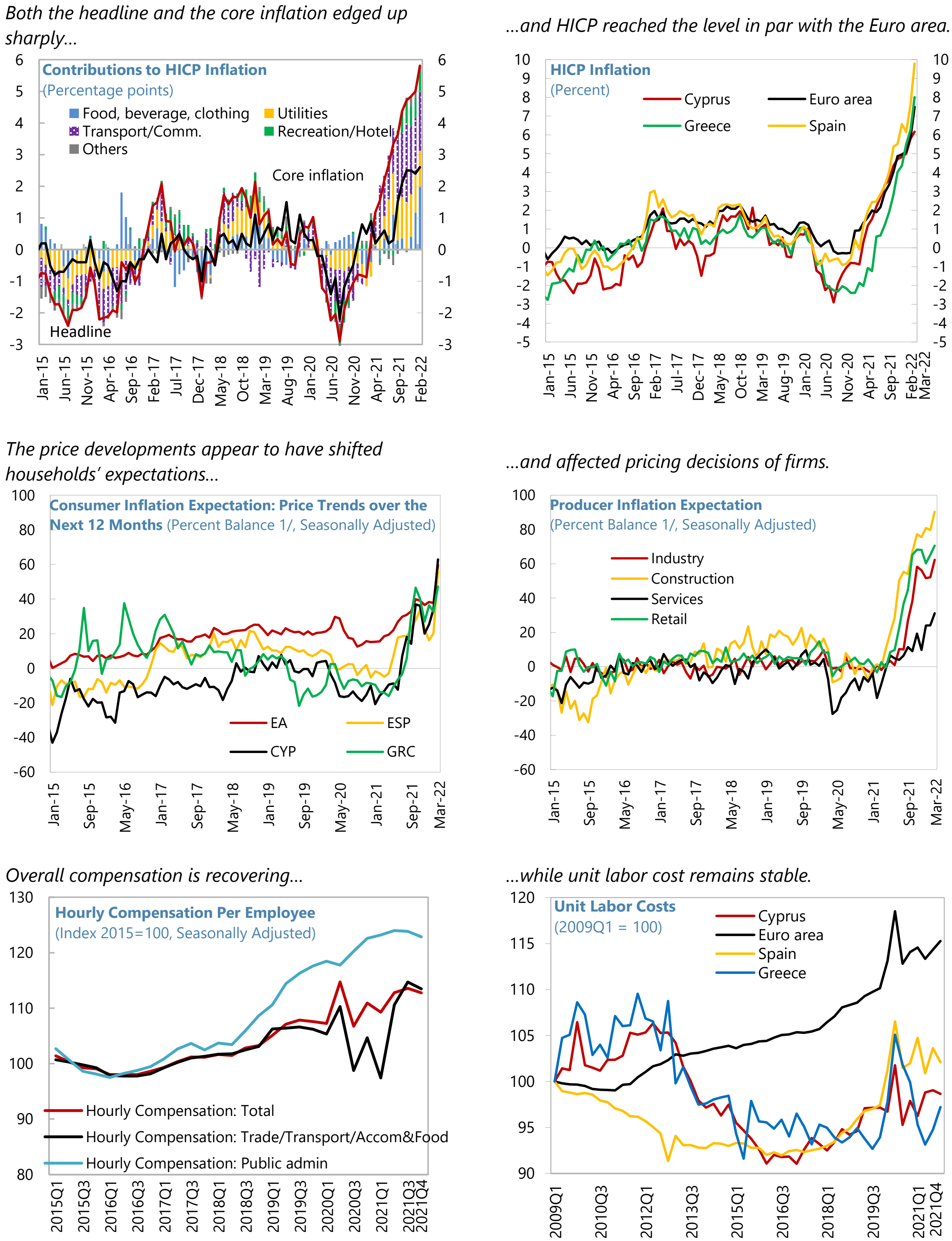
45. The planned Mortgage-to-Rent scheme to protect living conditions of vulnerable borrowers should be well-targeted. To avoid further weakening credit discipline, the scheme should be limited to the most vulnerable households strictly on a means-tested basis. Other safeguards should include making support timebound; a robust transfer pricing mechanism to minimize fiscal costs and risks; and a strong governance framework with emphasis on transparency and accountability.

46. Timely and effectively implementation of structural reforms in the RRP will address impediments to growth. The authorities have made progress in implementing the RRP, including passing the long-standing legislation on difficult civil service and local government reforms, and legislation to address corruption. Continued progress in strengthening the AML/CFT and governance frameworks is expected to help manage Cyprus's reputational risks, particularly in the current geopolitical context. Reforms in other areas, including judicial reforms (critical for the operation of the foreclosure framework) and other reforms to boost potential growth (in education and to address infrastructure and digital gaps) should be accelerated.

47. Achieving the national climate goals can help Cyprus transit to a more resilient and sustainable growth model. The war reinforces the importance of energy diversification and energy security for the economy. Achieving Cyprus's climate target could help diversify energy sources and reduce the high energy dependency. The authorities should continue efforts to address the challenges to implement their green agenda, including to the planned green tax reform. Additional measures, including feebates, could be considered at the sectoral level to enhance the emissions reduction.

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

Figure 2. Cyprus: Inflation and Wages

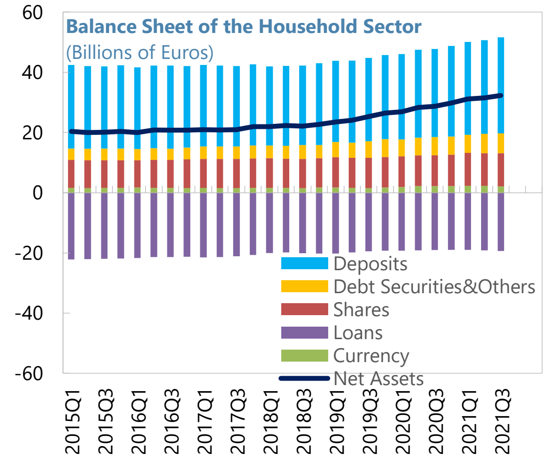


Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; and IMF staff calculations.

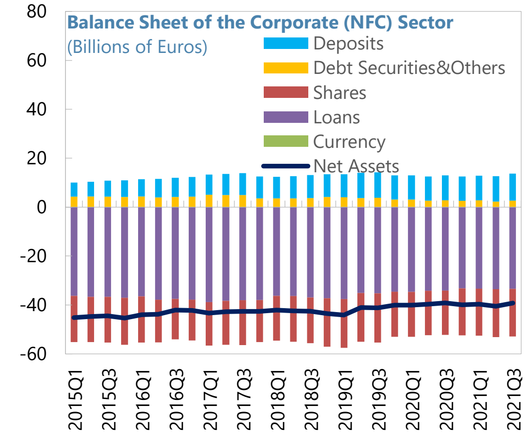
1/ Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Figure 3. Cyprus: Banking Sector and Balance Sheets

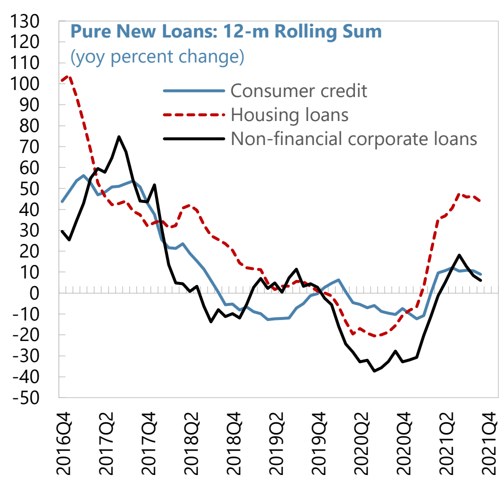
Deposits of household are steadily increasing...



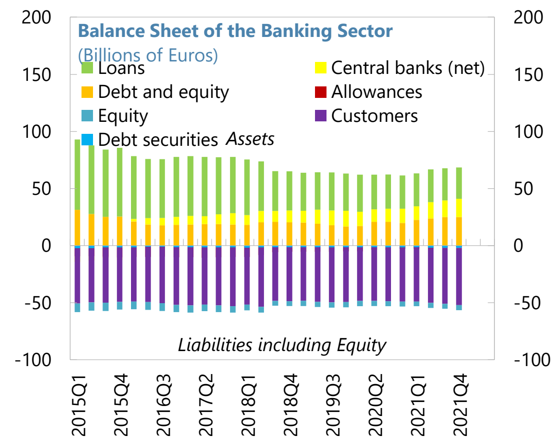
... while corporates' debt has declined.



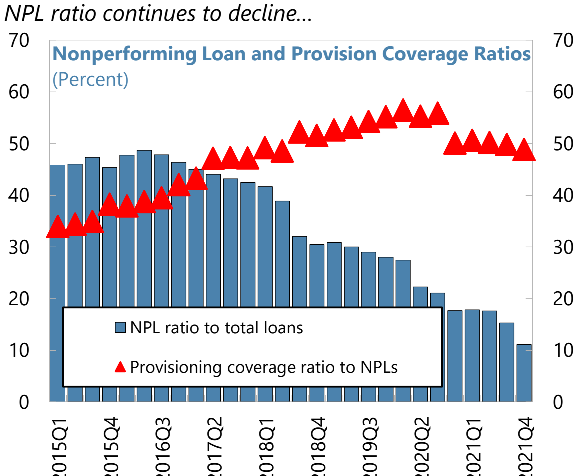
New credit has grown markedly.



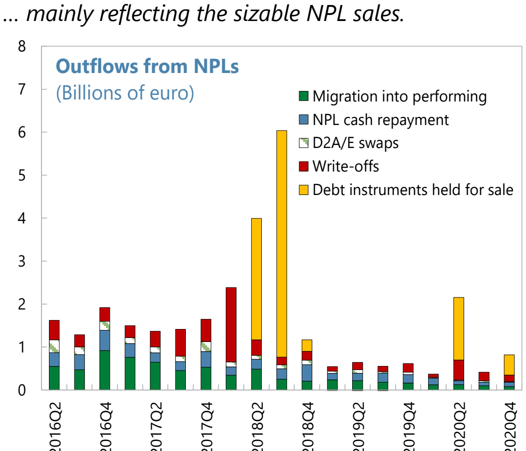
Banks have continued to dispose non-performing assets.



NPL ratio continues to decline...



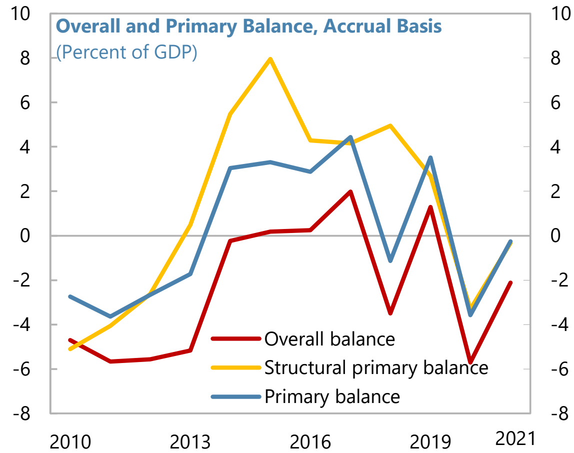
... mainly reflecting the sizable NPL sales.



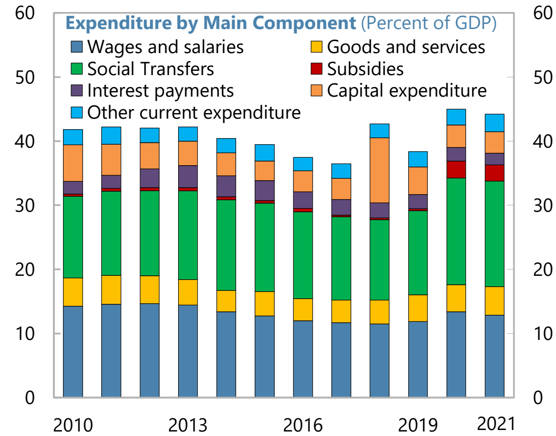
Sources: Central Bank of Cyprus; Cystat; Eurostat; Haver Analytics; and IMF staff calculations.

Figure 4. Cyprus: Fiscal Developments

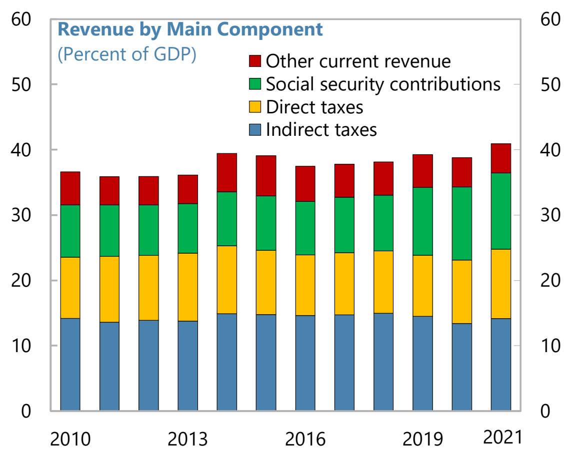
The fiscal balance only improved marginally in 2021…



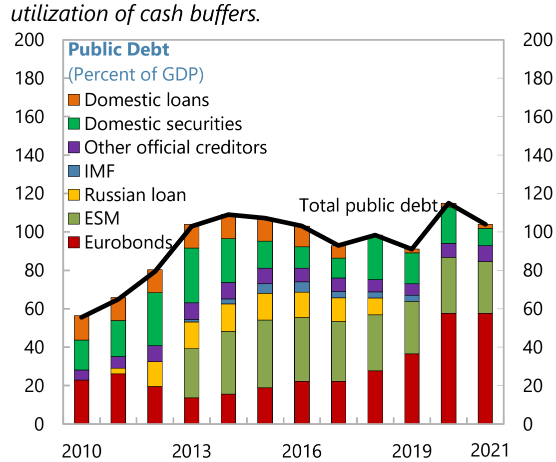
… as expenditure remained high due to Covid-related spending,…



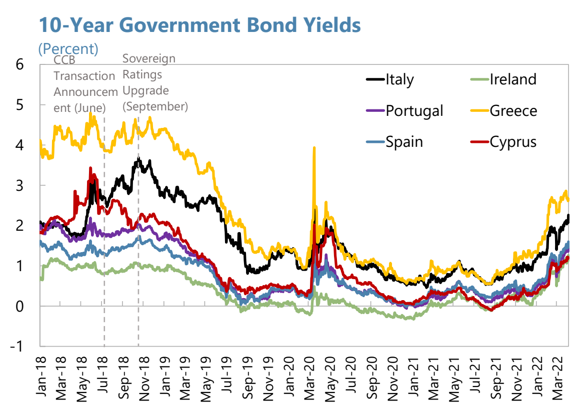
…while revenue is recovering.



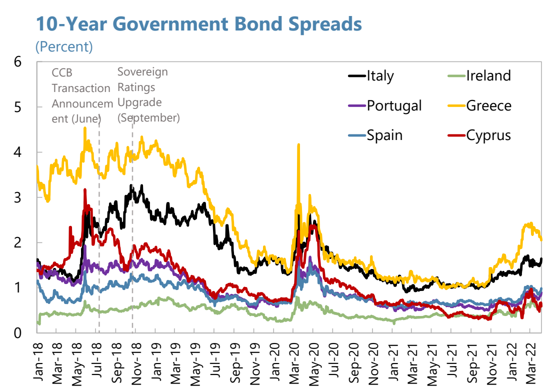
Public debt declined reflecting GDP growth and the utilization of cash buffers.



Bond yields have increased recently.



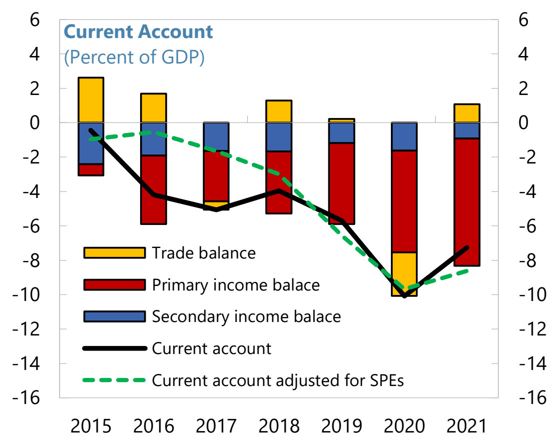
Spreads remain low compared with some peer countries.



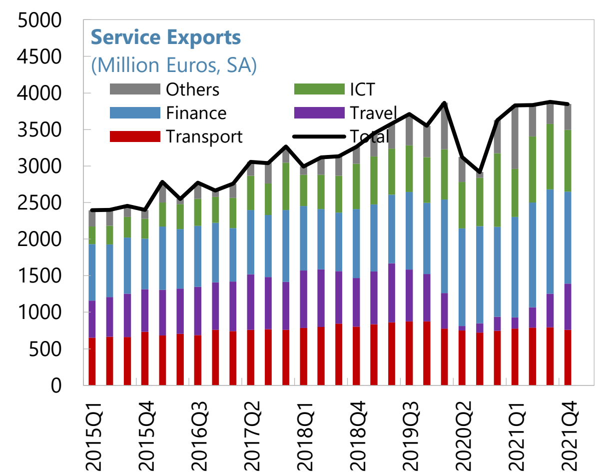
Sources: Bloomberg Finance LP; Ministry of Finance; and IMF staff estimates.

Figure 5. Cyprus: External Developments

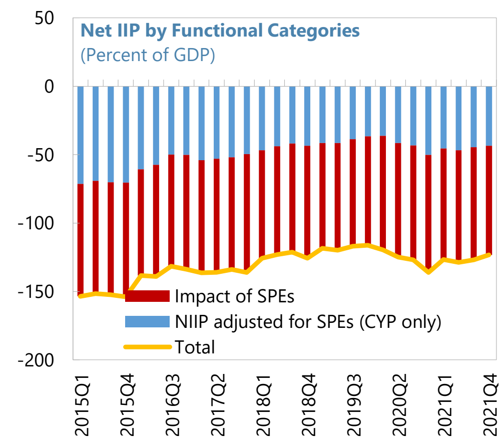
Current account deficit remains elevated…



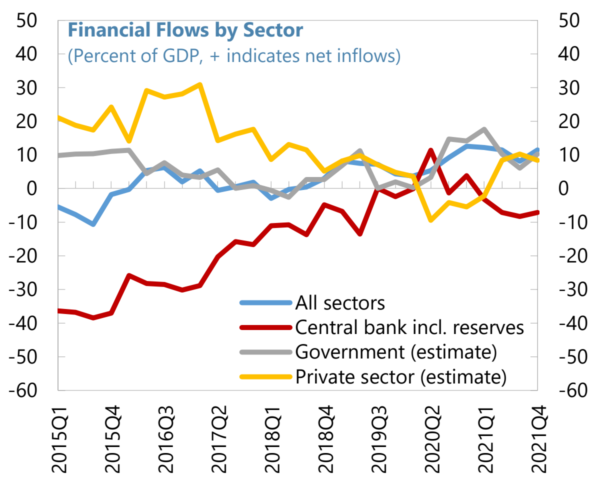
…even as service exports have recovered.



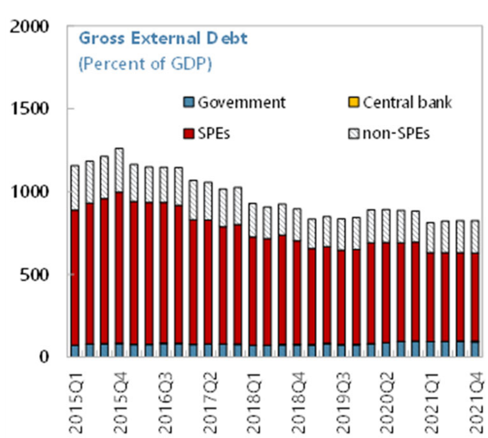
Net IIP remains highly negative…



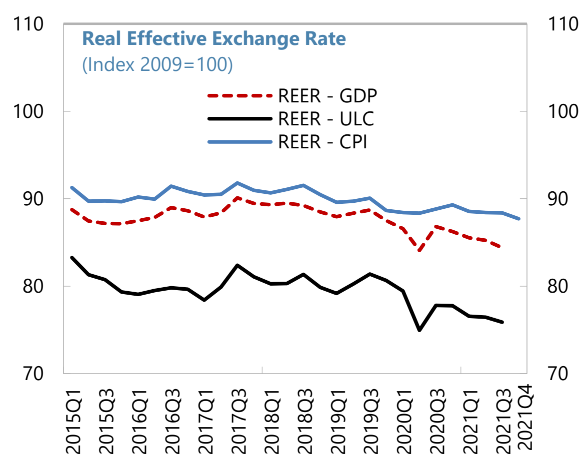
Net capital inflows to the private sector increased.



Gross external debt remains high.



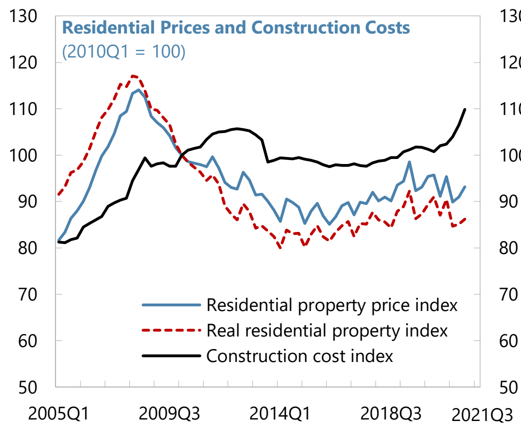
The real effective exchange rate has declined.



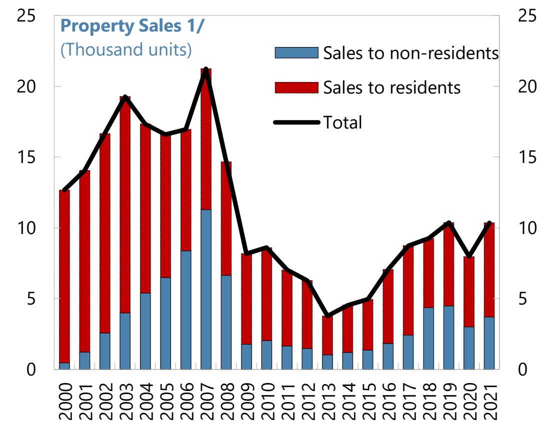
Sources: Eurostat, Cystat; IMF IFS; Haver Analytics; and IMF staff calculations.

Figure 6. Cyprus: Housing Market

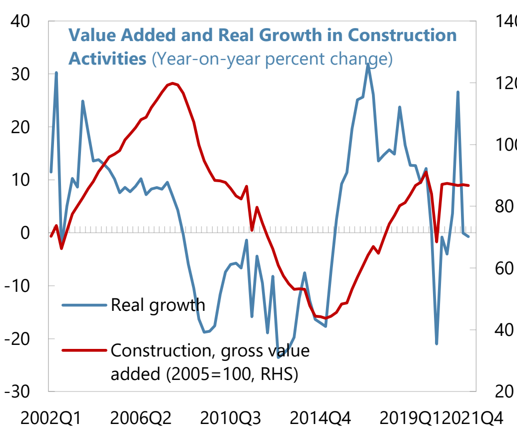
Transaction-based property prices are rising together with surging construction cost...



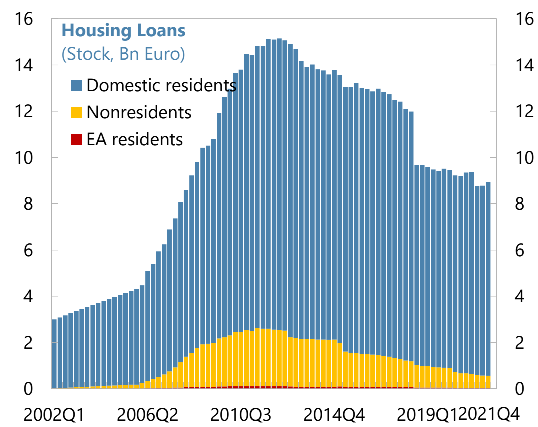
...and property sales staged a recovery.



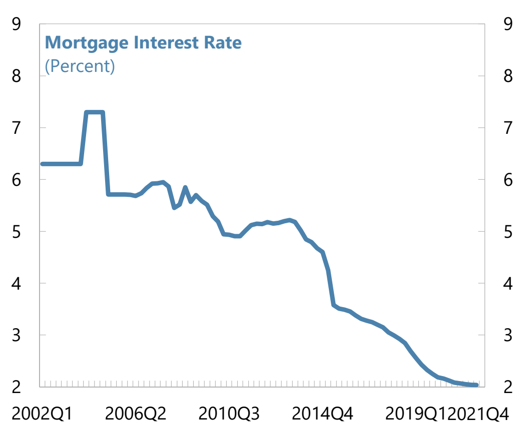
Growth in construction activities rebounded after an initial dip during the lockdown...



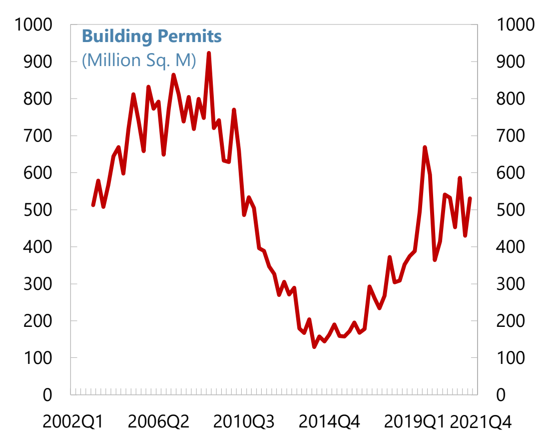
...while the stock of housing loans is gradually declining in line with the reduced external loans. Domestic loans are generally stable...



...as mortgage interest rates continued to decline.



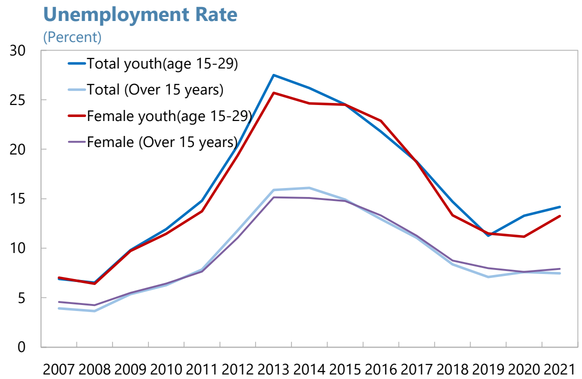
The issuance of building permits fluctuated after the rebound in the second half of 2020.



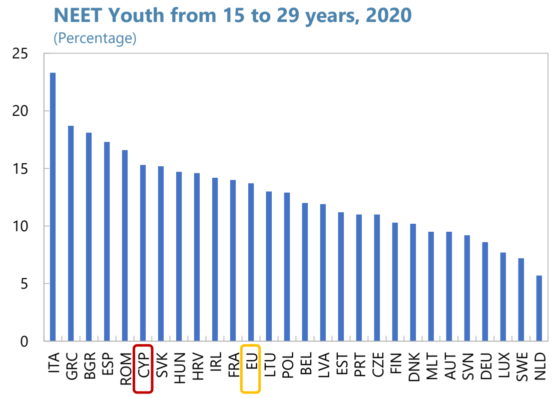
Sources: Central Bank of Cyprus; Eurostat; Haver Analytics; IFS; and IMF staff calculations.
1/ Post-2018 and pre-2018 data on sales to non-residents are not directly comparable as the methodology to compile data has changed.

Figure 7. Cyprus: Growth Inclusiveness Indicators

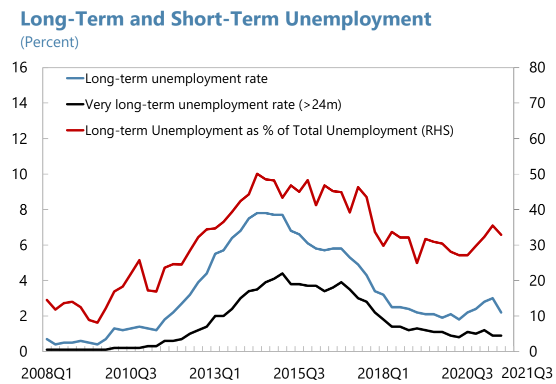
Youth unemployment rates were pushed up in 2020 and declined slower than overall in 2021…



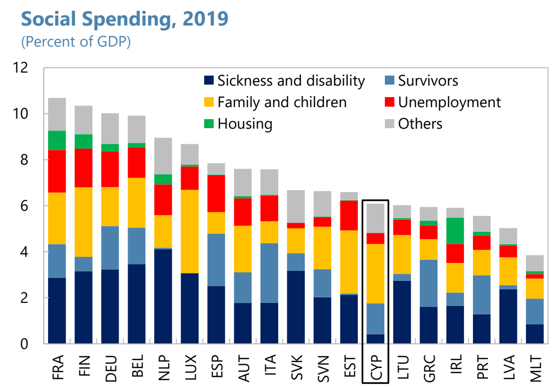
…and young population who are inactive are relatively large.



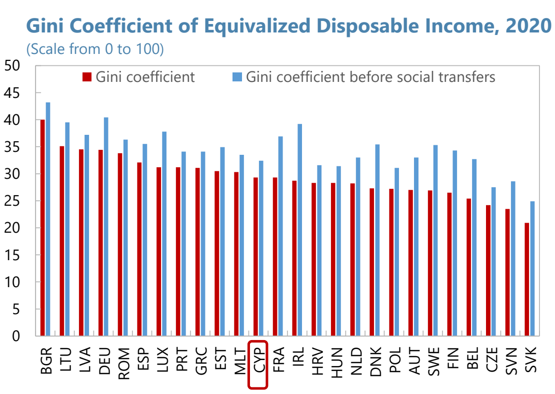
Long-term unemployment also declined slower than the overall unemployment rate.



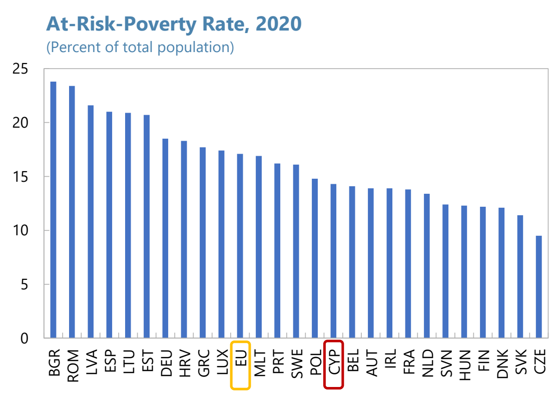
The social safety nets spending in Cyprus are relatively low…



…but Income equality is comparable to European peers…



…and the poverty level in Cyprus remains below the EU average.



Sources: Eurostat, Haver Analytics; and IMF staff calculations.

Table 1. Cyprus: Selected Economic Indicators, 2019–27

	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Projections			
Real Economy									
Real GDP	5.3	-5.0	5.5	2.0	3.5	3.0	2.7	2.8	2.9
Domestic demand	6.0	-2.9	2.7	2.6	3.0	3.0	2.8	3.1	3.4
Consumption	4.9	-0.7	4.9	2.0	2.6	2.6	2.7	3.0	3.2
Private consumption	3.0	-5.0	3.7	2.3	2.5	3.0	3.3	3.3	3.5
Public consumption	12.7	15.0	8.4	1.0	2.8	1.4	0.8	2.0	2.3
Gross capital formation 1/	10.6	-11.5	-6.6	5.8	5.1	5.0	3.5	3.7	4.4
Foreign balance 2/	-0.7	-1.9	2.7	-0.4	0.5	-0.1	-0.2	-0.3	-0.5
Exports of goods and services	7.5	-5.1	13.4	5.1	4.5	3.8	3.4	3.6	3.6
Imports of goods and services 1/	8.3	-2.5	9.5	5.5	3.9	3.9	3.6	3.9	4.2
Potential GDP growth	4.6	-1.3	4.3	2.5	3.1	2.8	2.5	2.9	3.0
Output gap (percent of potential GDP)	2.5	-1.3	-0.2	-0.6	-0.2	0.0	0.1	0.1	0.0
HICP (period average)	0.5	-1.1	2.3	5.3	2.3	2.0	1.8	1.8	1.9
HICP (end of period)	0.7	-0.8	4.8	3.0	2.5	2.0	1.8	1.8	2.0
GDP deflator	1.1	-1.1	2.4	3.8	3.3	3.0	2.6	2.6	2.7
Unemployment rate (percent, period average)	7.1	7.6	7.5	7.9	7.5	7.0	6.5	6.0	5.5
Employment growth (percent, period average)	3.9	0.2	3.4	0.0	1.5	1.5	1.4	1.4	1.3
Labor force	2.4	0.8	3.3	0.5	1.0	1.0	0.9	0.8	0.8
Public Finance									
General government balance	1.3	-5.7	-2.1	-1.3	-0.1	0.6	1.2	1.5	1.6
Revenue	39.7	39.3	42.1	41.0	41.2	41.1	40.8	40.1	39.8
Expenditure	38.4	45.0	44.2	42.3	41.3	40.5	39.5	38.6	38.2
Primary Fiscal Balance	3.5	-3.6	-0.3	0.5	1.4	1.9	2.5	2.4	2.5
General government debt	91.1	115.0	103.9	97.7	94.1	87.8	84.5	78.2	73.6
Balance of Payments									
Current account balance	-5.7	-10.1	-7.3	-8.2	-6.8	-5.7	-5.5	-5.2	-5.0
Trade Balance (goods and services)	0.2	-2.5	1.1	-1.1	0.3	1.2	1.8	2.1	2.3
Exports of goods and services	75.6	75.8	81.3	86.4	86.1	85.6	85.2	84.7	84.3
Imports of goods and services	75.4	78.3	80.2	87.6	85.8	84.4	83.4	82.6	82.0
Goods balance	-20.1	-19.2	-18.4	-20.4	-19.8	-19.2	-18.9	-18.7	-18.7
Services balance	20.3	16.7	19.5	19.3	20.1	20.4	20.6	20.8	21.1
Primary income, net	-4.7	-5.9	-7.4	-6.6	-6.6	-6.6	-6.4	-6.2	-6.1
Secondary income, net	-1.2	-1.6	-0.9	-0.5	-0.5	-0.3	-0.9	-1.1	-1.2
Capital account, net	0.1	0.1	0.8	0.2	0.4	0.3	0.3	0.3	0.1
Financial account, net	-4.4	-12.5	-4.8	-8.0	-6.4	-5.4	-5.2	-4.9	-4.9
Direct investment	0.4	-17.9	-9.5	-14.4	-13.7	-13.2	-12.8	-12.6	-12.4
Portfolio investment	7.6	-19.3	-2.8	-2.5	0.0	0.0	-1.9	2.2	1.9
Other investment and financial derivatives	-12.3	24.5	6.0	8.9	7.2	7.7	9.5	5.5	5.6
Reserves (+ accumulation)	0.0	0.2	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Program financing 3/	0.0	-3.3	0.0	0.0	0.0	0.0	-1.2	-3.2	-3.0
Errors and omissions	1.2	-2.5	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Saving-Investment Balance									
National saving	13.1	9.9	10.6	10.1	11.7	12.9	13.2	13.5	13.8
Government	5.6	-2.2	1.2	2.1	3.4	4.3	4.8	4.8	4.6
Non-government	7.5	12.1	9.4	8.0	8.3	8.6	8.3	8.8	9.2
Gross capital formation	18.8	19.9	17.9	18.4	18.5	18.6	18.6	18.7	18.8
Government	4.3	3.5	3.4	3.4	3.5	3.7	3.6	3.3	3.0
Private	14.5	16.5	14.5	14.9	14.9	14.9	15.1	15.4	15.8
Foreign saving	-5.7	-10.1	-7.3	-8.2	-6.8	-5.7	-5.5	-5.2	-5.0
Memorandum Item:									
Nominal GDP (billions of euros)	23.0	21.6	23.4	24.7	26.4	28.0	29.5	31.2	32.9
Structural primary balance	2.7	-3.3	-0.4	0.7	1.5	2.0	2.5	2.4	2.6
External debt	843.3	880.9	825.2	762.4	719.7	684.3	656.1	626.7	599.0
Net IIP	-116.1	-136.2	-123.3	-124.3	-122.8	-121.1	-120.2	-118.8	-117.3

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.

Table 2. Cyprus: Fiscal Developments and Projections, 2019–27[1]

(Percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
Revenue	39.7	39.3	42.1	41.0	41.2	41.1	40.8	40.1	39.8
Current revenue	39.3	38.8	40.9	40.5	40.8	40.7	40.4	39.7	39.4
Tax revenue	23.9	23.1	24.8	23.5	23.7	23.6	23.5	23.4	23.3
Indirect taxes	14.5	13.4	14.2	14.1	14.0	13.8	13.7	13.7	13.6
Direct taxes	9.4	9.7	10.6	9.4	9.6	9.7	9.7	9.7	9.7
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	10.3	11.2	11.7	11.8	11.7	11.5	11.3	11.2	11.1
Other current revenue	5.1	4.5	4.5	5.2	5.4	5.7	5.6	5.2	4.9
Capital revenue	0.4	0.5	1.1	0.5	0.4	0.4	0.4	0.4	0.4
Expenditure	38.4	45.0	44.2	42.3	41.3	40.5	39.5	38.6	38.2
Current expenditure	34.0	41.5	40.8	38.8	37.8	36.8	35.9	35.3	35.2
Wages and salaries	11.9	13.4	12.9	12.9	12.8	12.5	12.3	12.2	12.1
Goods and services	4.2	4.2	4.5	4.4	4.2	4.0	3.9	3.8	3.8
Social Transfers	13.1	16.6	16.4	16.5	16.1	15.7	15.4	15.4	15.4
Subsidies	0.3	2.7	2.5	0.4	0.4	0.4	0.3	0.3	0.2
Interest payments	2.2	2.1	1.9	1.8	1.5	1.4	1.2	1.0	0.9
Other current expenditure	2.4	2.5	2.7	2.9	2.8	2.8	2.8	2.7	2.7
Capital expenditure	4.3	3.5	3.4	3.4	3.5	3.7	3.6	3.3	3.0
Capital transfers, payable	1.8	0.7	0.7	0.3	0.3	0.4	0.4	0.4	0.3
Gross capital formation less NFA disposal	2.5	2.8	2.7	3.1	3.2	3.3	3.2	2.9	2.8
Overall balance	1.3	-5.7	-2.1	-1.3	-0.1	0.6	1.2	1.5	1.6
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	1.3	-5.7	-2.1	-1.3	-0.1	0.6	1.2	1.5	1.6
Net financial transactions	1.2	-5.9	-2.3	-1.3	-0.1	0.6	1.2	1.5	1.6
Net acquisition of financial assets	-0.4	14.1	-4.8	-1.6	2.5	-0.3	2.3	-0.4	1.2
Currency and deposits	-0.4	14.1	-4.8	-1.6	2.5	-0.3	2.3	-0.4	1.2
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	-1.7	20.0	-2.4	-0.4	2.7	-0.9	1.1	-1.9	-0.4
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	6.8	22.0	-4.2	-1.1	2.3	-1.3	2.5	1.9	2.4
Loans	-8.5	-2.0	1.8	0.7	0.4	0.4	-1.4	-3.8	-2.8
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Output Gap	2.5	-1.3	-0.2	-0.6	-0.2	0.0	0.1	0.1	0.0
Primary balance	3.5	-3.6	-0.3	0.5	1.4	1.9	2.5	2.4	2.5
Structural overall balance	0.5	-5.5	-2.2	-1.1	-0.1	0.6	1.2	1.5	1.6
Structural primary balance	2.7	-3.3	-0.4	0.7	1.5	2.0	2.5	2.4	2.6
Public debt	91.1	115.0	103.9	97.7	94.1	87.8	84.5	78.2	73.6
Public debt net of cash holding	87.0	98.2	92.1	88.2	82.7	77.4	72.2	66.9	61.8

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

Table 3. Cyprus: General Government Financing Requirements and Sources, 2019–27

(Millions of Euros, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
Gross borrowing needs	3,034	3,677	2,919	2,782	1,727	2,491	1,702	2,479	2,359
Overall deficit	-287	1,270	543	321	37	-168	-366	-461	-517
Primary surplus	-809	774	62	-129	-362	-546	-731	-759	-829
Interest payments	523	496	480	450	399	379	365	298	312
Amortization	3,288	2,407	2,377	2,461	1,690	2,659	2,068	2,940	2,876
Medium- and long-term	3,288	1,403	901	2,161	1,390	2,359	1,418	1,640	1,576
Foreign	2,158	541	90	1,095	1,097	1,947	1,247	1,093	1,329
Eurobonds	199	458	0	1,000	1,000	1,850	1,000	1,000	1,250
Russia	1,875	0	0	0	0	0	0	0	0
Other	84	83	90	95	97	97	247	93	79
Domestic	1,131	862	811	1,066	293	412	172	547	247
Short-term	0	300	1,475	300	300	300	300	300	300
EU and IMF	0	705	0	0	0	0	350	1,000	1,000
Stock-flow adjustment 1/	33	0	0	0	0	0	0	0	0
Gross financing sources	2,466	4,057	2,657	2,782	1,727	2,491	1,702	2,482	2,364
Privatization receipts	0	0	0	0	0	0	0	1	2
Market access	2,900	6,725	1,803	2,374	2,395	2,400	2,396	2,353	2,750
Medium- and long-term	2,600	5,250	1,503	2,074	2,095	2,100	2,096	2,053	2,450
Foreign	2,600	4,850	1,503	1,974	1,995	2,000	1,996	1,953	2,350
Domestic	0	400	0	100	100	100	100	100	100
Short-term	300	1,475	300	300	300	300	300	300	300
EU and IMF	0	0	0	0	0	0	0	0	0
Use of deposits 2/	-434	-2,669	854	408	-668	91	-694	129	-386
Net placement	-388	4,318	-574	-87	705	-259	328	-587	-126
Medium and Long Term Debt	-688	3,847	602	-87	705	-259	678	413	874
Domestic Securities	-1,131	-462	-811	-966	-193	-312	-72	-197	-147
Eurobonds	2,401	4,042	1,000	700	800	-50	800	800	950
Domestic Loans	0	0	0	0	0	0	0	-250	0
Foreign Loans	-1,959	267	413	179	98	103	-51	60	71
Short term (Net increase)	300	1,175	-1,175	0	0	0	0	0	0
EU and IMF	0	-705	0	0	0	0	-350	-1,000	-1,000
Memorandum item:									
Cash holding (eop)	947	3,616	2,762	2,354	3,022	2,931	3,625	3,496	3,882
General government debt (eop)	20,958	24,852	24,271	24,184	24,889	24,630	24,958	24,371	24,245
General government debt (eop, percent of GDP)	91.1	115.0	103.9	97.7	94.1	87.8	84.5	78.2	73.6
General government net debt (eop, percent of GDP) 3/	87.0	98.2	92.1	88.2	82.7	77.4	72.2	66.9	61.8

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 4: Cyprus: Balance of Payments, 2019–27

(Percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
Current Account Balance	-5.7	-10.1	-7.3	-8.2	-6.8	-5.7	-5.5	-5.2	-5.0
Trade Balance (Goods and Services)	0.2	-2.5	1.1	-1.1	0.3	1.2	1.8	2.1	2.3
Goods Balance	-20.1	-19.2	-18.4	-20.4	-19.8	-19.2	-18.9	-18.7	-18.7
Exports	13.4	13.7	15.4	18.5	17.9	17.4	16.9	16.4	15.9
Imports	33.5	32.9	33.7	38.9	37.7	36.6	35.8	35.1	34.6
Services Balance	20.3	16.7	19.5	19.3	20.1	20.4	20.6	20.8	21.1
Exports	62.2	62.1	65.9	68.0	68.2	68.3	68.2	68.3	68.4
Imports	41.9	45.4	46.5	48.7	48.2	47.8	47.6	47.5	47.4
Primary Income	-4.71	-5.93	-7.42	-6.6	-6.6	-6.6	-6.4	-6.2	-6.1
Secondary Income	-1.19	-1.62	-0.91	-0.5	-0.5	-0.3	-0.9	-1.1	-1.2
Capital Account	0.1	0.1	0.8	0.2	0.4	0.3	0.3	0.3	0.1
Financial Account (- financing)	-4.4	-12.5	-4.8	-8.0	-6.4	-5.4	-5.2	-4.9	-4.9
Direct Investment	0.4	-17.9	-9.5	-14.4	-13.7	-13.2	-12.8	-12.6	-12.4
Portfolio Investment	7.6	-19.3	-2.8	-2.5	0.0	0.0	-1.9	2.2	1.9
Financial Derivatives	0.1	-1.6	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Other Investment	-12.4	26.1	5.7	8.7	7.0	7.5	9.3	5.3	5.4
Reserves (+ accumulation)	0.0	0.2	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omission	1.2	-2.5	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current Account Balance, adjusted for SPEs 1/	-5.8	-9.7	-8.6	...	...	...	...	...	...
Program Financing 2/	0.0	-3.3	0.0	0.0	0.0	0.0	-1.2	-3.2	-3.0
Private Net Capital Flows 3/	-4.7	5.4	...	...	...	...	...	...	...
o/w Portfolio Investment	19.5	0.8	...	...	...	...	...	...	...
o/w Other Investment	-24.6	24.1	...	...	...	...	...	...	...
o/w MFIs	9.9	4.1	...	...	...	...	...	...	...
o/w Non-MFIs	-34.5	20.0	...	...	...	...	...	...	...
Gross External Debt	843.3	880.9	825.2	762.4	719.7	684.3	656.1	626.7	599.0
o/w Short-term Debt	187.4	177.2	170.1	157.7	143.5	133.5	125.1	117.2	109.8

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 5. Cyprus: External Financing Requirements and Sources, 2019–27

(Millions of Euros)

	2019	2020	2021	2022	2023	2024	2025	2026	2027
				Projections					
GROSS FINANCING REQUIREMENTS	**48,415**	**54,319**	**46,847**	**53,480**	**51,984**	**51,516**	**50,619**	**50,575**	**50,387**
Current account deficit ("-" = CA surplus)	1,308	2,177	1,696	2,035	1,792	1,602	1,624	1,611	1,661
Medium- and long-term debt amortization	12,392	8,319	6,834	11,239	11,179	11,969	11,220	11,008	11,186
Public sector	2,158	541	90	1,095	1,097	1,947	1,247	1,093	1,329
Banks	424	341	233	279	278	277	278	279	279
Other private	9,810	7,437	6,511	9,865	9,805	9,745	9,696	9,636	9,577
Short-term debt amortization	34,714	43,118	38,317	40,206	39,013	37,945	37,424	36,956	36,541
Public sector	398	399	78	683	683	683	683	683	683
Central Bank	381	399	69	683	683	683	683	683	683
General government and SOEs	16	0	9	0	0	0	0	0	0
Banks	13,407	10,641	9,567	10,582	10,404	10,315	10,739	11,183	11,648
Other private	20,910	32,078	28,672	28,941	27,926	26,947	26,002	25,090	24,210
EU and IMF	0	705	0	0	0	0	350	1,000	1,000
SOURCES OF FINANCING	**48,415**	**54,319**	**46,847**	**53,480**	**51,984**	**51,516**	**50,619**	**50,575**	**50,387**
Capital account (net)	24	17	176	46	96	96	81	85	46
Foreign direct investment (net)	-82	3,864	2,226	3,574	3,621	3,690	3,791	3,920	4,094
Cypriot investment abroad	37,438	-3,996	-2,596	6,972	7,425	7,827	8,204	8,613	9,055
Foreign investment in Cyprus	37,357	-132	-191	10,546	11,047	11,517	11,996	12,533	13,149
New borrowing and debt rollover	49,074	50,559	48,530	50,828	49,732	49,242	48,638	48,540	48,882
Medium and long-term borrowing	5,956	12,242	8,324	11,815	11,787	11,818	11,682	11,584	11,925
General government	2,600	4,850	1,503	1,974	1,995	2,000	1,996	1,953	2,350
Banks	346	-72	551	271	272	283	283	284	285
Other private	3,010	7,464	6,270	9,570	9,519	9,535	9,403	9,346	9,290
Short-term borrowing	43,118	38,317	40,206	39,013	37,945	37,424	36,956	36,956	36,956
Public sector	399	78	683	683	683	683	683	683	683
Central Bank	399	69	683	683	683	683	683	683	683
General government and SOEs	0	9	0	0	0	0	0	0	0
Banks	10,641	9,567	10,582	10,404	10,315	10,739	11,183	11,183	11,183
Other private	32,078	28,672	28,941	27,926	26,947	26,002	25,090	25,090	25,090
Other	-602	-122	-4,085	-968	-1,465	-1,512	-1,892	-1,970	-2,634
Of which: Net errors and omissions	279	-546	404	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	120%	899%	1523%	180%	182%	103%	160%	179%	177%
Central bank	105%	17%	989%	100%	100%	100%	100%	100%	100%
Private	103%	90%	103%	97%	97%	98%	98%	99%	100%
Banks	79%	86%	114%	98%	99%	104%	104%	100%	96%
Non-financial corporates	114%	91%	100%	97%	97%	97%	97%	99%	102%

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

Table 6. Cyprus: Financial Soundness Indicators, 2013–21[1]

(Percent, unless otherwise specified)

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Capital Adequacy									
Total capital ratio	13.5	15.3	16.6	16.8	16.3	17.5	19.9	20.4	20.3
Tier I capital ratio	12.3	14.6	16.0	16.4	15.4	16.5	19.0	19.3	18.9
Asset Quality									
Non-performing loans (NPLs) to total gross loans 2/	44.4	47.5	45.3	46.4	42.5	30.5	28.0	17.7	11.1
Non-performing loans (NPLs) to total gross loans (local operations) 3/	44.4	47.8	45.8	47.2	43.7	30.3	27.9	17.7	11.1
Provisions to NPLs	...	33.9	38.3	42.1	47.2	51.6	55.2	50.1	48.8
Restructured loans classified as NPLs to total NPLs	28.0	33.9	40.1	40.8	40.9	44.8	44.6	43.7	49.1
Earnings and Profitability									
Return on assets 4/	-4.3	-0.6	-0.6	-0.3	-1.1	0.2	0.3	-0.3	0.0
Return on equity 4/	-69.5	-8.1	-7.4	1.7	-11.2	6.4	3.4	-3.9	1.6
Net interest income to gross income ratio	86.2	78.4	81.2	75.3	70.7	67.1	68.5	67.6	73.2
Net fees and commissions income to gross income ratio	13.4	11.6	13.8	14.6	16.4	19.6	20.5	19.7	25.1
Net interest margin	2.4	2.9	2.8	2.6	2.3	1.8	1.9	1.8	1.5
Liquidity									
Cash, trading and available-for-sale assets to total assets ratio	7.0	14.4	19.8	22.9	27.9	27.6	29.3	28.8	37.2
Others									
Total loans and advances to total assets ratio	83.6	73.4	73.6	69.1	64.1	54.6	53.8	51.0	44.3
Total deposits (other than from credit institutions) to total assets ratio	63.8	63.0	65.1	74.9	75.6	79.2	82.8	80.7	74.7

Sources: Central Bank of Cyprus.

1/ Unless otherwise specified, these FSIs cover consolidated accounts of domestic and foreign banks operating in Cyprus up to 2021Q3. The data on asset quality ratios is up to 2021Q4.

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. In order to deflect pressures for the weakening of the framework, a subsidized MtR scheme is planned to resolve NPLs backed by primary residences and business premises of vulnerable borrowers. The key terms of the plan are yet to be decided. CAMC has yet to become fully operational.
Mitigate Crisis Impact and Maintain Debt Sustainability	
Fighting the health crisis and contain the adverse economic impact of the crisis and recalibrating fiscal support measures.	The authorities took measures to mitigate the economic impact of the pandemic. Most measures have been withdrawal given the improvement of the pandemic.
Control the growth of the public sector wage bill.	The authorities have contained the public wage bill within the nominal GDP growth. A more durable mechanism to keep the public-sector wage bill in check has not been adopted by Parliament.
Reorient to more growth-friendly and inclusive spending and enhance fiscal transparency and accountability.	The implementation of the Recovery and Resilience Plan is underway. Legislative reform of SOEs, however, has stalled.
Containing the fiscal risks from the National Health System (NHS).	The authorities are implementing cost control measures for the NHS. Reforms are ongoing to make the public health sector more competitive.
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. The legislations on civil services and local government reforms have been passed.
Continue to improve the AML/CFT framework, including by ensuring effectively mitigating inherent AML/CFT risks.	The CIP scheme has been terminated from end-Nov 2020. Cyprus continues to make progress in strengthening AML/CFT regulation and conducting on-site and off-site supervision. In December 2021, Cyprus published an assessment of money laundering and terrorist financing risks presented by virtual assets and the related services providers.

Annex II. Fiscal and Financial Sector Policy Measures During the Pandemic

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 December
Subsidized sick leave for individuals in quarantine and vulnerable workers	0.1	March to December
Overseas student allowance covering the costs of students staying overseas	0.1	March to December
Repatriation Scheme covering cost of the accommodation of quarantine	0.05	March to December
Schemes to support the self-employed and unemployed workers	0.2	March to December
Support for Firms		
Subsidy scheme for very small and self-employed enterprises	0.5	April to July
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	0.01	
Other Measures		
Suspending the increased NHS contributions for three months	0.2	April to June
Total:	3.5	

Measures	2021	Duration
	% of GDP	
Health Sector Support		
Budget allocation to the health care sector to combat the pandemic	0.4	
Support for Employment		
Wage compensation to the employees of businesses that are suspended	1.2	January to December
Support for Households		
Interest subsidy scheme for housing loans to encourage home ownership	0.01	For loans contracted till December
Unemployment benefit	0.1	
Support for Firms		
One-off grants to cover operating expenses of companies and self-employed	1.0	One-off grant
Interest subsidy scheme for New Business Loans	0.0	For loans contracted till December
Other Measures		
Subsidies not subject to contributions (indirect estimated cost)	0.3	
Total:	3.0	

Sources: MoF and staff estimates.

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).	2020-2021
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.	2021
2. **New business loans:** for all businesses facing pandemic related difficulties.	up to December 31, 2021
3. **New mortgages:** to support households for new home ownership.	up to Dec. 31, 2021
Forbearance: Nine-Month Loan Moratorium	April 2020 - June 2021
1. **Public Covid-19 moratorium** available to all customers with arrears of less than 30 days.	
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.	
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	2020-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-mid 2021
1. The 2020 stress tests was postponed and took place in 2021.	
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.

Annex III. External Sector Assessment

Overall Assessment: On a preliminary basis adjusted for the impact of Covid-related factors (tourism and remittances), the external position of Cyprus in 2021 was moderately weaker than the level implied by fundamentals and desirable policies. The current account (CA) deficit improved in 2021 due to recovery of services exports, which was partially offset by deteriorating terms of trade and continued decline in primary income. Over the medium term, the current account deficit is set to continue recovering and gradually narrow while the NIIP is projected to gradually decline over the medium term. **Potential Policy Responses:** Gradual fiscal adjustment and continued efforts to deleverage would be essential for external rebalancing by raising the current account and lowering net IIP liabilities. Structural reforms to raise productivity and enhance competitiveness will help to improve the external position. The Recovery and Resilience Plan both at the national and EU-levels will support these efforts.
Foreign Assets and Liabilities: Position and Trajectory
Background. The net international investment position (NIIP), which averaged about –146 percent during 2014–17, improved to –116 percent of GDP in 2019, before deteriorating to -136 percent in 2020. In 2021, the NIIP increased to –123 percent of GDP, largely due to the increases in direct investment and financial derivatives, offset by the improvements in portfolio and other investment. Excluding the contribution of SPEs' foreign financial positions, the underlying NIIP improved from -78 percent of GDP in 2014 to -37 percent of GDP in 2019, decreased to -50.1 percent in 2020Q4 and improved slightly to -43.5 percent in 2021Q4. The NIIP is dominated by the private sector, which stood at -113 ½ percent of GDP (-41 excluding SPEs) in 2019 and -115 percent of GDP (-35 excluding SPEs) in 2021Q4. Gross liabilities declined to 2371 percent of GDP in 2019, with around one third in the form of external debt. Under the IMF staff's baseline scenario, the NIIP is projected to gradually decline through the medium term, on the back of improved CA balances. **Assessment.** External vulnerabilities increased with a deterioration in the NIIP since before the pandemic in 2020. The significant size of NIIP reflects Cyprus's role as a financial center and the effects of SPEs, and the NIIP remains broadly sustainable when excluding SPEs. Projected improvements in CA deficits suggest that the NIIP-to-GDP ratio will improve at a moderate pace in the medium term.
Current Account
Background. The overall current account deficit widened substantially in 2020 mainly due to collapsed services exports in the wake of the pandemic and larger deficit in primary income. The overall current account deficit improved in 2021, with a higher services balance offset by the negative terms of trade shock and a further decline in primary income. **Assessment.** The EBA model estimates a CA norm at -4.0 percent of GDP, against a CA of -4.3 percent of GDP adjusted for cyclical contributions, SPE effects, and additional temporary factors to account for the impact of the pandemic on tourism and remittances. Policy gaps—reflecting deviations of current policy settings in Cyprus and the rest of the world (ROW) from their desired settings—contribute 5.6 percentage points. Based on the CA model, IMF staff

assesses the CA gap to be -0.3 percent for 2021, which corresponds to an assessment that the external position was slightly weaker than the level warranted by fundamentals and desirable policy settings in 2021.

Cyprus: Results from EBA-Lite Model for 2021 (in percent of GDP)

	CA model	REER model	ES model
CA-Actual	**-7.3**		
Cyclical contributions (from model) (-)	0.0		
COVID-19 adjustor (+) 1/	1.6		
Additional temporary/statistical factors (+)	1.3		
Natural disasters and conflicts (-)	-0.1		
Adjusted CA	**-4.3**		
CA Norm (from model) 2/	**-4.0**		
Adjustments to the norm (+)	0.0		
Adjusted CA Norm	**-4.0**		
CA Gap	**-0.3**	**0.0**	**0.1**
o/w Relative policy gap	5.6		
Elasticity	-0.53		
REER Gap (in percent)	**0.7**	**0.0**	**-0.2**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (4 percent of GDP), and on remittances (-0.02 percent of GDP)
2/ Cyclically adjusted, including multilateral consistency adjustments.

2021 (% GDP)	Actual CA: -7.3	Cycl. Adj. CA: -7.3	EBA-lite CA Norm: -4.0	Staff Adj. CA: -4.3	Staff CA Gap: -0.3

Real Exchange Rate

Background. In 2020, the CPI-based REER and the ULC-based REER depreciated from their average 2019 levels by 0.8 and 3.6 percent, respectively. In 2021, the CPI-based REER depreciated further by 0.5 percent relative to their 2020 averages.

Assessment. The EBA-lite REER model estimates an undervaluation of 0 percent in 2021. The REER gap derived from the IMF staff's CA gap assessment, with an estimated elasticity of -0.53, implies that the real exchange rate was overvalued by 1.3 percent in 2021. 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 of the REER gap in 2021 are in the range of -0.2 to 1.3.

Capital and Financial Accounts: Flows and Policy Measures

Background. Mirroring the narrowing current account deficits in 2021, capital inflows declined to 4.8 percent of GDP, mainly reflecting higher portfolio outflows (debt repayment) while net FDI inflows other investment outflows both increased. A sharp turnaround in net private inflows from 0.3 percent of GDP in 2020 to -12.8 percent of GDP in 2021 was only partially offset by a decline in

public inflows of 2.8 percent of GDP in 2020 (vs 19.8 percent of GDP in 2020). Net public outflows from the central bank were -3.8 percent in 2020, declining from 12.4 percent in 2017, with TARGET2 balance increasing to 38 percent of GDP. **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.
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 IV. 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 from 2021 after a sharp increase in 2020 due to the Covid pandemic. Risks have receded over the past year, reflecting strong growth recovery in 2021 and better medium-term outlook. Low financing costs will provide considerable cushion for some time. Debt is sustainable with high risks from large contingent liabilities and especially when combined with macro-fiscal shocks. Moreover, the debt trajectory is also susceptible to the risks of lower growth and weaker-than-envisaged fiscal adjustment due to increased geopolitical tensions, flow reversals and rollover difficulties due to global financial tightening, and contingent liabilities stemming from weaknesses in bank balance sheets.

A. Baseline Scenario

1. Public debt to GDP ratio declined in 2021, mainly reflecting the strong output growth and a less cash buffer.[1] While the fiscal deficit remained high in 2021 due to the continued sizable fiscal response to the pandemic, the government managed to utilize its cash buffer to cover the financing needs. The real GDP growth rate reached 5.5 percent. As a result, the debt-to-GDP ratio declined by 11 percentage points to 104 percent at end-2021.

2. Public debt is projected to resume a steady decline. Projected improvements in primary balances and a negative interest-economic growth differential going forward will support a durable decline in public debt to below 75 percent of GDP by 2027.

3. The gross public financing needs (GPFN) are expected to remain below the benchmark. The gross financing needs of the government declined to 12 percent of GDP in 2021 from 17 percent of GDP in 2020 and will remain well below the benchmark for advanced economies (20 percent of GDP) over the projection horizon. 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.

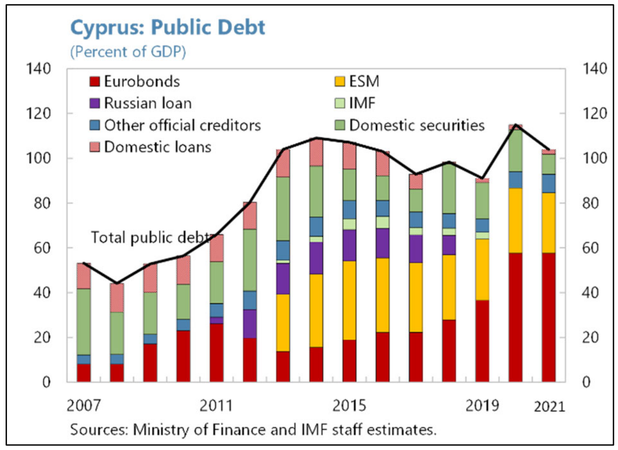
B. Risk Assessment

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.[2] 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).

[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] The fiscal cost is estimated at around €160 million (0.7 percent of GDP).

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 below the benchmark level for advanced economies (85 percent of GDP) in 2025. If adverse shocks to growth and the primary balance are more likely than favorable ones, public debt to GDP could remain above 85 percent in 2027 with a probability of 50 percent (fan chart in Annex Figure 1).[3]



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 2021 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 90 percent of public debt is owed to non-residents. However, about 35 percent of this debt reflects official financing from the ESM, and loans from the European Investment Bank and the Council of Europe Development Bank. 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.[4] While the market interest rates are projected to rise from the current low levels, the effective interest rates are expected to continue to decline in the next few years with the repayment and rollover of the high interest existing debt.

- 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

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

[4] As end-2021, the weighted average maturity of total debt is 7.6 years. The shares of debt that falls due within 1 year and 5 years are 9.3 percent and 42.5 percent, respectively.

63 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 (5.1 percentage points) decrease in growth during 2023–24, accompanied by (i) a 65 and 133 basis points (bps) rise in interest rates in 2023 and 2024 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 reduction in GDP growth, would raise public debt by 20 percentage points relative the baseline to 108 percent of GDP by 2024, before declining to 93 percent of GDP by 2027.

- **Primary balance shock and real interest rate shock.** A decrease in the primary surplus by 1.5 percent of GDP during 2023–24, accompanied by 37 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 648 bps during 2023–27 would raise public debt marginally to 76 percent and 78 percent of GDP by 2027, respectively.

- **Combined macro-fiscal shocks.** Combining the growth and interest rate and primary balance shocks discussed above would cause public debt to peak at 111 percent of GDP in 2024 before declining to 102 percent of GDP by 2027. Gross financing needs would peak at 18 of GDP in 2024 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 177 basis points in 2023 and 37 basis points thereafter. Under this scenario, public debt would rise to 101 percent of GDP in 2023 and thereafter decline to 86 percent in 2027. Gross financing needs would spike to 14 percent of GDP in 2023 before declining to 10 percent in 2027.

11. Under an alternative adverse scenario of lower economic growth and primary fiscal balances combined with shocks from the banking sector, which include a further realization of contingent liabilities from the banking sector and estimated cost of KEDIPES expansion (adverse macro-fiscal-banking 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. The estimated cost of the planned expansion of KEDIPES in included for 2023 (3.4 percent of 2023 GDP, see discussions in the main text). Further realization of contingent liabilities from the banking sector (4.3 percent of GDP) in 2023, on top of the support already provided to the CCB, is also assumed.[5] Under this adverse scenario, public debt would rise to 106 percent of GDP in 2023 and would decline only slowly to 104 percent of GDP in 2027. Gross financing needs would also spike to 16 percent of GDP in 2023 before declining to 12 percent of GDP over the medium term.

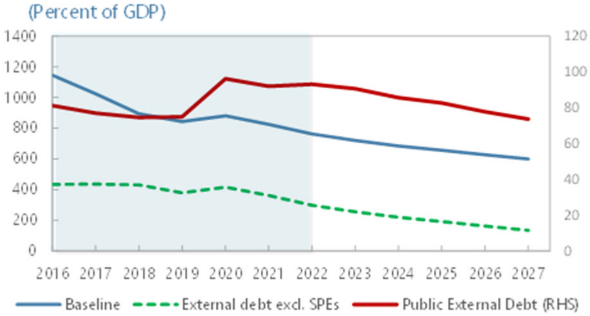
E. External Debt Sustainability Analysis

12. 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.

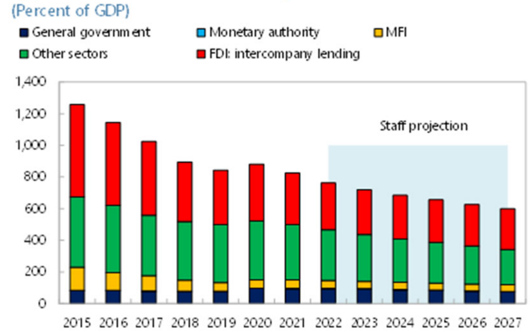
13. Under the baseline scenario, the external debt-to-GDP ratio is projected to decline in 2021, partially reversing the increase in 2020, before declining further in the medium-term. In 2021, Cyprus's external debt declined to 825 percent of GDP, thanks to the continued recovery after

[5] 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 (excluding the NPLs covered by KEDIPES expansion); and (iii) 15 percent default rate for loans covered by the national guaranteed scheme, under which the government covers 70 percent of loss.

crisis. The high external debt level reflects its role as a financial center and the presence of SPEs. In 2021, the government external debt was generally stable at 92 percent of GDP in 2021, and net debt is estimated to decline to 253 percent of GDP for the economy and -15 after excluding SPEs. In 2022, gross external debt is projected to decline to 762 percent of GDP, mainly reflecting declining rollover needs as the economy improves, then gradually declines to 599 percent of GDP by 2027. Government external debt is projected to gradually decline over the medium-term to around 74 percent of GDP, supported by GDP growth and fiscal consolidation efforts.



Sources: Central Bank of Cyprus, Ministry of Cyprus, and IMF staff estimates.



Sources: Central Bank of Cyprus, Ministry of Cyprus, and IMF staff estimates.

14. Despite the projected decline, the high level of external debt leaves Cyprus vulnerable to a variety of risks. Standardized shocks to interest rates and economic growth would significantly impede debt reduction, as the large size of external debt would markedly increase debt services costs in the case of higher interest rates and reduce the denominator effect on the debt-to-GDP ratio. Standardized current account deficit shocks would have a more limited impact on the debt ratio.

15. The Cypriot economy remains exposed to liquidity and other risks as a result of continued large gross financing needs. Gross external financing needs are projected start to decline in 2021 but remain elevated (over 150 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 and limit risks of a new boom-bust cycle. 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 of external assets and liabilities.

16. In conclusion, Cyprus's public debt and external debt remain at high levels although debt sustainability risks have receded over the past year, reflecting strong growth recovery and a better medium-term outlook. Ensuring continued fiscal adjustment, reducing risks to financial stability, and strengthening structural reforms to enhance the resilience of the economy are needed to reduce risks to debt sustainability. The debt reduction path could be affected by the growth shock, geopolitical tensions, global financial tightening, and the realization of contingent liabilities. As recommended in the main text of the staff report, maintaining strict fiscal discipline is important to ensuring 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 public and external debt.

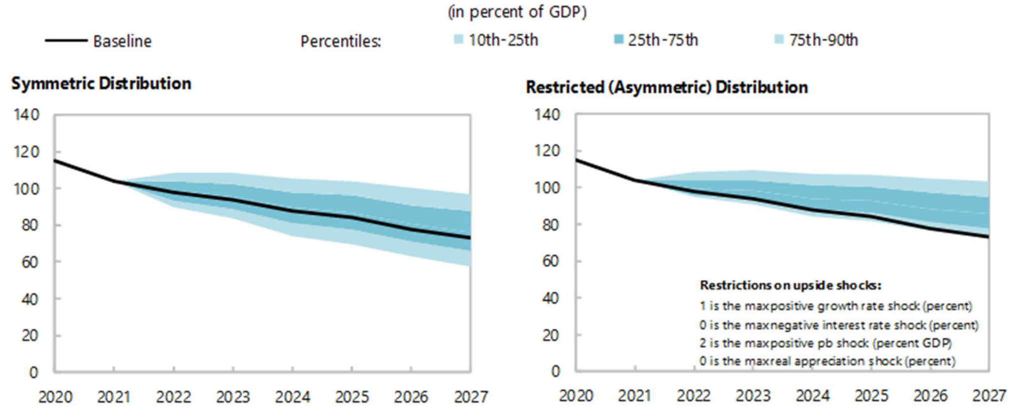
Figure 1. Cyprus: Public Risk DSA Assessment

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

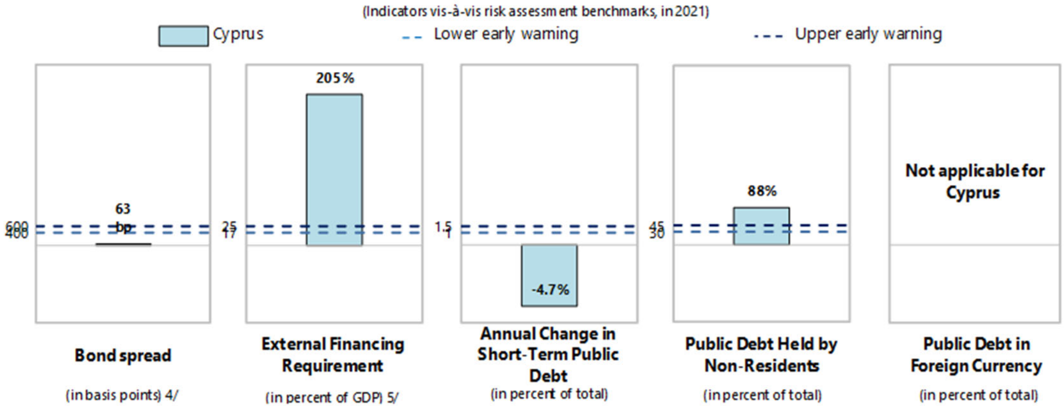
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% 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% 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.

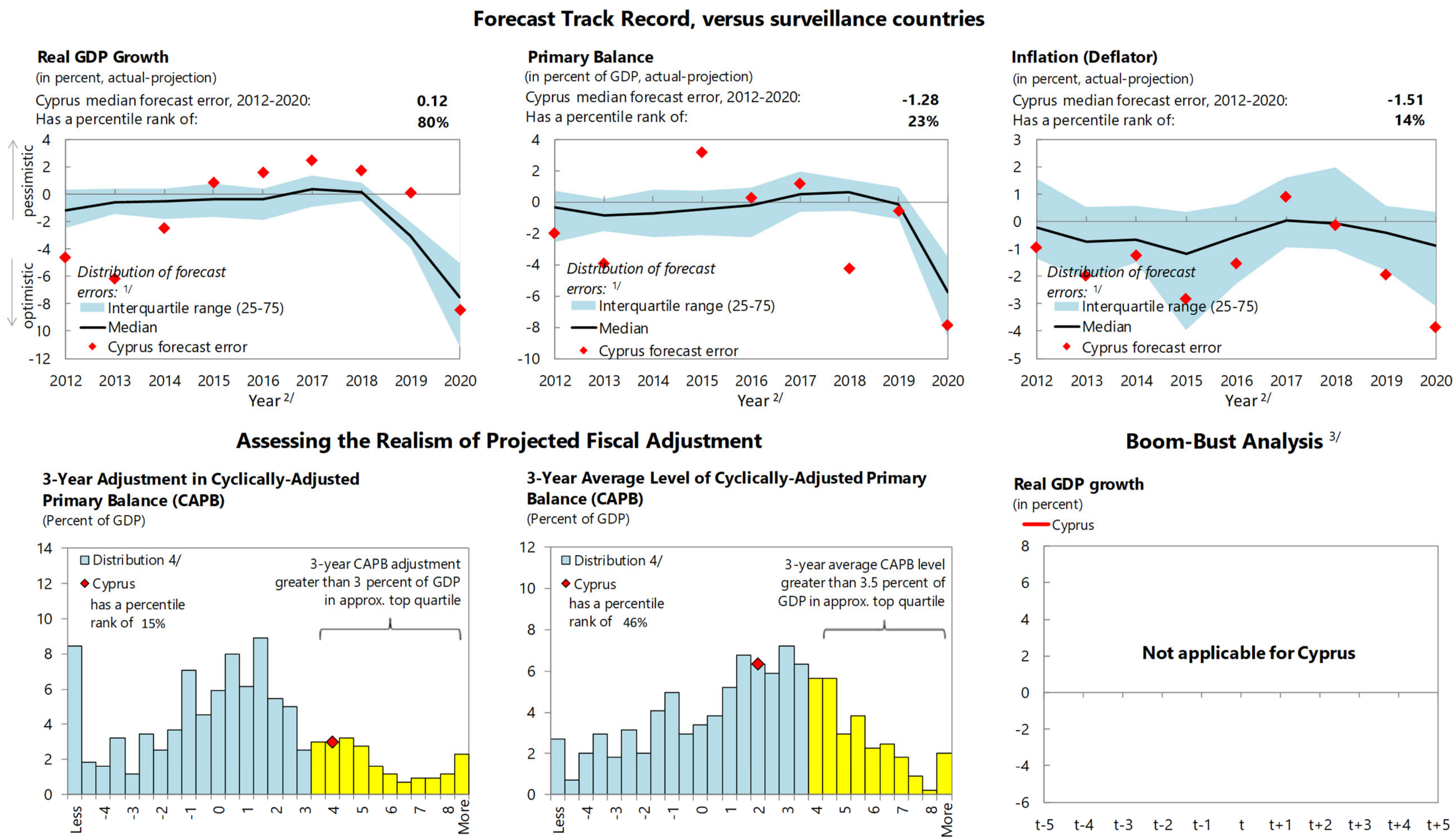
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 24-Dec-21 through 24-Mar-22.

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)

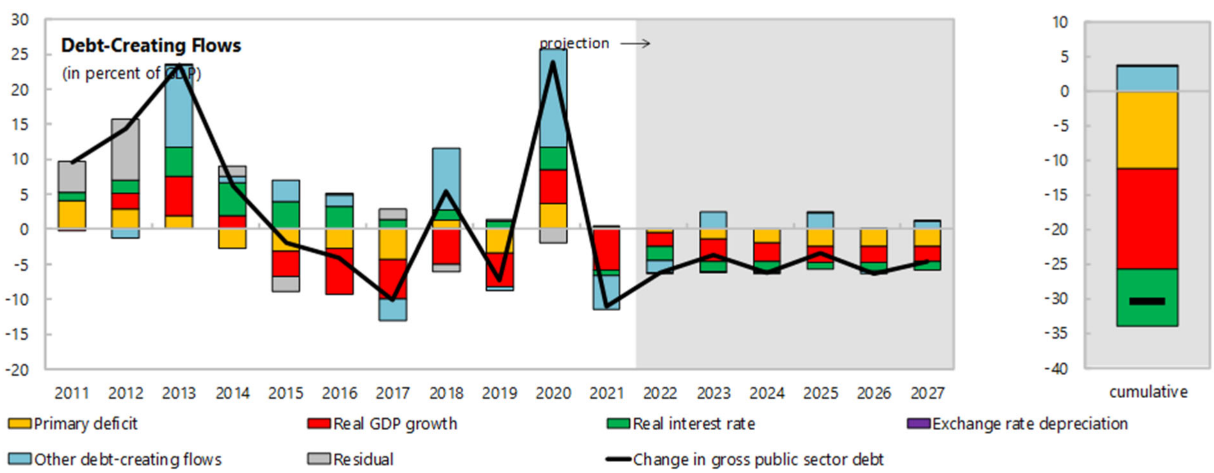
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2011-2019 [2]	2020	2021	2022	2023	2024	2025	2026	2027
Nominal gross public debt	94.3	115.0	103.9	97.7	94.1	87.8	84.5	78.2	73.6
Public gross financing needs	11.9	16.8	12.3	11.2	6.5	8.9	5.8	7.9	7.2
Real GDP growth (in percent)	1.7	-5.0	5.5	2.0	3.5	3.0	2.7	2.8	2.9
Inflation (GDP deflator, in percent)	0.3	-1.1	2.4	3.8	3.3	3.0	2.6	2.6	2.7
Nominal GDP growth (in percent)	2.0	-6.0	8.0	6.0	6.9	6.0	5.4	5.5	5.7
Effective interest rate (in percent) [4]	3.2	2.2	1.7	1.9	1.6	1.5	1.5	1.2	1.3

As of March 24, 2022		
Sovereign Spreads		
EMBIG (bp) 3/		56
5Y CDS (bp)		80
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	4.0	23.9	-11.0	-6.2	-3.6	-6.3	-3.4	-6.3	-4.6	-30.3	
Identified debt-creating flows	2.5	25.8	-11.1	-6.2	-3.6	-6.3	-3.4	-6.3	-4.6	-30.4	
Primary deficit	-0.7	3.7	0.4	-0.5	-1.4	-1.9	-2.5	-2.4	-2.5	-11.3	-2.1
Primary (noninterest) revenue and grants	38.1	39.2	42.0	41.0	41.2	41.1	40.8	40.1	39.8	243.9	
Primary (noninterest) expenditure	37.4	42.9	42.3	40.5	39.8	39.2	38.3	37.7	37.3	232.7	
Automatic debt dynamics [5]	0.8	8.0	-6.7	-4.0	-4.8	-4.0	-3.2	-3.5	-3.2	-22.8	
Interest rate/growth differential [6]	0.8	8.0	-6.7	-4.0	-4.8	-4.0	-3.2	-3.5	-3.2	-22.8	
Of which: real interest rate	2.6	3.2	-0.8	-2.0	-1.6	-1.4	-1.0	-1.2	-1.1	-8.3	
Of which: real GDP growth	-1.8	4.8	-5.9	-2.0	-3.2	-2.6	-2.2	-2.3	-2.2	-14.5	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	2.4	14.1	-4.8	-1.6	2.5	-0.3	2.3	-0.4	1.2	3.7	
Privatization/Drawdown of Deposits	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	14.1	-4.8	-1.6	2.5	-0.3	2.3	-0.4	1.2	3.7	
Residual, including asset changes [8]	1.5	-1.9	0.1	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 $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ 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 $r - \pi(1+g)$ and the real growth contribution as -g.

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

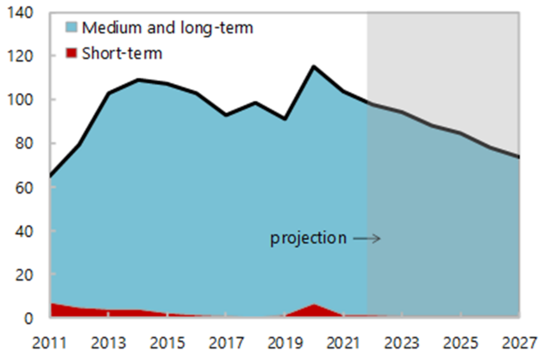
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

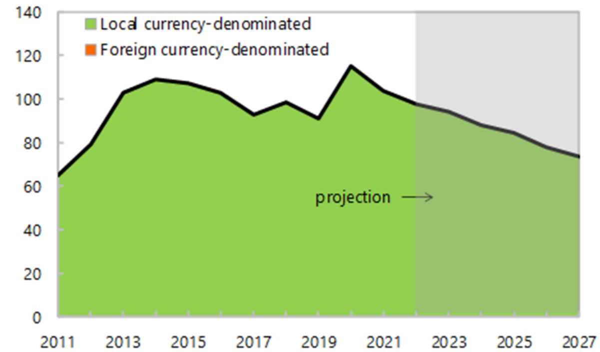
Figure 4. Cyprus: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



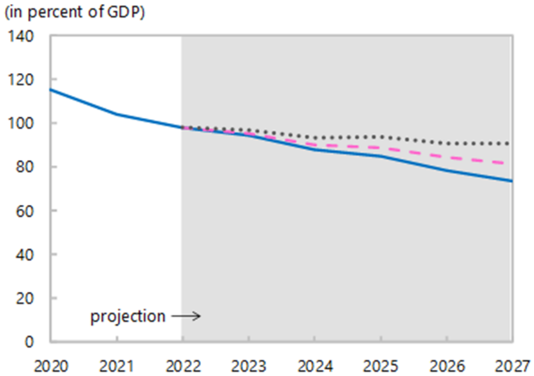
By Currency
(in percent of GDP)



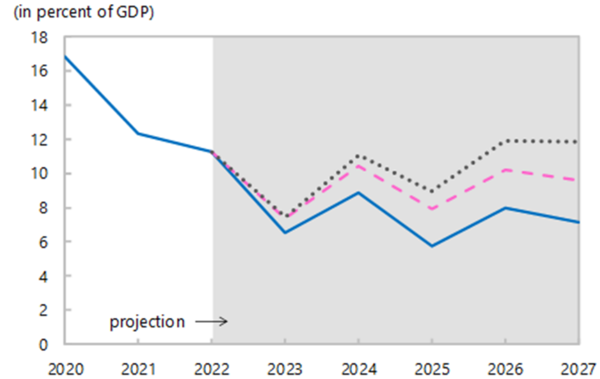
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions

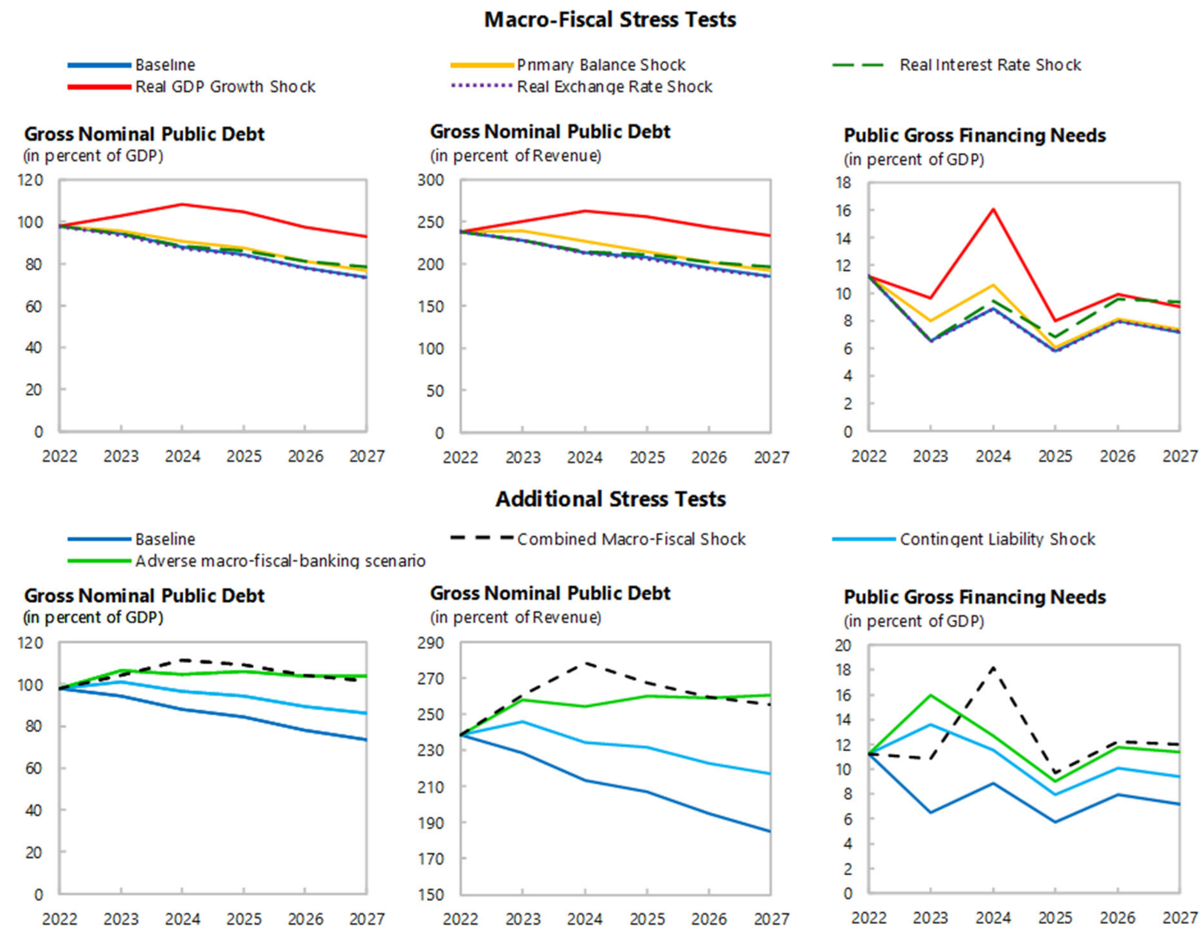
(in percent)

Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary Balance	0.5	1.4	1.9	2.5	2.4	2.5
Effective interest rate	1.9	1.6	1.5	1.5	1.2	1.3
Constant Primary Balance Scenario						
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary Balance	0.5	0.5	0.5	0.5	0.5	0.5
Effective interest rate	1.9	1.6	1.5	1.5	1.2	1.4

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	2.0	1.5	1.5	1.5	1.5	1.5
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary Balance	0.5	0.6	0.6	0.6	0.6	0.6
Effective interest rate	1.9	1.6	1.9	2.3	2.4	3.0

Source: IMF staff.

Figure 5. Cyprus: Public DSA – Stress Tests



Underlying Assumptions
(in percent)

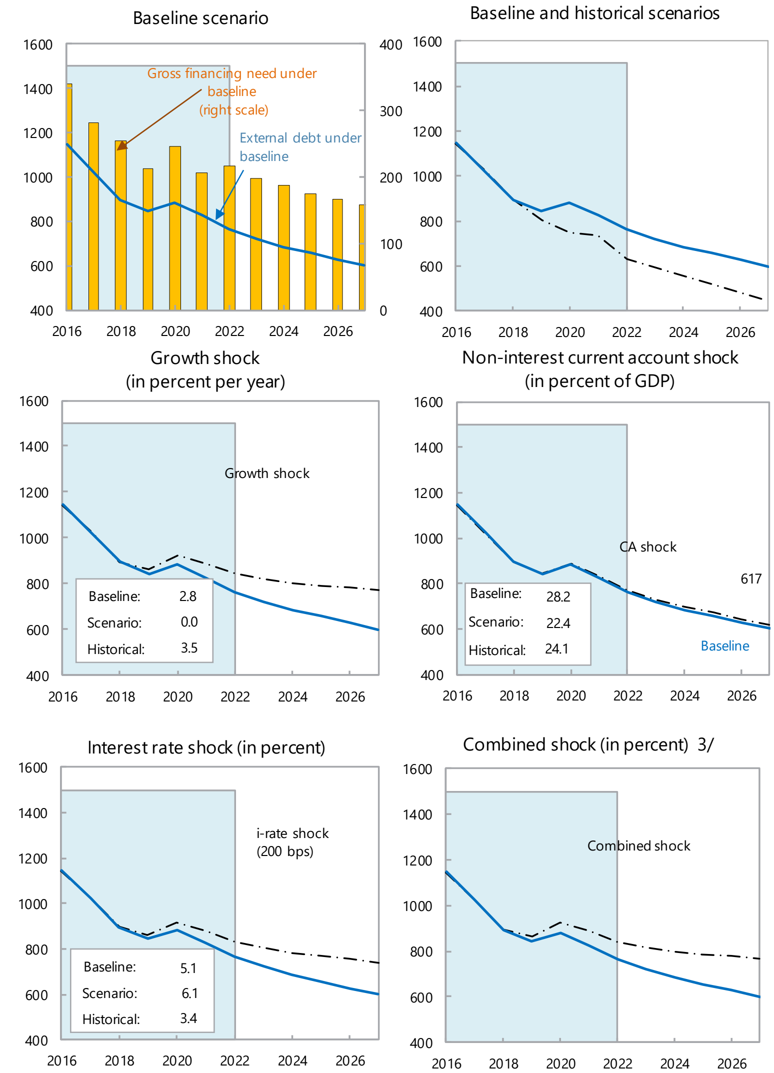
Primary Balance Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary balance	0.5	-0.1	0.5	2.5	2.4	2.5
Effective interest rate	1.9	1.6	1.6	1.6	1.3	1.5
Real Interest Rate Shock						
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary balance	0.5	1.4	1.9	2.5	2.4	2.5
Effective interest rate	1.9	1.6	2.1	2.7	3.0	3.8
Combined Shock						
Real GDP growth	2.0	-1.6	-2.2	2.7	2.8	2.9
Inflation	3.8	2.0	1.7	2.6	2.6	2.7
Primary balance	0.5	-2.4	-4.5	2.5	2.4	2.5
Effective interest rate	1.9	1.6	2.3	3.1	3.5	4.3

Real GDP Growth Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	2.0	-1.6	-2.2	2.7	2.8	2.9
Inflation	3.8	2.0	1.7	2.6	2.6	2.7
Primary balance	0.5	-1.2	-3.4	2.5	2.4	2.5
Effective interest rate	1.9	1.6	1.6	1.7	1.5	1.6
Real Exchange Rate Shock						
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.7	3.0	2.6	2.6	2.7
Primary balance	0.5	1.4	1.9	2.5	2.4	2.5
Effective interest rate	1.9	1.6	1.5	1.5	1.2	1.4
Contingent Liability Shock						
Real GDP growth	2.0	3.5	3.0	2.7	2.8	2.9
Inflation	3.8	3.3	3.0	2.6	2.6	2.7
Primary balance	0.5	-5.7	0.5	1.0	1.0	1.0
Effective interest rate	1.9	1.6	1.8	1.8	1.5	1.7

Source: IMF staff.

Figure 6. Cyprus: External Debt Sustainability—Bound Tests[1,2]

(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.

Table 1. Cyprus: External Debt Sustainability Framework, 2016–27

(Percent of GDP, unless otherwise indicated)

	Actual								Projections						Debt-stabilizing non-interest current account 5/
	2016	2017	2018	2019	2020	2021			2022	2023	2024	2025	2026	2027	
Baseline: External debt	1144	1024	894	843	881	825			**762**	**720**	**684**	**656**	**627**	**599**	**0.3**
Change in external debt	-114.4	-120.4	-129.7	-51.0	37.6	-55.6			-62.8	-42.7	-35.4	-28.2	-29.4	-27.7	
Identified external debt-creating flows (4+9+14)	-112.7	-102.4	-136.8	-21.7	41.4	-64.8			-39.2	-42.3	-35.1	-27.9	-29.1	-27.6	
Current account deficit, excluding interest payments	-32.8	-29.3	-26.8	-23.9	-20.4	-20.2			-21.9	-29.3	-30.6	-29.9	-29.4	-28.4	
Deficit in balance of goods and services	-1.7	0.5	-1.3	-0.2	2.5	-1.1			1.1	-0.3	-1.2	-1.8	-2.1	-2.3	
Exports	70.5	73.9	75.1	75.6	75.8	81.3			86.4	86.1	85.6	85.2	84.7	84.3	
Imports	68.8	74.4	73.8	75.4	78.3	80.2			87.6	85.8	84.4	83.4	82.6	82.0	
Interest receipts (negative)	-14.7	-12.4	-12.9	-12.4	-14.3	-13.0			-14.6	-19.8	-20.4	-20.3	-20.1	-19.6	
Net non-debt creating capital inflows (negative)	-49.0	-22.7	-55.5	4.5	-14.8	7.4			-24.3	-0.1	0.2	1.4	0.2	0.9	
Net foreign direct investment, equity	-39.8	-19.9	-46.4	-3.9	-19.0	-12.2			-28.4	-5.6	-5.2	-5.0	-4.8	-4.7	
Net portfolio investment, equity	3.6	16.4	-15.5	2.1	0.7	1.6			0.3	2.8	0.1	0.7	4.3	4.3	
Net sales of assets under other investment	-13.6	-20.3	4.5	5.3	4.4	14.8			3.2	2.0	4.5	4.8	0.1	0.6	
Financial derivatives, net	1.7	1.4	3.2	0.1	-1.4	0.2			0.2	0.2	0.2	0.2	0.2	0.2	
Automatic debt dynamics 1/	-31.0	-50.4	-54.5	-2.2	76.5	-52.1			6.9	-12.9	-4.6	0.5	0.1	-0.2	
Contribution from nominal interest rate	37.0	34.4	30.7	29.6	30.4	27.4			30.1	36.1	36.3	35.4	34.6	33.4	
Contribution from real GDP growth	-77.0	-61.4	-52.2	-46.8	43.9	-43.3			-17.0	-25.0	-20.1	-17.2	-17.6	-17.3	
Contribution from price and exchange rate changes 2/	9.0	-23.4	-33.1	15.0	2.2	-36.1			-6.2	-24.1	-20.9	-17.6	-16.9	-16.2	
Residual (2-3 or 19+20+21+22)	-1.6	-18.0	7.1	-29.4	-3.8	9.2			-23.6	-0.4	-0.3	-0.3	-0.3	-0.1	
Net accumulation of official reserve assets	-0.1	0.0	0.2	0.0	0.1	1.3			0.0	0.0	0.0	0.0	0.0	0.0	
Captial account flows, net (negative)	-0.1	-0.4	-0.5	-0.1	-0.1	-0.6			-0.2	-0.3	-0.3	-0.2	-0.2	-0.1	
Errors and omissions, net (negative)	-2.0	-2.5	-0.3	-1.1	2.2	-1.5			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	-15.5	-22.2	-10.7	-5.0	-12.8	-3.3			-0.2	0.0	0.0	0.0	0.0	0.0	
External debt-to-exports ratio (in percent)	1622	1385	1191	1116	1162	1015			882	836	799	770	740	710	
Gross external financing need (in billions of euros) 3/	71	64	65	55	61	57			60	58	58	58	58	58	
in percent of GDP	340	282	254	213	246	205			216	197	187	175	167	158	
Scenario with key variables at their historical averages 4/							5-Year	5-Year	**630**	**591**	**553**	**517**	**481**	**446**	
							Historical	Standard							Projected
Key Macroeconomic Assumptions Underlying Baseline							Average	Deviation							Average
Nominal GDP (in billions of euros)	20.9	22.9	25.5	25.8	24.7	27.6			27.6	29.5	31.3	32.9	34.8	36.7	
Real GDP growth (in percent)	6.5	5.9	5.7	5.3	-5.0	5.5	3.5	4.7	2.0	3.5	3.0	2.7	2.8	2.9	2.8
GDP deflator in euros (change in percent)	-0.8	3.1	5.7	-4.2	0.8	6.2	2.3	4.2	-2.2	3.3	3.0	2.6	2.6	2.7	2.0
Nominal external interest rate (in percent)	3.1	3.3	3.4	3.3	3.5	3.5	3.4	0.1	3.6	5.1	5.3	5.4	5.6	5.6	5.1
Growth of exports (euro terms, in percent)	6.2	14.4	13.4	1.6	-4.0	20.2	9.1	10.0	6.1	6.5	5.4	4.8	5.0	5.1	5.5
Growth of imports (euro terms, in percent)	7.7	18.0	10.7	3.1	-0.5	14.8	9.2	7.8	8.9	4.7	4.3	4.2	4.5	4.9	5.2
Current account balance, excluding interest payments	32.8	29.3	26.8	23.9	20.4	20.2	24.1	4.0	21.9	29.3	30.6	29.9	29.4	28.4	28.2
Net non-debt creating capital inflows	49.0	22.7	55.5	-4.5	14.8	-7.4	16.2	25.4	24.3	0.1	-0.2	-1.4	-0.2	-0.9	3.6

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.

Annex V. Risk Assessment Matrix[1]

Sources of Risks	Likelihood of Risk	Expected Impact of Risk	Policy Responses
External Risks			
Outbreaks of lethal and highly contagious Covid-19 variants	High Rapidly increasing hospitalizations and deaths, due to low vaccination rates or caused by vaccine-resistant variants, force lockdowns and increased uncertainty about the course of the pandemic. Policies to cushion the economic impact are prematurely withdrawn or for many EMDEs, constrained by lack of space.	High The recovery is delayed with larger scarring effects, unmasking vulnerabilities in the private sector. The needed containment measures would negatively affect economic activity, especially the tourism sector with delayed recovery. More layoffs could lead to a considerable increase in unemployment, which will weigh on productivity growth.	Provide further support to the healthcare sector. Allow automatic stabilizers to operate and extend targeted fiscal support as needed. Regulatory forbearance and broader policy support from the ECB would help banks withstand the shock.
De-anchoring of inflation expectations in the U.S. and/or advanced European economies.	Medium A fast recovery in demand amid a lagging supply-side response could lead to a rapid de-anchoring of inflation expectations, which prompts central banks to tighten policies abruptly.	Medium The higher inflation could create growth volatility and negatively affect the vulnerable population. The sharp tightening of global financial conditions and spiking risk premia could increase the refinancing cost for public debt and reduce fiscal space.	Announce credible medium-term fiscal plans Provide targeted support to vulnerable population to ensure the appropriate living standard.
Rising and volatile food and energy prices	High Energy prices are volatile and trend up amid pent-up demand and geopolitical tensions, or a bumpy transition to renewable energy sources.	High Cyprus has high oil intensity and dependence on energy imports. Higher oil prices would push up inflation, de-anchoring inflation expectations. This would negatively affect Cyprus by reducing consumer spending and growth and increase income inequality. In the scenario of low oil prices, the economy will benefit.	Allow automatic stabilizers to operate and provide temporary support to most vulnerable households, such as subsidies on electricity tariffs.
Widespread social discontent and political instability	High Social tensions erupt as the imposition of vaccine mandates and mobility restrictions and/or a withdrawal of pandemic-related policy support—amid increasing prices of essentials, slower growth, and rising inequality—result in higher unemployment and heavier household debt burdens. Political instability triggers capital outflows.	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 infection rate.	Provide targeted support to vulnerable population to ensure adequate access to healthcare and social assistance including unemployment benefits. Expand active labor market policies to facilitate reallocation of workers toward expanding sectors and limit labor market hysteresis.
Geopolitical tensions and de-globalization	High	High	

[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.

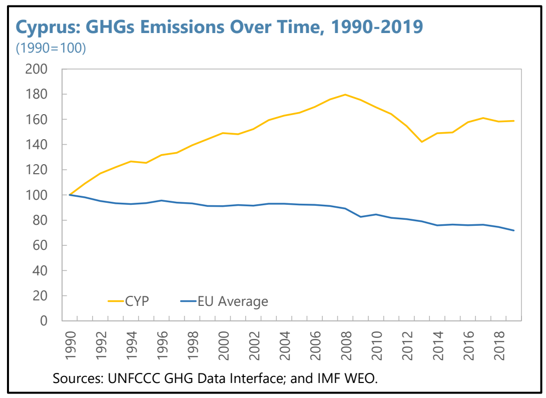
	Intensified geopolitical tensions, security risks, and conflicts cause economic and political disruptions, disorderly migration, production reshoring, a decline in global trade, and lower investor confidence.	Intensification of a conflict between Russia and Ukraine would have significant repercussions given Cyprus's exposures.	EU financing support could be expanded both in size and scope to restore confidence. Allow automatic stabilizers to operate and extend targeted fiscal support as needed. Regulatory forbearance and broader policy support from the ECB would help banks withstand the shock.
Domestic Risks			
Low NPL workouts	High The persistently low efficiency of the court has impeded timely resolution of legacy NPLs, hindering banks' profitability and the economy-wide access to 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.	Implement the NPLs reduction strategy more forcefully. 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.
Higher-than-expected fiscal pressures	Medium Healthcare demand could increase rapidly and progress in public hospital reforms could be slower-than-expected. Wage increases in the public sector may spin out of control amidst pre-election political pressures.	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 premia.	Enhance the competitiveness of public hospitals. Control the growth of the public sector wage bill.

Annex VI. Climate Policies in Cyprus

To address the climate challenges, Cyprus is planning a fiscally neutral green tax reform, which intends to introduce a carbon tax for fuels used in the sectors that are not covered by the EU emissions trading system (ETS). Together with planned investment to increase the share of Renewable Energy Sources (RES) and increase energy efficiency, Cyprus is projected to move closer—but not fully achieve—its ambitious climate goals.

1. Cyprus is placing climate change and the environment as an important element of the country's development agenda.

- **Cyprus has made some progress in reducing emissions, but they are still notably higher than EU average.** Cyprus has cut its total greenhouse gas emissions (GHGs) by about 5 percent since 2005, but the pace of emission reduction of Cyprus has been at a slower pace than the EU average. The emissions per capita and emissions per GDP are also notably above EU average.

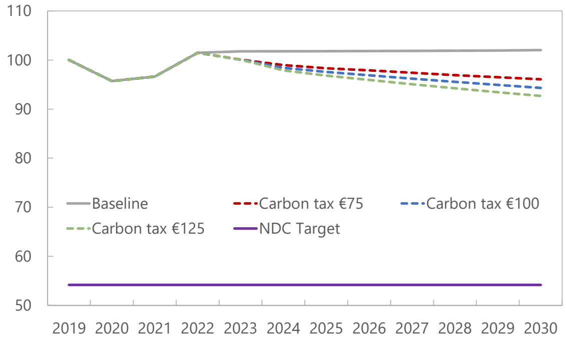


2. Cyprus aims to reduce emissions by 32 percent in non-ETS sectors by 2030 (relative to 2005) and is expected to become emission neutral by 2050. To achieve its climate targets, Cyprus has developed various investment projects and measures to support RES penetration and enhance the energy efficiency, including enhancing electricity connectiveness, promoting electricity generation from cleaner sources, improving public transporting, and supporting energy efficiency investments in the residential sectors. The National Energy and Climate Plan (NECP) envisages the investment of €3.3 billion on RES and €2.3 billion on energy efficiency from 2021 to 2030.

3. Introducing a carbon tax can contribute to achieving Cyprus's national emissions reduction targets. The government is planning to introduce a carbon tax for fuels used in the Non-ETS sectors. Using the IMF Carbon Price Assessment Tool (CPAT), staff estimates that introducing a carbon tax starting at €25 per metric tonne of carbon emission in 2023 and gradually increasing to €100 by 2030 would reduce the total emissions by 7.5 percent and the emissions in Non-ETS sectors by 12 percent by 2030, relative to the baseline.

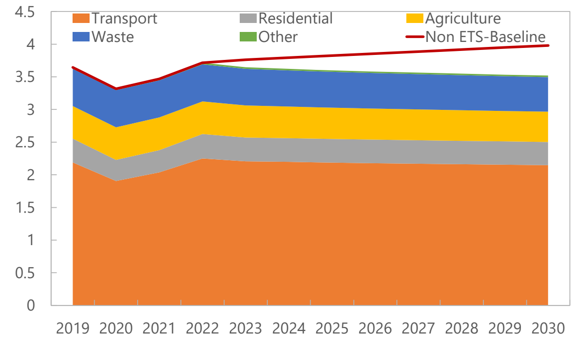
Cyprus: GHG Emissions

(2019=100)



Sources: CPAT; IMF staff estimates.

GHG Emissions: Non ETS Sectors

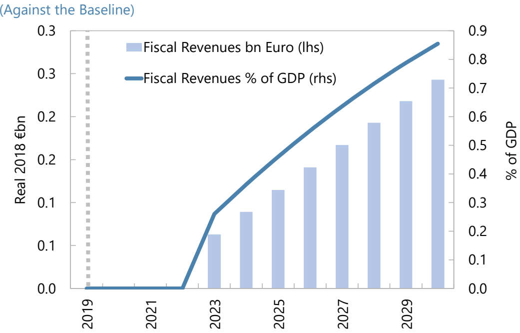


Sources: CPAT; and IMF staff estimates.

4. The potential revenue gains from carbon pricing can be used to minimize potential impacts of carbon pricing on the economy. A carbon tax of €100 is estimated to generate additional fiscal revenue of 0.85 percent of GDP by 2030. The adverse impact of carbon pricing on GDP growth is expected to be manageable. A carbon tax of €100 would reduce the GDP growth rate by 0.5 percentage point by 2030. However, if the revenue gains are recycled, particularly for investments, most of the negative impact on GDP would be offset, and the net impact would become positive from 2030.[1]

Cyprus: Additional Fiscal Revenues from Carbon Tax

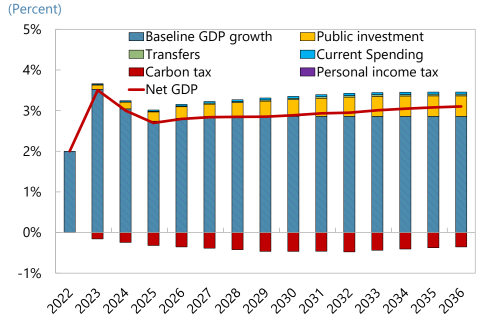
(Against the Baseline)



Sources: CPAT; IMF staff estimates.

Cyprus: Net Impact on Growth Rates

(Percent)

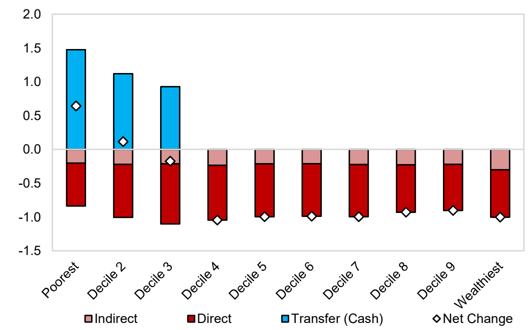


Source: CPAT; IMF staff estimates.

[1] Assuming that 70 percent of the revenue from carbon taxes is used for public investment,15 percent is used for social protection, and 15 percent is used for current spending to facilitate sector transition.

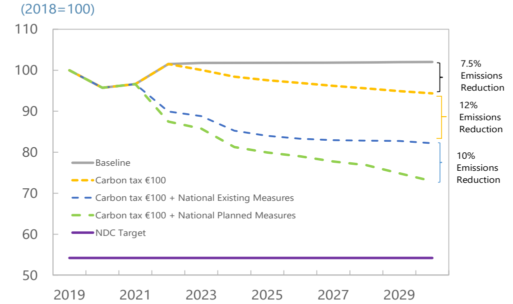
5. Alleviating burdens on households can be done through targeted fiscal measures. Although carbon taxation is also viewed favorably by Cypriots, one concern regarding carbon pricing is the negative impact on households.[2] Overall, a carbon tax of €100 is estimated to reduce the household consumption by 1 percent. Transition measures are needed to assist low-income households and vulnerable workers, for example, through targeted transfer and retraining. It is estimated that 15 percent revenues gains could be used for compensating consumption loss of the bottom 30th percentile of the households.

Cyprus: Relative Consumption Effect
(% of Consumption)



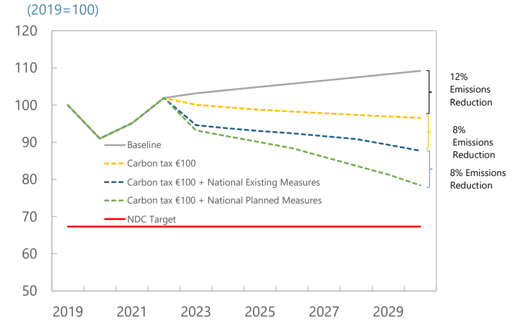
6. Effectively implementation of other government planned measures would further contribute to emissions reduction. Based on the analysis of the NECP, the emissions are expected to decline by 12 percent under existing policy scenario and by a further 10 percent under the planned measures scenario, compared with the baseline (8% for Non-ETS sectors, respectively). This would propel Cyprus closer to its ambitious emissions target, even though more actions would be needed to achieve it.

Cyprus: GHG Emissions
(2018=100)



Sources: CPAT; NECP; IMF staff estimates.

Cyprus: GHG Emissions of Non ETS Sectors
(2019=100)



Sources: CPAT; NECP; IMF staff estimates.

7. Cyprus could use the green transition as an opportunity to achieve a more sustainable growth model and consider additional measures to achieve its climate goals. Staff estimates that achieving the targets on RES could reduce the import needs of fuel and improve the current account by around 1 percent of GDP each year. The public investment on climate-related projects, if fully implemented, could increase the GDP level by over 10 percent by 2030. Since carbon pricing alone may not be sufficient to rapidly decarbonize in some sectors, feebates can be applied to specific sectors and enhance the emissions reduction of the sectors.

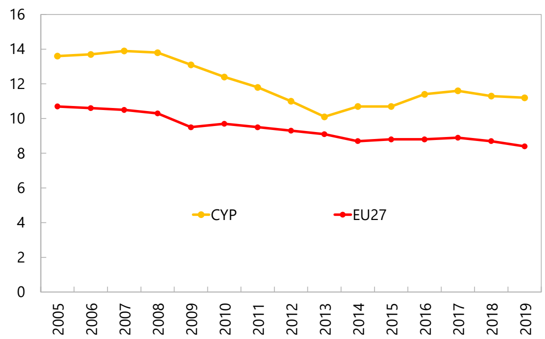
[2] According to the *2021-2022 EIB Climate Survey*, 89 percent of Cypriots think that climate change and its consequences are the biggest challenge for humanity in the 21st century, and 75 percent would welcome a tax on products and services that contribute most to global warming.

Figure 1. Cyprus: Climate and Emissions

Compared with EU average, Cyprus has higher emissions per capita…

Greenhouse Gas Emission per Capita

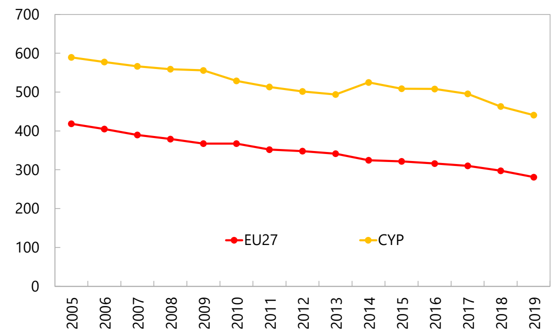
(Unit of CO_2e)



…emissions per unit of GDP.

Carbon Intensity: GHG emission per unit of GDP

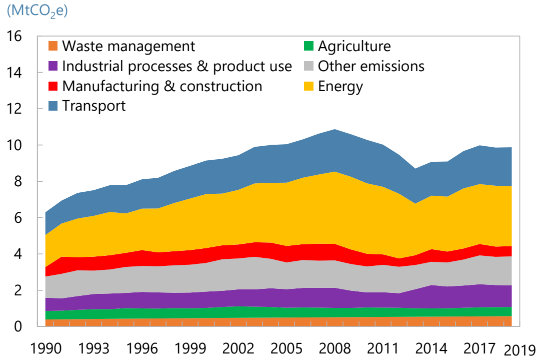
(gCO_2e per euro in 2015 price)



Energy, domestic transport, and industrial process are the top three sectors that have the largest GHS emissions.

Greenhouse Gas Emission by Sectors

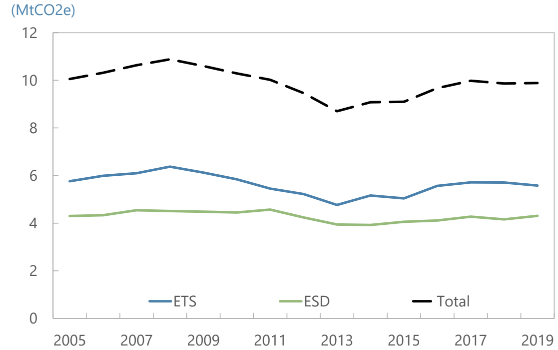
($MtCO_2e$)



Both the ETS and ESD sectors' emissions have increased since 2013

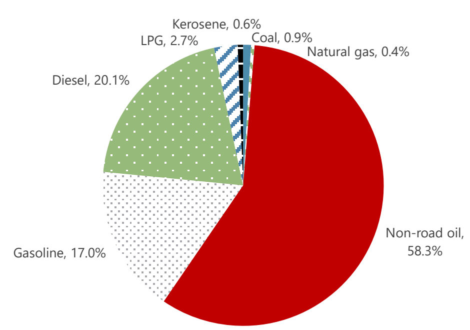
GHG Emissions

(MtCO2e)



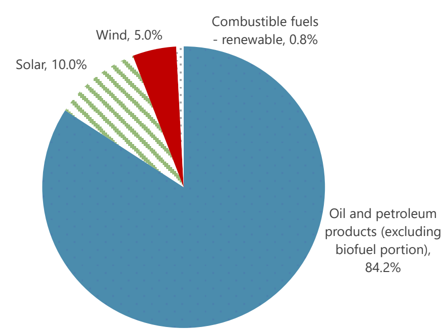
Liquid fuel accounts for more than 95 percent of emissions from total fuel.

CO2 Emissions by Fuel



Cyprus also relies mainly on imports of liquid fuel for power generation

Net Electricity Generation by Type of Fuel



Sources: EEA; Eurostat; and IMF/WB Carbon Pricing Assessment Tool (CPAT).

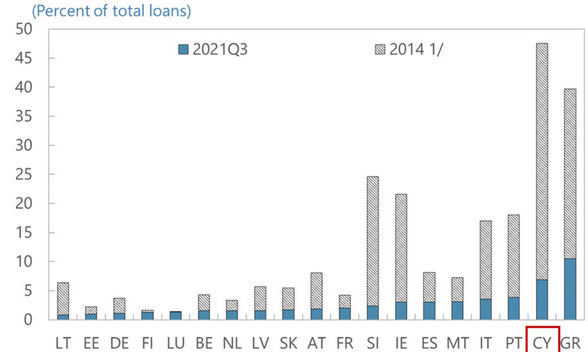
Annex VII. Expansion of the Public AMC

Despite notable progress in recent years, legacy NPLs backed by primary residences and business premises remain high. The Cypriot authorities plan to expand the public Asset Management Company (KEDIPES) to provide a solution to such socially sensitive legacy NPLs through a Mortgage-to-Rent (MtR) scheme. It should be well-targeted and include safeguards to avoid weakening credit discipline.

1. Despite progress, the Cypriot economy records the second highest NPL ratio in the EU. The NPL reduction process accelerated after assets of the failed CCB bank were transferred to KEDIPES in 2018, and banks started selling NPLs to credit acquiring companies (CACs). By the end of 2021, the NPL stock dropped to €2.6 bn, from its peak of €27.9 bn in 2014, and stand at 9.8 percent of outstanding loans in the Cypriot banking sector. Still, the workout of claims by KEDIPES and the CACs has been slow. Particularly, since SME and household loans are often collateralized by primary residences, their resolution is difficult due to the socially sensitive nature of the underlying assets.

NPL Ratios: 2014 vs 2021Q3

(Percent of total loans)



Sources: Haver, Central Bank of Cyprus and IMF Staff Calculations.

1/ 2015Q1 for Estonia and Malta, 2015Q3 for Slovenia.

2. The Cypriot authorities are considering transforming KEDIPES into the national AMC. KEDIPES will acquire the primary residences or primary business premises with a market value below €350,000 used as collateral to NPLs after a debt-to-asset swap with banks and private CACs. Targeted assets will be purchased at a discount from market value using agreed methodologies. The acquired properties will be rented back by KEDIPES to the borrowers through a mortgage-to-Rent (MtR) scheme, at a below-market rental yield. Within the tenancy duration, KEPIDES will give an option to the tenants to repurchase the property. KEDIPES could also sell the property to a third party. The core terms of the scheme are still under study.

3. The plan entails risks:

- **Impact on the payment culture.** The plan might further weaken the credit discipline and the payment culture as it bypasses the foreclosure framework in the resolution of NPLs.
- **Low participation**. KEDIPES initially obtained assets from the (near) failure of the state-owned coop bank. This time, however, a tri-party settlement agreement must be reached among KEDIPES, the debtors as well as the private banks and CACs to transfer assets. Not only would it be difficult to agree on a price, eligible debtors might also choose not to participate in the scheme, unless a solid foreclosure framework remains in place as the critical threats.
- **Operational risks for KEDIPES.** Additional large-scale transfers of risk from banks and CACs to the public sector introduces the potential for political interference, overpaying for assets and

even corruption. Also, adding more tasks to KEDIPES could also complicate its operations and monitoring, undermining its transparency

4. Some refinements of the PAMC expansion plan would reduce risks:

- **Eligible Assets.** The scope and features of the potential assets to be transferred to the national AMC should be clear and well justified. The threshold value of €350,000 for eligible loans as well as the income and wealth criteria should be carefully evaluated to ensure it adequately captures vulnerable borrowers, and the cut-off date strictly enforced.

- **Transfer price.** Robust and prudent approaches to pricing are required to ensure that the AMC "breaks even" as it winds down. Assets should be valued using a consistent and forward-looking approach. In this regard, staff welcome the planned valuation exercise by independent experts and encourage employing prudent application of international valuation standards.

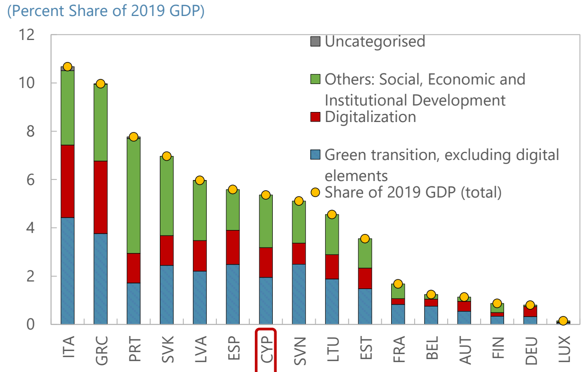
- **Governance and Safeguards.** Safeguards could include publishing an annual business plan with clear targets for value recovery that are consistent with the public AMC's sunset clause; outsourcing key loan recovery operations to private sector experts that are remunerated based on performance; and enhancing transparency by publishing detailed financial and performance reports. The government should reconsider including an MoF representative on the Board of Governor of KEDIPES, as this could undermine the independence of the board.

Annex VIII. Structural Reforms Under the Recovery and Resilience Plan (RRP)

The RRP will support growth through higher demand and by tackling structural impediments to growth. The impact of reforms is projected to be significant but fully materialize only beyond the medium term, partly reflecting their backloaded implementation.

1. Reforms in the RRP aim to tackle weak governance, skills gaps and mismatches, and digital and infrastructure gaps. Cyprus's RRP is designed to support recovery and implement pro-growth reforms. The total budget amounts to [€1.23] billion ([5.3] percent of 2021 GDP), of which €1 billion is financed by the NGEU grants and the rest by loans. The plan provides financing for spending and reforms under five policy areas: i) public health and civil protection; ii) the green transition; iii) economic resilience and competitiveness; iv) the digital transition; and v) the labor market, education, and human capital. Several of these reforms will address the structural weaknesses identified above, often reviving earlier efforts. The reform measures are to be taken in steps, spanning the period of 2021–26. Their implementation will be enforced by the quarterly assessment of completion of milestones.

Total RRF Amount (Grants + Loans)
(Percent Share of 2019 GDP)



Sources: Bruegel and IMF staff.

2. A number of RRP reforms aim to improve governance:

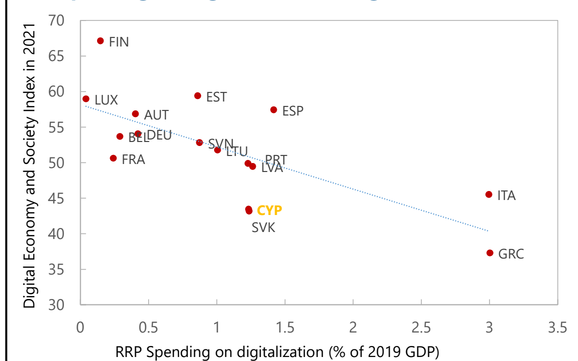
- **Rule of law.** The length of court proceedings in Cyprus remains the longest in the EU and the backlog of cases among the highest (Cyprus Competitiveness Report 2021). Inefficiencies in the judicial system impact business costs directly and has also been one of the impediments to the resolution of NPLs (weighing on access to financing). The RRP reforms includes increasing the number of judges (the system is understaffed and underfunded by cross-country comparisons) and their training, and improving processing (including through digitalization) with a view to gradually reduce the backlog of cases.

- **Control of corruption.** Latest indicators suggest that controlling corruption remains a major challenge, but progress is being made since 2021 as part of the RRP milestones. Legislation establishing a whistle-blower protection and a new independent anti-corruption agency—both reforms in the RRP—has recently been passed.

- **Government efficiency.** The RRP includes the long outstanding public service reform, steps toward administrative decentralization, digitalization of the public administration, improving the structure and operations of the public procurement, and enhancing e-system for issuing building permits.

3. The reforms also address skills gap and mismatches. Despite relatively high public spending on education, achievements have been sub-par. Cyprus scores low in OECD PISA scores, and, given its high share of population with tertiary education, produces a small number of STEM graduates. The already prevalent skills matching will likely worsen with the ongoing economic transition to a more digital economy. The RRP includes measures to improve teaching quality and enhance digital skills at all levels of education (e.g., introducing compulsory pre-primary education, reforming the teachers' appraisal system, and—given the already high spending—a rationalization of the utilization of human resources) and strengthening vocational education (including through upgrading infrastructure and facilitating distance learning).

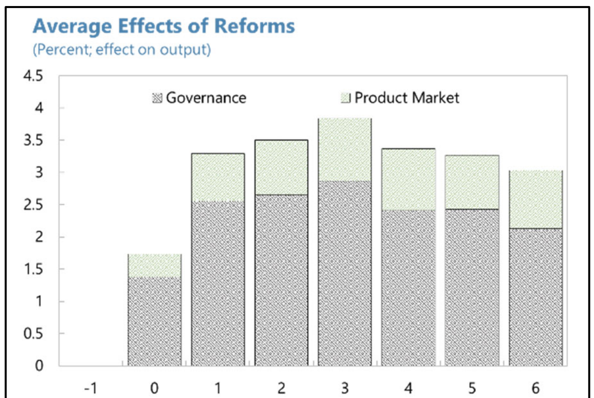
4. And will help close the digital infrastructure gap. Cyprus ranks low among EU countries in its use of digital technology, especially in human capital and digital skills. In addition to efforts to build the digital government and provide adequate digital skills, the RRP includes public investments and measures to facilitate private investments to upgrade the digital infrastructure (Cyprus is lagging European peers in connectivity measures). Total spending on digitalization efforts to about 1¼ percent of GDP—while significant, these numbers are lower than in peer countries with a similar gap.



Sources: Bruegel, European Commission and IMF staff.

5. The impact of reforms on growth will be strong but backloaded.

- **Higher fiscal spending will have an immediate impact on aggregate demand.** Spending is projected to increase in total by about 3½ percent of GDP over 2021-26 compared to projections without the RRP (considering that the RRP will finance some existing projects), reaching its peak (of around 1 percent of GDP) in 2024. Simulations from the IMF FSGM model (Andrle et al., 2015) suggest that the immediate impact on activity will be relatively modest given leakage through higher imports (Figure A1): in 2024, for instance, growth is projected to be ½ percentage points higher, but the current account will deteriorate by ½ percent of GDP as well. But the additional spending—mainly on investments—will add to production capacity.



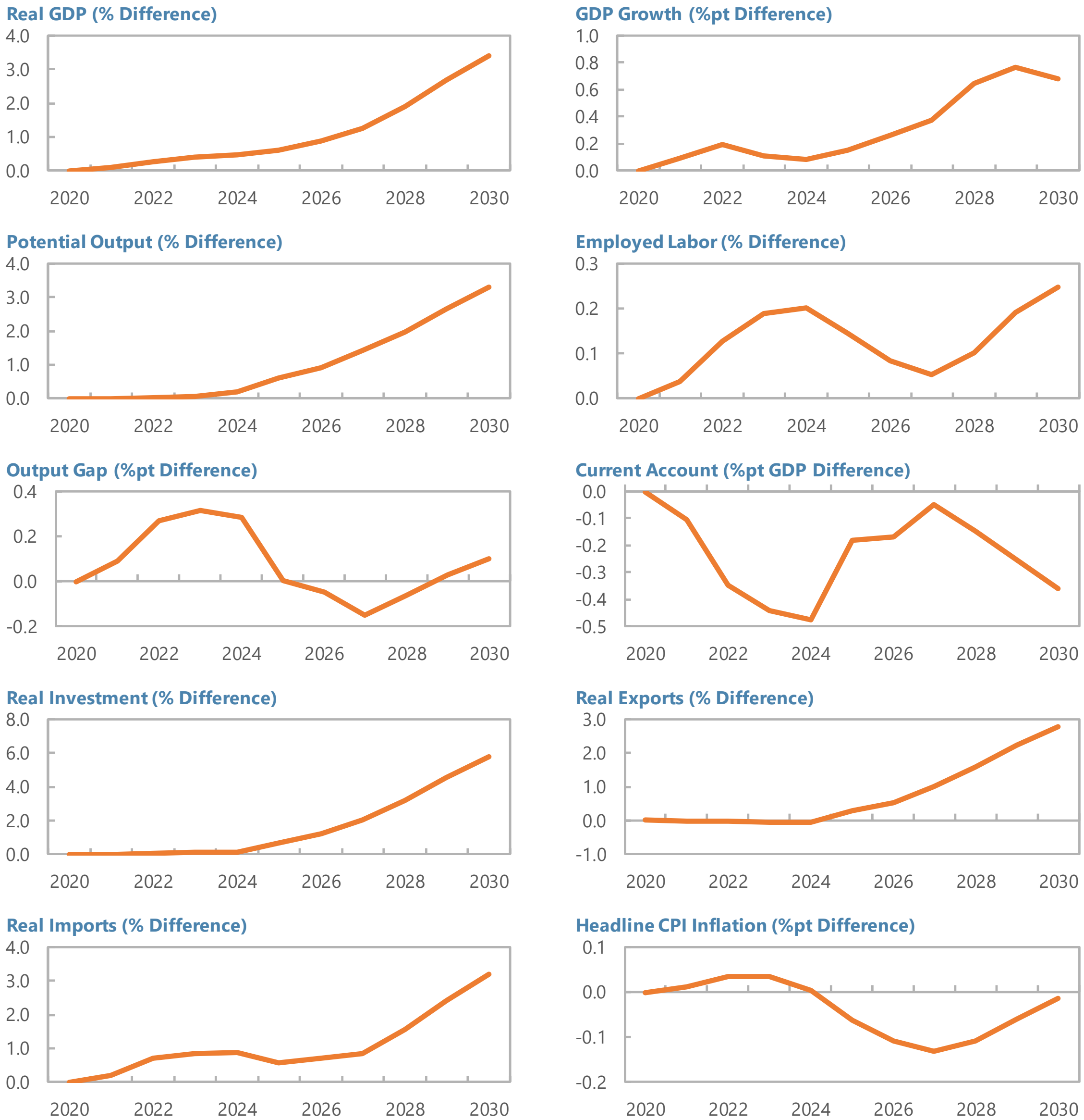
Sources: IMF (2019)

- **The effects of structural reforms will materialize later.** Cross-country evidence based on a sample of Emerging Markets and Developing Economies (EMDEs) suggest that major governance reforms could boost output by 2-3 percent and product market reforms by about

1 percent at their peaks three years after the reforms are implemented (IMF, 2019). The impact of reforms in Cyprus is likely to be smaller given that it is much closer to the efficiency frontier than EMDEs.

- **The overall impact will be significant.** Taken together, higher spending and the structural reforms are estimated in the FSGM model to boost GDP by 1¼ percent by 2027 and have a stronger cumulative impact on nearly 4 percent beyond the medium-term. Improvements in productivity will be accompanied by higher investments, which will temporarily worsen the current account deficit.

Figure 1. Cyprus: Economic Impact of RRP—Simulations using the FSGM Model



Source: IMF Staff Estimates.

INTERNATIONAL MONETARY FUND

CYPRUS

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 10, 2022

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2022)

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

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	423.98	100.00
Holdings	356.29	84.03

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 2022)

	Principal	**Charges/Interest**	**Total**
2022	0	0.16	0.16
2023	0	0.22	0.22
2024	0	0.22	0.22
2025	0	0.22	0.22
2026	0	0.22	0.22

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 May 18, 2021 (IMF Country Report No. 21/125).

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
STA	Property Price Statistics	April-May 2021

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, 2022)

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. STA will continue providing technical assistance in the area of property prices.
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. It also publishes in the IMF's Government Finance Statistics (GFS) database monthly and quarterly non-cash data based on the *GFSM 2014* for the general government.
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). Cyprus participates in the IMF data collection for the database on the cross-border flows and positions of SPEs.
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 reports thirteen core financial soundness indicators (FSIs) and seven additional FSIs for the deposit takers as well as two additional FSIs for real estate markets on a quarterly basis. Additional FSIs for other financial corporations and 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 19, 2022

	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. 2022	Apr. 2022	M	M	M
Reserve/Base Money	Feb. 2022	Mar. 2022	M	M	M
Broad Money	Feb. 2022	Mar. 2022	M	M	M
Central Bank Balance Sheet	Feb. 2022	Mar. 2022	M	M	M
Consolidated Balance Sheet of the Banking System	Feb. 2022	Mar. 2022	M	M	M
Interest Rates 2/	Current	Current	D	D	D
Consumer Price Index	Mar. 2022	April. 2022	M	M	M
Revenues, Expenditure, Balance and Composition of Financing 3/ - Central Government	Feb. 2022	Apr. 2022	M	M	M
Revenues, Expenditure, Balance and Composition of Financing 3/ - General Government 4/	Feb. 2022	Apr. 2022	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Feb. 2022	Apr. 2022	M	M	M
External Current Account Balance	2021: Q4	Mar. 2022	Q	Q	Q
Exports and Imports of Goods and Services	2021: Q4	Mar. 2022	Q	Q	Q
GDP/GNP	2021:Q4	Mar. 2022	Q	Q	Q
Gross External Debt	2021: Q4	Mar. 2022	Q	Q	Q
International investment position 6/	2021: Q4	Mar. 2022	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).

Statement by Luc Dresse and Michalis Ghalanos, Executive Director on Cyprus
May 25, 2022

On behalf of the authorities of the Republic of Cyprus, we thank the mission team, led by Mr. Maliszewski, for the productive discussions in March and the insightful report. The authorities broadly concur with the thrust of the staff analysis and will take the report's recommendations into pertinent consideration.

Macroeconomic developments and outlook

Cyprus weathered the pandemic waves well. Output recovered strongly from the 5.0 percent contraction in 2020 owing to the pandemic, with real GDP growth registered at 5.5 percent in 2021. High vaccination coverage and improved epidemiological developments have allowed the gradual lifting of almost all restrictive measures. While uncertainty about the course of the pandemic is not to be discounted, the ongoing war in Ukraine produces an additional set of adverse shocks that compounds uncertainty. Vulnerabilities mostly pertain to the tourism industry: about 20 percent of arrivals in the period 2017 to 2019 came from Russia. However, tourists from traditional markets such as the UK are showing a revived interest following the pandemic recovery. Reflecting also outreach to new and other existing markets, and incentives to prop up domestic tourism, the authorities project tourist arrivals in 2022 to reach 70 percent of the arrivals recorded in 2019, a record year in terms of arrivals. Moreover, economic diversification is reducing dependence on tourism in favor of high value-added sectors such as ICT. Other vulnerabilities relate to professional services, which are expected to be impacted by the sanctions on Russia. Exports of financial and other business services to Russia accounted for 2.7 percent of GDP on average over the period 2016 to 2021. Overall, exports of goods and services to Russia amounted to about 15 percent of total exports over the period 2016 to 2021.

At the present juncture, the authorities consider inflation to be the greatest risk: Harmonized Index of Consumer Prices (HICP) year-on-year inflation is estimated at 8.6 percent in April 2022, climbing from 5.0 percent in January 2022. This is mainly driven by rising international oil prices, which have a significant impact on domestic prices of energy products. However, the impact of inflation on consumer disposable income and confidence has not translated to material wage pressures. In addition, the pass-through of the automatic wage indexation system, which applies to employees in the government and part of the private sector, was weakened by the 2013 reform undertaken during the financial program with international creditors. As a result, Cyprus largely maintains the wage competitiveness achieved with substantial internal devaluation during the financial program. Real estate prices, which also fell sharply during the program period, are only now approaching the long-term trend, with a real estate sector relying more on domestic demand.

In aggregate, the impact of the ongoing pandemic, the war in Ukraine and rising global inflation is projected by the authorities to lower GDP growth this year to a range between 2.3 and 2.7 percent. This is slightly more optimistic than the 2.0 percent growth projected in the staff report, given the uncertainty. The May 2022 flash estimate for 2022-Q1 points to a higher-than-expected growth rate for the quarter, 5.8 percent over Q1 of 2021, which may positively affect the outcome for the year.

The current account deficit widened in 2020 owing to the exogenous shock of the pandemic, but narrowed in 2021 by about 3 percentage points, down to 7.2 percent of GDP. In 2022 it is expected to widen due to the war and the rise in oil and commodity prices impacting the trade balance. Strong FDI flows are the main contributor to financing.

Public finances

Cyprus recorded a significant fiscal correction in 2021: Budget deficit declined to -1.7 percent of GDP from -5.8 percent in 2020, and public debt dropped to 103.6 percent from 115.0 percent. This contributed to the build-up of extensive buffers to cope with near-term risks. While pandemic support measures lapsed for the most part towards the end of last year, a limited set of measures has been put in place to alleviate the impact from rising inflation on production costs and incomes. These range from targeted fiscal transfers to protect vulnerable households and to support affected agricultural sector segments, to across-the-board temporary reductions in VAT for electricity and excise duties on fuels to contain economic repercussions. The authorities agree with staff that additional support should be temporary, targeted, and not hinder labor reallocation should the situation deteriorate, as already foreseen in the authorities' contingency plans.

At the same time, the authorities underscore their firm commitment to further enhance fiscal buffers and maintain solid public finances over the medium-term. The authorities project for 2022 a return to a primary budget surplus and a reduction in public debt to below 100 percent of GDP, as expected before the pandemic, and sustained fiscal consolidation thereafter to anchor public debt reduction on a firmly downward path. Staff projects the same trend albeit at a more gradual pace. Ensuring the public wage bill does not accelerate beyond productivity and undertaking efficiency reforms in the National Health System (NHS) remain central to the government's objectives. The track record and policy credibility of the authorities towards maintaining a sound fiscal position is recognized by credit rating agencies, with one rating upgrade in April and two affirmations in March, amid the current challenging environment.

Financial Sector

The banking sector remained resilient during the pandemic and faced the fallout from the Russian invasion of Ukraine from a sound position, reflecting adequate capitalization and ample liquidity. Nonperforming loans (NPLs) on bank balance sheets fell to 11.3 percent (including branches of third countries) at the end of February 2022 from around 50 percent of total loans during the financial crisis in 2013. This was accomplished mainly by sales and transfers to credit acquiring companies (CACs) and write-offs. The performance of exposures exiting the pandemic moratoria schemes is encouraging as well. About 92 percent of the exposures started being repaid as of December 2021 and only a small residual is either in default or arrears. Lending is also showing signs of recovery for both households and NFCs, despite the economic shocks and the high level of indebtedness.

A source of concern, nevertheless, as also noted by staff, relates to the level and evolution of stage 2 loans – defined as under-performing loans with increased credit risk relative to their origination. Despite a recent improvement, stage 2 loans increased during the pandemic to 15 percent of total loans as of December 2021, versus a 9 percent EU average. While profitability improved over 2021, owing to lower loss provisioning, it remains a challenge, amidst a low-interest environment and cost rigidities.

Direct banking exposure to Russia is low. Russian deposits accounted for 3.5 percent of total deposits (including interbank deposits) in end-December 2021 and declined further to 1.8 percent at the end of March 2022. Loan exposure to Russia amounted to 0.6 percent of total lending (including interbank loans) at the end of March 2022. The Central Bank of Cyprus does not hold reserves with the Central Bank of the Russian Federation. The RCB Bank, a systemically important bank in Cyprus whose business model was affected by the war and ensuing sanctions, is voluntarily winding down its banking operations. Thanks to proactive measures by the Central Bank of Cyprus and the Single Supervisory Mechanism, all deposits were safeguarded without any loss to the taxpayer or any negative spillover to the rest of the banking sector.

Plans to transform the Cyprus Asset Management Company (KEDIPES) into a national asset management company are ongoing, conditional on, among other things, a well-functioning foreclosure framework and in conjunction with a mortgage-to-rent scheme for indebted households and firms. The authorities share staff's recommendation that the planned expansion of KEDIPES should be well-targeted and include safeguards to avoid weakening credit discipline. The authorities are also promoting further improvements in the working environment of CACs and credit servicing companies, including access to data from the land registry.

The authorities share staff's view of the criticality of maintaining a robust foreclosure framework to resolve legacy NPLs and are committed to enhancing its implementation. They also remain committed to mitigating reputational risks related to money laundering and corruption. Cyprus is fully or largely compliant with 36 out of the 40 FATF recommendations, based on a follow-up assessment by MONEYVAL in December 2021, and rated as partially compliant with 4 recommendations. There are ongoing efforts to fully address the findings of the MONEYVAL assessment. The Cyprus Investment Program (CIP) was abolished in October 2020 and citizenships granted without due diligence were revoked. A law establishing a national anti-corruption authority and a bill regulating political lobbying were ratified by the Parliament in February 2022, after the adoption of the whistleblower protection law a month earlier.

Structural Reforms, Digitalization, and the Green Transition

The authorities appreciate staff's dedicated analysis of the Recovery and Resilience Plan (RRP) and climate policies. The allocated amount to Cyprus from the Recovery and Resilience Facility (RRF) of Next Generation EU (NGEU) corresponds to EUR 1.2 billion in grants and loans, spread over 2021- 2026. This is a significant amount considering the size of the economy. The RRP of Cyprus foresees 41 percent of the amount to be used for financing the green transition, 23 percent for advancing digitalization, and the remaining amount for other related issues such as promoting resilience and efficiency in the health care sector.

In addition to investments, a series of structural reforms is encompassed in the RRP. Envisaged judicial reforms to enable timely proceedings would enhance the resilience of the financial sector, including through accelerating NPL workouts. Recent approved legislation refers to civil service and public administration reforms.

The medium-term prospects for inclusive and environmentally sustainable growth are promising: A study by the University of Cyprus in May 2021 estimates that the RRP can increase the GDP of Cyprus by about 3 percent in the short-term and by around 7 percent in the medium-term, compared to baseline. The authorities welcome staff's analysis projecting a more moderate but still significant impact.

The authorities reiterate the importance of achieving national climate targets as part of the country's environmental agenda. Despite rising energy prices, efforts on advancing the green transition continue unabated. In this regard, the authorities welcome staff's analysis of climate policies and dynamics.