

**LAPSE OF  
TIME**

SM/21/62  
Correction 1

May 18, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Cyprus—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/62 (5/4/21) have been provided by the staff:

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Pages 6, 8, 11, 15, 38, 39, 40, 42, 44, 46, 50, 57, 64, 65**

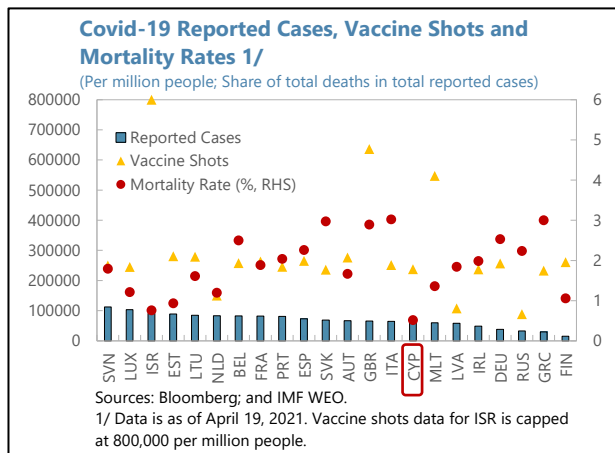
**Typographical Errors**

**Pages 10 and 33**

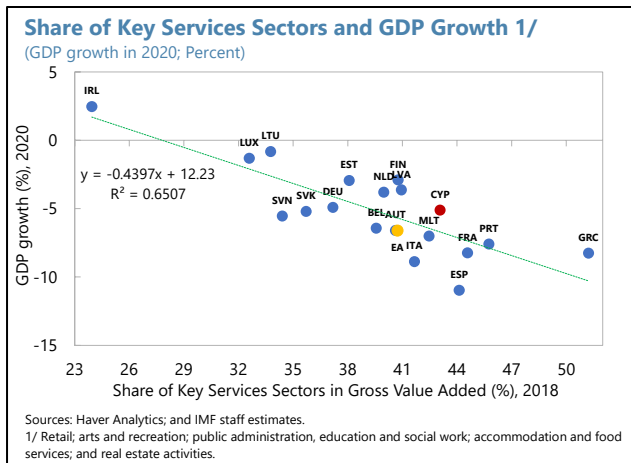
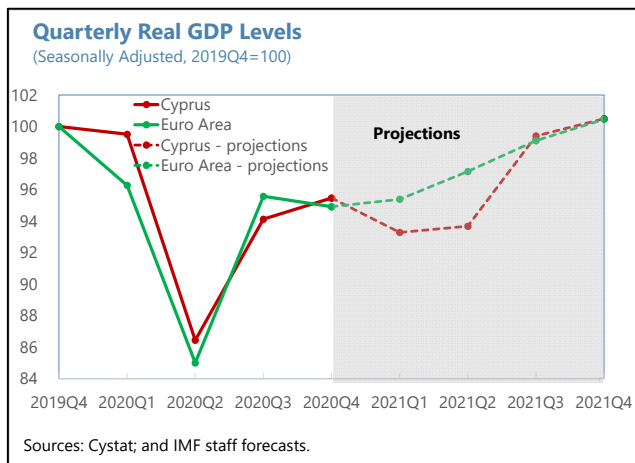
Questions: Ms. Tuladhar, EUR (ext. 34092)  
Ms. Liu, EUR (ext. 36618)  
Mr. Zhang, EUR (ext. 35955)



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



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



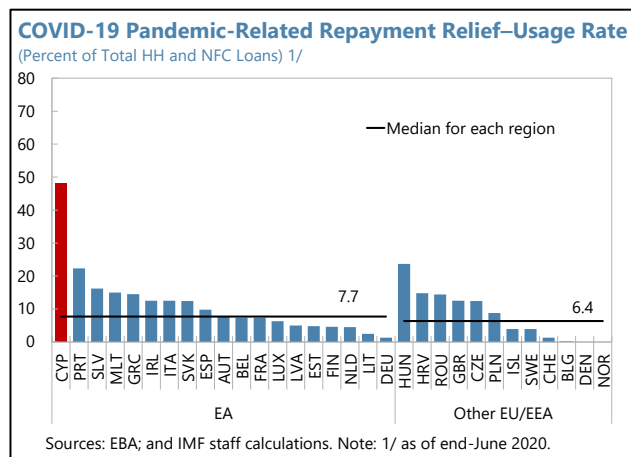
**5. The underlying current account deficit widened as external demand for Cypriot services declined** (Figure 5). Cyprus’s large exposure to the slowing EU and UK markets, as well as its heavy dependence on international tourism, makes it particularly vulnerable to the COVID-19 shock. Adjusted for the effects of special purpose entities (SPEs), the CA deficit widened to 11.96 percent GDP in 2020, compared to 6.38 percent of GDP in 2019. Tourism service receipts

<sup>2</sup> International tourism revenue was 12½ percent of GDP in 2019.

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

### 9. A wide range of supervisory and regulatory measures has also been taken to avoid widespread default and support credit flows

(Table 2). They include temporary capital and liquidity relief and a nine-month loan repayment moratorium from ~~April~~ ~~March~~ 2020 for all performing borrowers. The moratorium was subsequently extended by a further six months for targeted borrowers. With around half of previously performing loans under the moratorium in 2020, an immediate surge in NPLs was avoided. Liquidity strain was largely absent due to stable bank deposits. Payment arrears following the end of the 2020 moratorium have been limited so far, partly reflecting a seasonal repayment schedule that means repayments are not yet due for the most affected businesses.<sup>4</sup>



### 10. Credit growth has slowed substantially

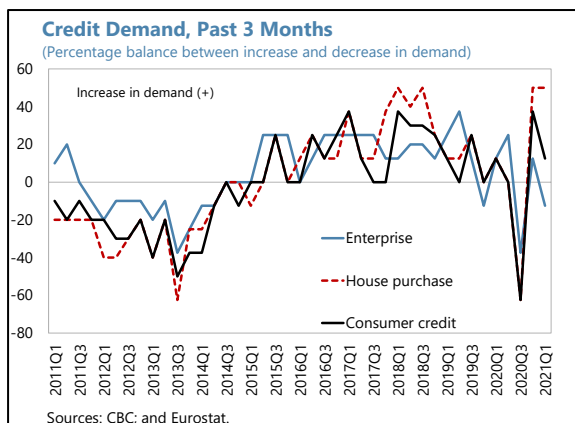
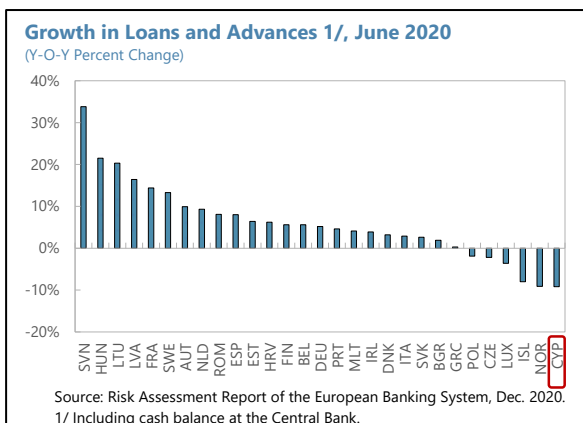
(Figure 6). Euro area monetary easing led to a significant drop in interest rates on new loans. Nevertheless, pure new loans to both non-financial corporates (NFCs) and households have contracted sharply since April. Low credit demand due to limited mobility, reduced refinancing needs, and high private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

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

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

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

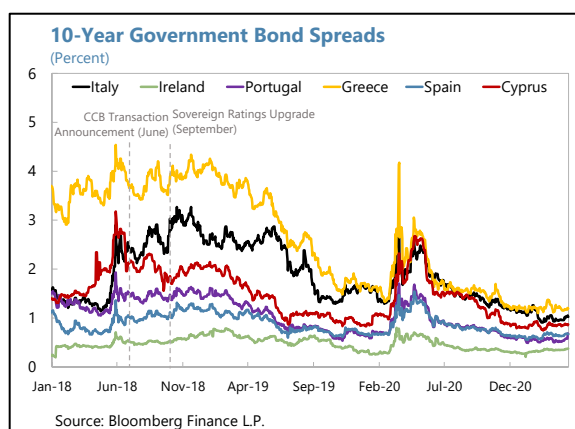
Measures	Application Period
<b>Capital and Liquidity Reliefs</b> <ol style="list-style-type: none"> <li>1. Allow banks to use certain capital buffers (P2G &amp;CCB).</li> <li>2. Allow banks to temporarily operate below the minimum liquidity requirements (LCR).</li> <li>3. Allow using lower quality own funds to meet Pillar 2 Requirements (P2R).</li> <li>4. Delay of phasing- in of Jan. 1 2021 O-SII buffer (0.5percent for banks) by 12 months.</li> </ol>	2020- 2020- 2020- 2021
<b>Interest Rate Subsidies</b> <ol style="list-style-type: none"> <li>1. <b>SME financing</b> through Cyprus Entrepreneurship Fund (CEF). Co-financing and risk sharing (50 percent-50 percent) between the government and the participating banks.</li> <li>2. <b>New business loans:</b> for all businesses facing pandemic related difficulties.</li> <li>3. <b>New mortgages:</b> to support households for new home ownership.</li> </ol>	Pending the signing of the Agreement with the EIF*  June 30, 2021 (pending for approval by the EC* an extension up to December 31, 2021). up to Dec. 31, 2020
<b>Forbearance: Nine-Month Loan Moratorium</b> <ol style="list-style-type: none"> <li>1. <b>Public Covid-19 moratorium</b> available to all customers with arrears of less than 30 days.</li> <li>2. <b>A subsequent moratorium</b> 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.</li> <li>3. The moratoria apply to both capital and interest, while interest continues to accrue, with maximum duration of the payment suspension of 9 months.</li> <li>4. Not an automatic trigger for increased credit risk, and flexibility is allowed in related provisioning requirements.</li> </ol>	April 2020–December 31, 2020 January - June, 2021.
<b>CBC's Relaxation on Criteria for New Loans and Restructuring</b> <ol style="list-style-type: none"> <li>1. <b>Relaxation from the requirements of the Loan origination Directive</b> of the CBC to specific existing customers of the banks for new short-term loans/overdrafts for a certain amount.</li> <li>2. A recommendation to banks to <b>assess borrowers who have applied for the suspension of payments</b> and in cooperation with the borrowers, to reach, without undue delays, a <b>viable restructuring solution</b>, should such a need arise. In such restructuring plans, any charges/fees should be kept at reasonable levels and be fully justifiable.</li> </ol>	Until March 31, 2021
<b>Restriction of Dividend Distributions, Bonus Pay-Outs and Share Buy-Backs</b> <ol style="list-style-type: none"> <li>1. Credit institutions are recommended to refrain from distributing cash dividends or conducting share buy-backs, or to limit such distribution.</li> <li>2. Insurance and re-insurance companies, and Cyprus Investment Firms are recommended to refrain from underlying pay-outs.</li> </ol>	Until September, 2021
<b>Supervisory Flexibility</b> <ol style="list-style-type: none"> <li>1. The 2020 stress tests is postponed.</li> <li>2. Adjusted timetables, including rescheduling on-site inspections, extending deadlines for certain non-critical supervisory measures and data requests.</li> <li>2. Adjusted SREP process, recovery planning, digital operational resilience, and ICT risks.</li> <li>3. Leeway for banks concerning the submission of supervisory reporting data.</li> </ol>	2020-
Sources: ECB, CBC and EBA.	
* EIF stands for European Investment Fund. EC stands for European Commission. OMV stands for open market value.	



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

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

Sources: Cystat and MoF.

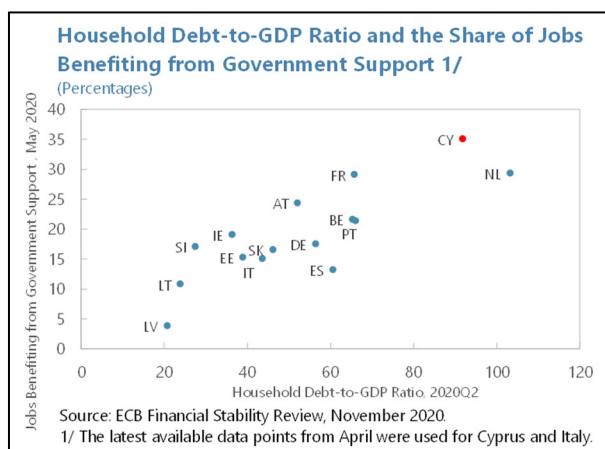


<sup>5</sup> In 2020, the government issued 5–30 year bonds with the total amount of 4.5 billion euros at yields ranging from 0.35 percent to 2.334 percent for pre-financing and debt management operations. Cyprus ~~will receive~~ has already received as a loan amounts to 479 million euros under SURE. Cyprus received the first disbursement of 250 million euros in 2020 and ~~is expected to receive~~ the second disbursement of 229 million euros in 2021. ECB’s net purchase of Cyprus’s sovereign bonds under PEPP and PSPP amounted to €1.71 billion through end-January 2021 and ~~€1.48~~ €3.43 billion through end-February 2021, respectively.

## POLICY ISSUES FOR DISCUSSION

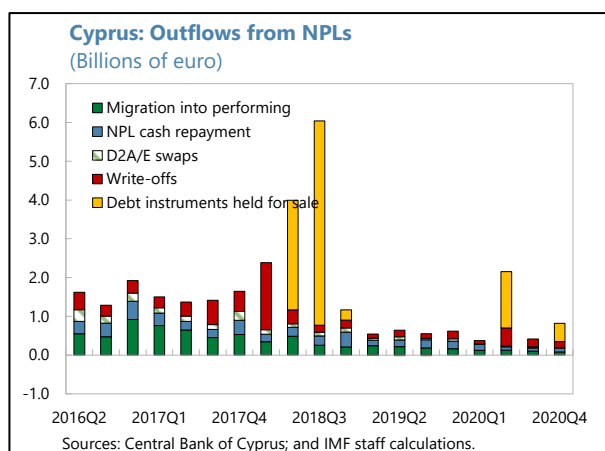
### 17. Policy priorities will depend crucially on the evolution of the health and economic crises.

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



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

**18. Banks have so far been resilient to the pandemic shock** (Figure 7). Liquidity remains abundant and capital ratios (with Tier1 capital at nearly 19 percent) have been stable. Bank profits narrowed due to increased impairment costs, while declining net interest income is mostly offset by consolidation of bank operations. Large NPL portfolio sales<sup>9</sup> and sizable write-offs helped NPLs decline to 17.7 percent at December 2020 from 27.99 percent in February 2020. Provision coverage of NPLs declined to 49.746.3 percent, near the euro area average.

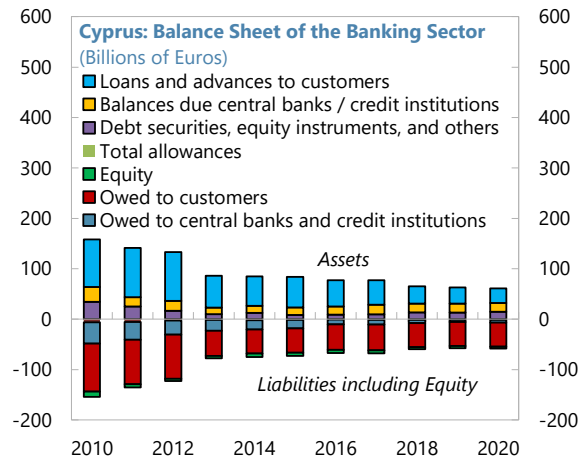


**19. Nevertheless, challenges are building.** Nearly half of legacy NPLs were terminated five years earlier, potentially requiring sizable write-downs (Annex VI). Foreclosures have been suspended until end-July for smaller, collateralized loans and proposals under discussion in Parliament are expected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

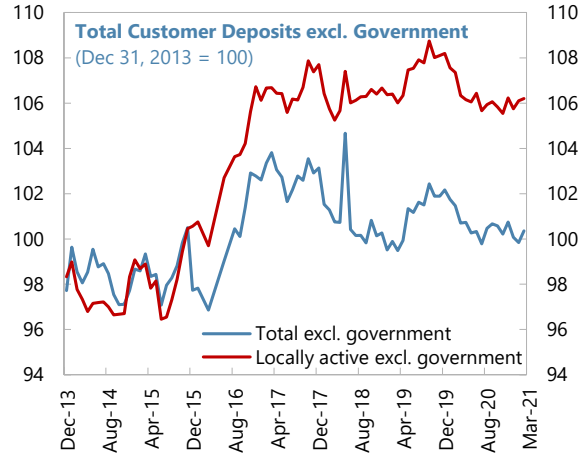
<sup>9</sup> The largest NPL sales were the Bank of Cyprus' Helix II transactions of €1.3 billion.

**Figure 7. Cyprus: Banking Sector<sup>1/</sup>**

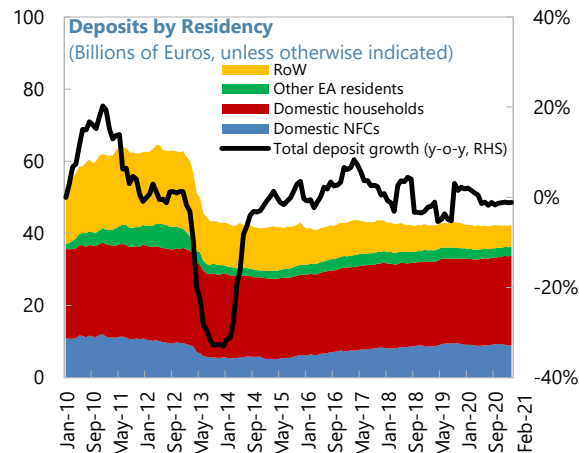
Banks have continued to deleverage.



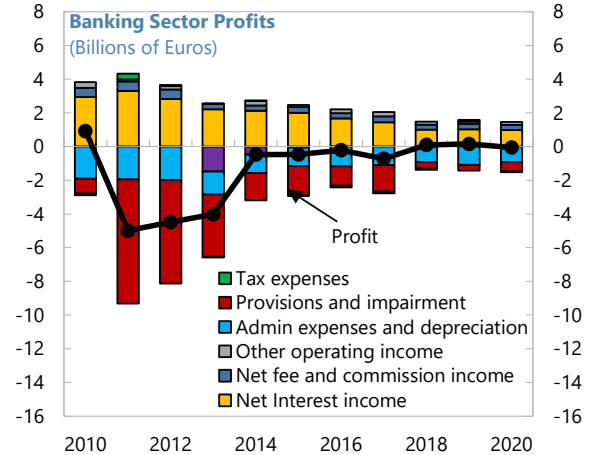
Total customer deposits of locally active banks were broadly stable after an initial decline...



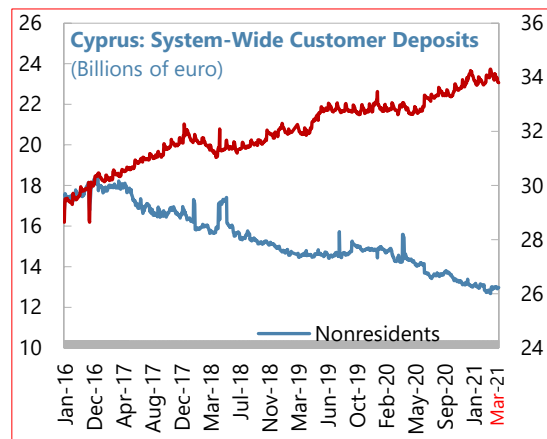
Deposits from both households and NFCs are increasing steadily.



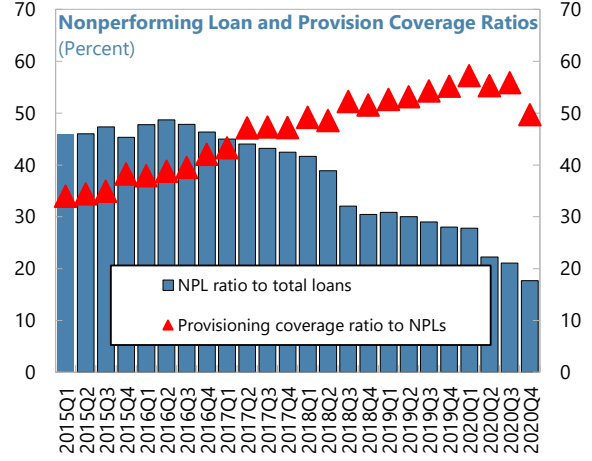
Total profit of the banking sector has declined to near zero as net interest income shrank.



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



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



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

<sup>1/</sup> At end-2014 the CBC adopted the European Banking Authority's definition of NPLs.

**Table 4. Cyprus: Fiscal Development and Projections, 2018–2026 <sup>1/</sup>**  
(Percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Projections			
Revenue	39.5	41.2	40.9	42.9	44.0	44.2	44.1	44.0	43.6
Current revenue	38.5	40.8	40.4	42.3	43.4	43.7	43.6	43.4	43.1
Tax revenue	24.7	24.6	23.9	24.3	24.8	25.0	25.2	25.2	25.2
Indirect taxes	15.1	14.9	13.8	14.3	14.7	14.9	15.0	15.0	15.0
Direct taxes	9.6	9.7	10.1	10.0	10.1	10.2	10.2	10.2	10.2
Other taxes (capital taxes)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	8.6	10.7	11.5	12.4	12.6	12.6	12.7	12.7	12.6
Other current revenue	5.2	5.5	5.0	5.7	6.0	6.1	5.7	5.5	5.3
Capital revenue	1.1	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Expenditure	43.0	39.7	46.6	47.6	45.0	44.6	44.0	43.4	42.8
Current expenditure	32.8	35.2	43.0	43.8	40.8	40.4	39.9	39.4	39.0
Wages and salaries	11.6	12.3	13.9	13.7	13.5	13.5	13.3	13.1	12.9
Goods and services	3.8	4.4	4.4	4.5	3.9	3.9	3.9	3.9	3.8
Social Transfers	12.6	13.5	17.0	17.9	18.1	18.1	18.1	18.1	18.1
Subsidies	0.3	0.3	2.8	2.8	0.8	0.7	0.6	0.5	0.4
Interest payments	2.4	2.3	2.2	2.4	2.3	1.9	1.8	1.6	1.5
Other current expenditure	2.2	2.5	2.7	2.5	2.2	2.2	2.2	2.2	2.2
Capital expenditure	10.2	4.5	3.7	3.8	4.2	4.2	4.1	4.0	3.8
Capital transfers, payable	5.3	1.9	0.7	0.7	0.7	0.7	0.7	0.7	0.6
Gross capital formation less NFA disposal	4.9	2.6	2.9	3.1	3.5	3.5	3.4	3.3	3.2
Overall balance	-3.5	1.5	-5.7	-4.8	-1.1	-0.4	0.1	0.6	0.8
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	-3.5	1.5	-5.7	-4.8	-1.1	-0.4	0.1	0.6	0.8
Net financial transactions	-3.1	1.4	-5.9	-4.8	-1.1	-0.4	0.1	0.6	0.8
Net acquisition of financial assets	9.0	-0.3	13.9	-6.0	-2.8	1.1	-2.3	1.3	-0.4
Currency and deposits	9.0	-0.3	13.9	-6.0	-2.8	1.1	-2.3	1.3	-0.4
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	12.1	-1.7	19.9	-1.3	-1.7	1.5	-2.4	0.7	-1.2
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	19.3	7.0	22.0	-2.6	-2.0	1.3	-2.7	2.4	3.1
Loans	-7.3	-8.8	-2.1	1.3	0.3	0.2	0.2	-1.7	-4.3
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memorandum items:</b>									
Underlying expenditure 2/	35.5	38.4	42.6	42.2	39.3	38.9	38.3	37.6	37.0
Output Gap	3.9	4.9	-1.6	-1.1	-0.5	-0.3	-0.1	0.0	0.0
Underlying overall balance 3/	3.8	1.5	-5.7	-4.8	-1.1	-0.4	0.1	0.6	0.8
Primary balance	-1.1	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
Primary balance (ESA2010)	-1.1	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
Underlying primary balance 3/	6.2	3.8	-3.6	-2.4	1.2	1.5	1.9	2.3	2.4
Structural overall balance 3/	2.1	-0.2	-5.4	-4.5	-0.9	-0.3	0.1	0.6	0.8
Structural primary balance 3/	4.4	2.1	-3.2	-2.1	1.4	1.7	1.9	2.2	2.4
Public debt	99.2	94.0	119.1	114.0	106.4	102.8	95.6	91.8	86.1
Public debt net of cash holding	96.8	89.8	101.8	103.3	99.0	94.6	90.1	85.3	80.2

Sources: Ministry of Finance; and IMF staff estimates.

1/ Accrual basis, unless otherwise indicated.

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

3/ All the three series exclude the fiscal impact of the sale of the CCB transaction and state-owned AMC of 7.4 percent of GDP.

Structural overall balance and primary balance also exclude the impact of the cyclical components.

**Table 5. Cyprus: General Government Financing Requirements and Sources, 2020–2026**  
(Millions of Euros, unless otherwise indicated)

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

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

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

3/ General government debt minus cash holding.

**Table 6. Cyprus: Balance of Payments, 2018–2026**  
(Percent of GDP, unless otherwise indicated)

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

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

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

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

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

**Table 8. Cyprus: Financial Soundness Indicators, 2012–2020 <sup>1/</sup>**  
(Percent, unless otherwise specified)

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

Sources: Central Bank of Cyprus.

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

<sup>2/</sup> 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.

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

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

## Annex II. External Sector Assessment

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

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

### Foreign Assets and Liabilities: Position and Trajectory

**Background.** In 2020, the net international investment position (NIIP) declined to ~~-128~~-141.3 percent of GDP, as lower direct investment liabilities were offset by higher portfolio and other investment liabilities. Excluding the contribution of SPEs' foreign financial positions, the underlying NIIP improved from -78 percent of GDP in 2014 to ~~-41~~-52 percent in 2020. Gross liabilities increased to 2543 percent of GDP in 2020, with around one third in the form of external debt. Under the IMF staff's baseline scenario, the NIIP is projected to decline further temporarily and then gradually improve through the medium term on the back of lower CA deficits.

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

2020 (% GDP)	NIIP: <del>-128</del> <u>-141.3</u> (underlying - <u>41</u> <u>52</u> )	Gross Assets: <u>2411</u> <u>2402</u> (underlying 402)	Debt Assets: <del>530</del> <u>539</u>	Gross Liab.: 2543 (underlying 459)	Debt Liabilities.: 909
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### Capital and Financial Accounts: Flows and Policy Measures

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

## Annex III. Debt Sustainability Analysis

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

### A. Baseline Scenario

1. **Public debt rose sharply in 2020, reflecting the negative output growth and the discretionary fiscal response to the pandemic.**<sup>1</sup> In addition, the government issued Eurobonds of €1.75 billion in April 2020 to pre-finance anticipated spending needs and started accessing EC's SURE funds, building up a large cash buffer of around 20 percent of GDP.<sup>2</sup> As a result, the debt-to-GDP ratio increased by 25 percentage points to above 119 percent at end-2020. In February 2020, Cyprus repaid early the remaining balance of the Extended Fund Facility credit to the IMF.
2. **Public debt is projected to resume a steady decline from 2021.** Projected improvements in primary balances and a negative interest-economic growth differential going forward will support a durable decline in public debt to around 86 percent of GDP by 2026.
3. **The gross public financing needs (GPFN) are expected to remain below the benchmark.** The debt issuance to the Cyprus Cooperative Bank (CCB) was implemented through a private off-market placement of domestic bonds, which are being redeemed gradually over a five-year period beginning 2018. The gross financing needs of the government increased to 17.3 percent of GDP in 2020 from 13.3 percent of GDP in 2019 but will remain well below the benchmark for advanced economies (20 percent of GDP) over the projection horizon<sup>3</sup>. 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.

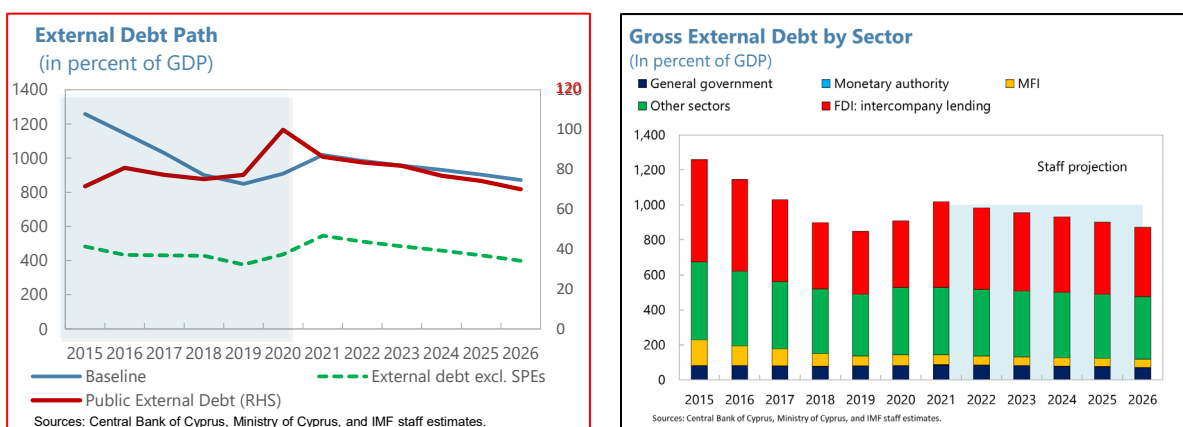
<sup>1</sup> The coverage of the public DSA is the general government. Debt guaranteed by the government is not included in the baseline DSA, but debt of public entities guaranteed by the general government as well as deficits of public entities is included in the calculation of the DSA contingent liabilities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

<sup>2</sup> In April 2020, the government issued a seven-year bond of 1.25 billion euros at a yield of 1.556 percent and a 30-year bond of 0.5 billion euros at 2.334 percent. Cyprus ~~will receive~~ has already received as a loan amounts ~~up to~~ 479 million euros under SURE. Cyprus received the first disbursement of 250 million euros in 2020 and ~~is expected to receive~~ the second disbursement of 229 million euros in 2021.

<sup>3</sup> The projection assumes interest rates of 1.4 percent for 7-year Eurobond and 1.8 percent for 15-year Eurobond.

## E. External Debt Sustainability Analysis

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



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

<sup>8</sup> 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.

**Figure 6. Cyprus: External Debt Sustainability Framework**  
(Percent of GDP, unless otherwise indicated)

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

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 VI. Solutions for Legacy Non-Performing Loans in Cyprus

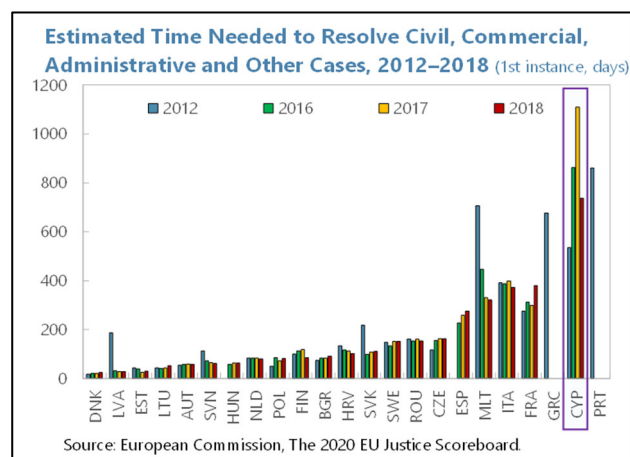
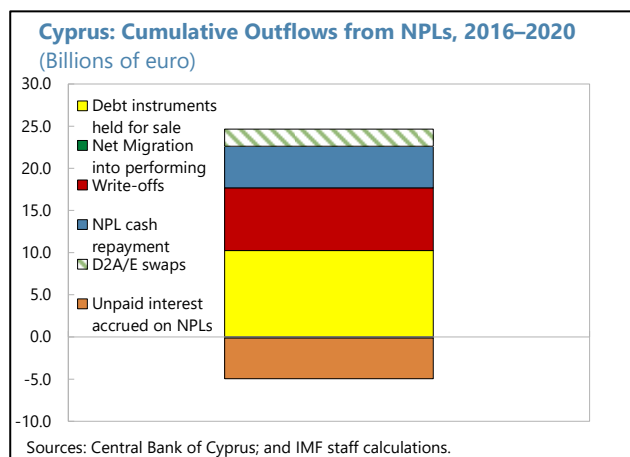
**1. NPLs in Cyprus remain sizable, with an aged portfolio split among households and SMEs.** While the NPLs have declined significantly, the stock remains large (23.5 percent of GDP, 17.7 percent of loans) at end-December 2020. NPLs of households (HHs) account for 54 percent of total NPLs, while that of SMEs (predominantly construction, tourism, and trade sectors) account for 34½ percent. Although the portfolio is estimated to be largely secured, the share of NPLs more than 5 years past due stood at 45 percent at end-2020, underscoring potential difficulties with loan recovery. Provisions for NPLs has declined to 49.746.3 percent in December 2020. Provisioning is lower for NPLs to households at 4442.1 percent.

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

Source: Central Bank of Cyprus and IMF staff calculations.

Note: Non-performing loans are defined as in Commission Implementing Regulation (EU) 227/2015 on Supervisory reporting on forbearance and non-performing exposures.

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



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

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