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In-Depth Review for Cyprus

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

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EXECUTIVE SUMMARY

The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for Cyprus to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "excessive macroeconomic imbalances" in Cyprus. These excessive imbalances related to a very high share of non-performing loans that burdens the financial sector and high private sector, government and external debt, in a context of moderate potential growth. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year's in-depth review (IDR) for Cyprus is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the 2021 spring forecast, which expects a recovery in economic activity in Cyprus with the easing of the COVID-19 crisis.** After the steep drop of 5.1% in 2020, real GDP is projected to increase by 3.1% this year and 3.8% next year, allowing the economy to recover its pre-pandemic level in 2022.

- **External debt remains high and the current account deteriorated substantially.** The negative net international position (NIIP) worsened from -122% of GDP in 2019 to -141% in 2020. Excluding Special Purpose Entities (SPEs), it stood at -52% of GDP in 2020, slightly above fundamental and prudential benchmarks. The NIIP, both standard and excluding the SPEs, is likely to deteriorate going forward, due to large projected current account deficits of around 11% and 9% of GDP in 2021 and 2022, respectively. A quicker recovery of international tourism than projected and a swifter return to the government's pre-pandemic net lending position could help mitigate such developments.

- **The high public debt ratio increased significantly in 2020, but is expected to return on a declining path in 2021.** While in 2019 the public debt ratio had declined to 94% of GDP, it went up to 118% in 2020, due to the combined effect of the fall in economic activity and the measures taken to address the COVID-19 pandemic and its impact. The government built a sizeable cash buffer throughout 2020, covering its increased financing needs and managing liquidity risks. The debt ratio is forecast to decline to 112% in 2021 and further to 107% in 2022, due to GDP growth and the use of excess cash reserves accumulated since the beginning of the pandemic to cover financing needs.

- **The COVID-19 crisis interrupted the private sector deleveraging.** In consolidated terms, the private debt-to-GDP ratio has been falling in the last years, from a peak of 352% of GDP in 2014 to 259% of GDP at the end of 2019, which was still high even when excluding the debt of non-financial SPEs. The debt ratios of both households and non-financial corporations increased in 2020, mostly due to the drop in GDP, but also to deferred payments under a loan moratorium. Provided that repayments restart smoothly after the moratorium, deleveraging should resume.

- **Resolving the remaining non-performing loans (NPLs) continues to be challenging and ensuring an effective foreclosure framework remains essential for further progress to take place.** NPLs remain high at 18% of gross loans as of the end of 2020, despite a substantial decline from close to 45% in 2015. The strategies to reduce NPLs currently depend, largely, on a well-functioning foreclosure framework. Proposals for further weakening this framework, following the 2020 amendments that lengthen procedures, are a source of concern. The high share of NPLs (45%), in arrears for five years or more underscores the need for additional efforts to facilitate legacy asset disposal. Moreover, the absence of an efficient and reliable system for transferring and issuing property rights also hinders foreclosure procedures and makes it difficult to value collaterals.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "excessive macroeconomic imbalances" in Cyprus. These excessive imbalances related to a very high share of non-performing loans that burdens the financial sector, and high private sector, government, and external debt, in a context of moderate potential growth. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review (IDR) should be undertaken for Cyprus with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this supports adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRPs and does not draw on information included in RRPs. It is therefore without prejudice to the Commission's assessment of RRPs, which is ongoing at the time of publication of this report.

The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at the external position (chapter 2), household debt (chapter 3) and corporate debt (chapter 4). In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

Real GDP growth is forecast to rebound after the COVID-19 crisis, moderately in 2021 and more strongly in 2022 when real GDP is expected to surpass its 2019 level. The COVID-19 pandemic and the accompanying lockdown measures resulted in a sharp real GDP contraction in 2020 (5.1%), albeit less than the EU average (6.2%). The rising infection rate at the end of 2020 and in April 2021 led to the adoption of lockdown measures in Cyprus in the first half of 2021. The measures affected a smaller share of economic activity than in spring 2020, however, the hospitality industry has borne the brunt. A modest recovery is expected in 2021, with 3.1% real GDP growth. In 2022, the growth rate is expected to accelerate to 3.8%, as prospects for the tourism sector are expected to further improve. The current account deficit deteriorated in 2020 to 11.9% of GDP in 2020 from 6.3% in 2019, due to the plummeting receipts from travel accompanied by a lower than expected decline in the imports of services, and is expected to improve only slowly to around 9% of GDP by 2022. The impact of the COVID-19 pandemic on the labour market has been mitigated by temporary income support measures (such as short-time work schemes), with employment decreasing by only 0.6% in 2020 and the unemployment rate increasing to 7.6%, from 7.1% in 2019. The labour market is expected to recover in 2021 and 2022 and unemployment to gradually decrease to 7.2% in 2022. Inflation is expected to edge up to 1.7% in 2021 due to significantly higher oil prices, and to moderate to 1.1% in 2022.

The economic recovery is expected to be mainly driven by domestic demand and a small positive contribution from net exports. Domestic demand increased by 0.7% in 2020 compared to 2019, helped by policy measures adopted to contain the COVID-19 crisis. Private consumption showed signs of a moderate recovery in the first half of 2021 and it is expected to further grow due to pent-up demand.

Public consumption is expected to continue to make a positive contribution to growth in 2021, as several support measures to contain the crisis continue and the public sector pay-roll is expected to increase. Investment is forecast to surpass its pre-crisis level in 2022 mainly on the back of construction activity and the positive contribution of the Recovery and Resilience Plan, which will gradually have an impact as of the end of 2021 with the implementation of investments and reforms. Construction has so far escaped disruption from the lockdown measures in 2021 and the planned large-scale infrastructure projects continue. The abolition of the citizenship-by-investment scheme in November 2020 is expected to gradually reduce demand for high-end residences over the next years, but new lending for housing has picked up since the third quarter of 2020, helped by the mortgage subsidisation scheme adopted by the government for first residences. Tourism is set to recover only moderately in 2021, as the COVID-19 pandemic continues to disrupt air travel and the outlook for the summer season. Uncertainty and downside risks to the growth outlook remain significant. The sizeable pre-existing private- and public sector debt levels exacerbate the downside risks. On the positive side, the swifter-than-expected vaccination campaigns in the EU could be a significant benefit for the tourism sector in Cyprus.

Imbalances and their gravity

The country's net international investment position (NIIP), particularly concerning net external debt, remains a source of vulnerability. In 2020, the NIIP stood at around -141% of GDP — one of the largest in the EU. The part of the NIIP that excludes foreign direct investment and equity positions (NENDI), amounted to around -176% of GDP, reflecting large external debt liabilities. A sizeable portion of the Cypriot external assets and liabilities can be attributed to special purpose entities (SPEs). According to the Central Bank of Cyprus data, excluding SPEs' positions, a different picture of external stocks emerges, with the NIIP equals to -52% of GDP end of 2020, only slightly above both fundamental and prudential benchmarks and below the scoreboard threshold of -35%. Yet, gross external debt of Cyprus excluding SPEs remains relatively high at 287% of GDP, of which 47% of GDP are related to non-SPE intercompany debt while the external debt of general government amounts to 99.7% of GDP. The latter largely comprises the debt to international financial institutions under the macroeconomic adjustment programme, and is less exposed to short-term risks (see section 2).

The large current account deficit is not conducive to external rebalancing. The current account deficit deteriorated from -6.3% of GDP in 2019 to -11.9% of GDP in 2020. This deterioration reflects to a significant extent the large decline in exports of services, notably tourism, due to the COVID-19 crisis: international travel balance, which equalled 6.6% of GDP in 2019, turned negative at -0.9% of GDP in 2020. At the same time, imports of goods and services were relatively cushioned from the negative shock to GDP, as the government's support measures helped mitigating the decline in domestic demand. Prior to the pandemic, the cyclically-adjusted current account balance of Cyprus was close to the current account required to stabilise the NIIP excluding SPEs at a level just above the prudential benchmark (a required current account of around -1.8% of GDP). Following the strong deterioration in 2020, the cyclically adjusted current account balance fell well below this required current account.

The high public debt to GDP ratio increased significantly in 2020. While in 2019 Cyprus reduced its public debt ratio to 94% of GDP, the government debt ratio increased to 118% by end-2020 on the back of the COVID-19 pandemic and measures to protect the economy. The latest debt sustainability analysis confirms that the country faces *medium* risk in the medium-term. ([1]) Cyprus has enjoyed a supportive market environment when tapping the international markets and it continues to enjoy 'investment grade' ranking by three major rating agencies. The government built a sizeable cash buffer throughout 2020, covering its increased financing needs and managing liquidity risks.

Vulnerabilities relate to high corporate and households indebtedness, which have been exacerbated by the COVID-19 crisis. In consolidated terms, the private debt-to-GDP ratio has been falling in the last years from the peak of 352% in 2014, to reach 259% of GDP at the end of 2019. A year later, the ratio rose to 267%. As it stands, the private debt ratio is well above the prudential threshold (129% in 2020)

([1]) See Article 126(3) report (June 2021) and European Commission (2021), Post-Programme Surveillance Report – Cyprus, Spring. The Debt Sustainability Monitor 2020 contains detailed methodological explanations.

and above the fundamental benchmark (249%), remaining among the highest in the EU. Household debt-to-GDP stood at 89% at end of 2019, while in Q4 2020 it increased to 92%. For the same period, the NFC debt-to-GDP ratio was 170%, increasing to 179% at the end of Q4 2020. ([2]) The increase in the private debt ratios is mostly due to the drop in the GDP (see sections 3 and 4).

Despite the COVID-19 pandemic, the non-performing loans in the banking sector were reduced through both sales and write-offs. At the end of December 2020, the total stock of non-performing loans held by the banks stood at EUR 5.1 billion (17.7% of gross loans), down from EUR 9 billion (27.9%) a year earlier. ([3]) The decline was mainly the result of sales (EUR 2.0 billion) and write-offs (EUR 1.1 billion) made by the main banks (Bank of Cyprus and Hellenic Bank). ([4]) Non-performing loans were reduced for both non-financial corporations and households. For the household segment, the progress was achieved primarily through write-offs.

Evolution, prospects and policy responses

Cyprus' net international investment position is becoming more negative as the current account deficit is deteriorating. The negative net international position worsened from -122% of GDP at the end of 2019 to -141% in 2020. An increase in external government debt by about 22 percentage points (year-on-year) contributed to the widening of the defaultable part of the NIIP, from -159% in 2019 to -176% in 2020. The NIIP, both standard and excluding the SPEs, is likely to deteriorate quickly going forward, due to large projected current account deficits of around 11% of GDP in 2021 and 9% in 2022 (section 2). A quicker recovery of international tourism than projected could help mitigate such developments. In addition, consistent with the phasing out of the government support measures once the COVID-19 pandemic had receded, the general government net borrowing position is projected to improve gradually. A potentially swifter return to government's pre-pandemic net lending position would also contribute to improved external balance dynamics.

The government debt-to-GDP ratio is forecast to resume its declining path in 2021. Public debt is projected to gradually decline to 112% in 2021, and to 107% in 2022. Output growth and the use of excess cash reserves (accumulated since the beginning of the COVID-19 pandemic) to cover financing needs are the key factors behind the decrease in the public debt ratio. The fiscal outlook is surrounded by downside risks, whereby the main one relates to the future evolution of the COVID-19 pandemic and its adverse effects on the recovery. ([5])

The increase in the private debt ratio in 2020 halts its decreasing trend. Going forward, deleveraging depends on the strength of the economic recovery. After a strong deleveraging since its macroeconomic adjustment programme, the private debt-to-GDP increased in 2020, mainly reflecting the fall in GDP in light of the COVID-19 crisis. Past debt reduction has been supported by both nominal GDP growth and nominal debt stock declines (driven by write-offs of bad loans, cash repayments and debt-to-asset swaps). In 2020, lending to households was positive, but lending to non-financial corporations was slightly negative (sections 3 and 4). Overall, private sector credit flows (as % of GDP) accelerated from 2.4% in 2019 to 5.4% in 2020, which is still well below levels in previous years. About 50% of performing loans benefited from the first loan payment moratorium - representing the highest share in the EU. While early signs following the lifting of the 2020 moratorium were encouraging, the outlook is uncertain with respect to the new inflows of non-performing loans. Prolonged financial problems for firms and households could pose threats to their debt repayments. If the capacity of households and firms to absorb losses becomes insufficient, non-performing or forborne loans and defaults will increase. As such, finalizing the organizational structure of the new Department of Insolvency, digitalizing its tools and promoting the insolvency proceedings are important measures that Cyprus should accelerate.

([2]) The NFC figures include the debt of special-purpose entities.
([3]) The NPL ratios (i.e. ratios of NPL stock to total gross loans) are based on the data and scope used by the Central Bank of Cyprus. In particular, no account is taken of banks' exposures to central banks and credit institutions, or their overseas operations (branches and subsidiaries located abroad). Source: Aggregate Cyprus banking sector data (non-performing loans data), https://www.centralbank.cy/en/licensing-supervision/banks/aggregate-cyprus-banking-sector-data
([4]) Hellenic Bank reduced its NPL stock mainly through write-offs.
([5]) Se also European Commission (2021), Post-Programme Surveillance Report – Cyprus, Spring.

Resolving the remaining non-performing loans continues to be challenging. Preserving the foreclosure framework is essential for making further progress. Most of the non-performing loans held by the banks are classified as 'terminated' (i.e. no feasible negotiation options remaining). In addition, a high share of non-performing loans (45%), have been in arrears for five years or more. Due to its low take-up, the ESTIA scheme ([6]) is expected to help address a perimeter of only about EUR 170 million of NPLs. As such, it did not materialise as the tool the authorities were envisioning for significantly reducing non-performing loans in the economy. Although several factors might have contributed to the low take-up of the scheme, a key driver appears to be debtors' reluctance to reveal their net-wealth position, as well as expectations of a more generous scheme or reliance on a less stringent approach to collateral enforcement. Furthermore, new discussions have resurfaced on legislative amendments potentially weakening further the foreclosure framework. Such proposals are a source of concern as it is important to preserve the foreclosure framework in order to make further headway with non-performing loans workouts, asset sales and improving payment discipline. In addition, about 50% of performing loans benefited from the first loan payment moratorium in 2020 (the highest take-up in the EU). While early signs were encouraging following the lifting of the 2020 moratorium, the outlook is uncertain with respect to the new inflows of NPLs. Moreover, the absence of an efficient and reliable system for transferring and issuing property rights hinders foreclosure procedures and makes it difficult to value collaterals.

Overall assessment

Despite progress in previous years, Cyprus continues to face significant vulnerabilities relating to external, public and private debt – which have been exacerbated by the COVID-19 pandemic. The impact of the COVID-19 crisis on the tourism sector played an important role in the GDP decline and deterioration of the current account and will continue to dampen growth and services net exports looking forward. The current account deficit has widened sharply in 2020 and is expected to remain at around this level in 2021 and 2022. The large and negative NIIP deteriorated further in 2020. The public debt increased by more than 20 percentage points in 2020 as the government borrowed extensively in order to cover the increased financing needs and for securing cash reserves for handling adverse scenarios. Nevertheless, it is forecast to start declining already this year. While still excessive before the COVID-19 pandemic, the private debt was on a declining trend. In the aftermath of COVID-19 shock, both households and non-financial corporations experienced increased debt ratios. Vulnerabilities associated with non-performing loans persist, but stocks held by the banks declined in 2020 mostly through sales. However, despite the off-loading from the banking sector, the bad loans still remain in the economy and need to be resolved. Following the lifting of the loan payment moratorium, early performance signs have been positive, but more time is needed for a clearer view on new non-performing loan flows.

Measures are still needed to foster competitiveness and diversify investments towards more productivity-enhancing sectors and the environment, thus ensuring sustainable growth in the long term and rebalancing the current account. Stable and well-functioning foreclosure and insolvency frameworks remain essential for the reduction of non-performing loans and debt work-outs. Resolving remaining issues of the state-owned asset management company and overcoming functional shortcomings of credit acquiring companies and servicers when dealing with credit facilities are important as well (for reducing the bad loans outside the banking sector). Furthermore, steadfast efforts are needed to improve the system for issuing and transferring property titles, the handling of the non-performing loans in the courts and the enforcement of judgements.

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

Table 1.1: **Assessment of Macroeconomic Imbalances Matrix - Cyprus**

	Gravity of the challenge	Evolution and prospects	Policy response
Imbalances (unsustainable trends, vulnerabilities and associated risks)			
External position	The net international investment position remains very negative. It stood at -141% of GDP in 2020 from -122% in 2019. Adjusting for special purpose entities (SPEs), which are often without links to the Cypriot economy, according to Cyprus Central Bank's data, the net international investment position amounted to -52% of GDP. Gross external debt of Cyprus remains high at 287% of GDP excluding SPEs, of which 47% of GDP are related to non-SPE intercompany debt and 99.7% of GDP to debt of the general government. The current account is in substantial deficit, at -11.9% of GDP in 2020 (section 2).	The net international investment position is widening mainly as a result of a deteriorated current account and a decrease in GDP, both related to the pandemic. Decreased exports of tourism services due to the Covid-19 crisis and strong domestic demand for imports are projected to keep the current account in substantial deficit, despite some gradual improvement expected in 2021 and 2022, to 11% of GDP and 8.9%, respectively. Post-pandemic phasing out of the government support measures is expected to improve the general government net borrowing position and thus contribute to an improvement in overall external position. (section 2). Domestic savings increased in 2020, due to forced savings by the crisis, but remain relatively low, particularly for the household sector.	The Covid-19 crisis has had a severe impact on the tourism sector and it will take some time to go back to or surpass the pre-crisis levels. A tourism strategy is set to be implemented with the aim of further extending the season and improving the quality of tourism services. However, its medium-term impact remains to be seen. Diversification of the export products of Cyprus would also help to improve the sustainability of the current account.
Public debt	Public debt increased by more than 20 percentage points, to 118% of GDP in 2020.	Cyprus' debt-to-GDP ratio is expected to return to a declining path in 2021, and fall to around 107% by the end of 2022 (based on the Commission's Spring Forecast). The decline comes on the back of GDP growth and usage of cash reserves (accumulated through extensive borrowings undertaken in 2020).	The general government deficit is expected to narrow to 5.1% of GDP in 2021, down from 5.7% in 2020. Additional support measures undertaken to mitigate the effects of the pandemic, supporting employment and businesses, should amount to around 3.5% of GDP in 2021. The deficit is forecast to narrow further to 2% of GDP in 2022 on the back of the continuing recovery of the economy and withdrawal of support measures.
Private debt	Standing at 273% of GDP in Q4 2020, private sector debt remains one of the highest in the EU. The level of debt is above both prudential and fundamental benchmarks (sections 3 and 4). A large proportion of private debt stock is non-performing (see 'Financial sector' below).	The private sector debt-to-GDP ratio increased, largely because GDP fell in 2020 due to the COVID-19 crisis. Under the March-December 2020 moratorium, loan payments were deferred. Borrowers' participation in insolvency processes should facilitate debt-workouts, but, so far, there has been limited progress with insolvency proceedings. Examinership and personal insolvency arrangements continue to be scarcely used.	A New Department of Insolvency was established in 2020 but several steps still need to be undertaken to make it effective. The transposition of the Directive 2019/1023 on preventive restructuring frameworks into Cypriot law is considerably delayed. Debt repayment discipline is still weak and justice reform, which would improve the handling of the NPLs in courts and the enforcement of judgements, remains pending. A quick and transparent system for issuing and transferring property titles that would enable liquidation of collaterals is also pending.

(Continued on the next page)

Table (continued)

Financial sector	Cyprus continues to have one of the highest ratios of non-performing loans (NPL) in the EU. The NPL ratio was at 17.7% at end 2020 (considering only the non-financial private sector). Both households and non-financial corporations have large shares of NPLs (sections 3 and 4). In addition, a non-negligible share of NPLs lies outside the banking system, held by credit-acquiring companies, including the state-owned asset management company, KEDIPES.	Progress in reducing NPLs in the banking sector continued in 2020, despite the pandemic. Portfolio sales and write-offs were the key drivers behind the sizeable decline in the stocks of bad loans. NPLs declined for both non-financial corporations and households. The remaining stock of NPLs is dominated by terminated accounts, and furthermore, a high share of NPLs (45%), have been in arrears for five years or more. During 2020, creditors voluntarily suspended foreclosures between March and August, but activity resumed thereafter. Foreclosures of primary residences and primary business commercial real estate, have been further suspended from December 2020 to end-July 2021.	The foreclosure framework was strengthened in 2018, but in 2019 new amendments were brought in, which backtracked on key elements of the previous year's reform. The 2019 amendments were confirmed by the Supreme Court in 2020. Recent attempts to weaken the framework generate legal uncertainty. Furthermore, these proposals are worrying as they would threaten NPL resolution and payment discipline. The government implemented the ESTIA scheme, which has however fallen short of its purpose (reducing NPLs) due to its low take-up. Nevertheless, the scheme indicates the existence of strategic defaulters. While KEDIPES progressed on the loan servicing agreement, efforts need to be sustained in resolving remaining issues such as revising the business plan, reducing staff, and data-cleansing information on loans. The supervision of credit acquiring companies (CAC) has been strengthened. The authorities also prepared a package of bills on improving the working environment for credit acquirers and credit servicers (for example by granting them access to the land registry). It is essential to accelerate reforms that would improve the handling of NPL cases by the courts.

Main takeaways

- Cyprus has for long been marked by significant vulnerabilities such as large stocks of external liabilities, elevated public and private debt, and still high levels of non-performing loans, alongside a very negative current account deficit.
- In view of the pandemic and ensuing recession, these vulnerabilities have augmented. The current account deficit deteriorated significantly to double-digit territory, due to the Covid-19 crisis, a development which does not bode well with the large negative NIIP. In general, debt burdens have increased. Government debt increased significantly as Cyprus has issued several bonds since the beginning of the pandemic, in response to the increased financing needs. Household and corporate debt increased also as GDP declined and loan payments have been deferred under the moratoria. In contrast, the NPLs stock held by banks has declined on the back of sales and write-offs in 2020, but may edge up going forward especially as the moratorium expires.
- Measures are still needed to foster competitiveness and diversify investments towards more productivity-enhancing sectors and the environment, thus ensuring sustainable growth in the long term and rebalancing the current account. Stable and well-functioning foreclosure and insolvency frameworks remain essential for the reduction of non-performing loans and debt work-outs. Resolving remaining issues of the state-owned asset management company and overcoming functional shortcomings of credit acquiring companies and servicers when dealing with credit facilities are important as well (for reducing the bad loans outside the banking sector). Furthermore, steadfast efforts are needed to improve the system for issuing and transferring property titles, the handling of the non-performing loans in the courts.

Source: European Commission

Table 1.2: **Selected economic and financial indicators, Cyprus**

	2004-07	2008-12	2013-18	2019	2020	2021	2022
Real GDP (y-o-y)	4.9	0.1	0.3	3.1	-5.1	3.1	3.8
Potential growth (y-o-y)	3.8	2.1	0.1	1.9	1.6	1.7	1.7
Private consumption (y-o-y)	6.2	0.4	1.7	1.8	-3.9	1.1	2.3
Public consumption (y-o-y)	2.7	2.4	-1.2	15.1	13.1	4.0	-1.6
Gross fixed capital formation (y-o-y)	10.0	-8.1	4.7	2.0	-2.0	3.8	4.8
Exports of goods and services (y-o-y)	3.5	1.4	7.0	-0.4	-12.4	5.3	7.6
Imports of goods and services (y-o-y)	5.9	-0.1	6.5	2.0	-4.2	3.7	4.8
Contribution to GDP growth:							
Domestic demand (y-o-y)	6.5	-1.1	-0.2	3.8	-0.7	2.3	2.1
Inventories (y-o-y)	-0.2	0.4	-0.1	1.0	1.4	0.0	0.0
Net exports (y-o-y)	-1.4	0.5	0.5	-1.7	-5.8	0.8	1.7
Contribution to potential GDP growth:							
Total Labour (hours) (y-o-y)	1.3	0.9	0.0	0.9	0.8	0.8	0.6
Capital accumulation (y-o-y)	2.0	1.4	0.4	1.0	0.8	0.9	0.9
Total factor productivity (y-o-y)	0.4	-0.3	-0.3	0.0	0.0	0.1	0.1
Output gap	4.0	0.4	-2.9	5.4	-1.9	-0.9	0.7
Unemployment rate	4.6	7.0	12.9	7.1	7.6	7.5	7.2
GDP deflator (y-o-y)	3.0	2.0	-0.2	0.9	-1.5	1.4	1.2
Harmonised index of consumer prices (HICP, y-o-y)	2.1	2.7	0.3	0.5	-1.1	1.7	1.1
Nominal compensation per employee (y-o-y)	3.7	2.7	-1.0	1.9	-3.2	1.6	1.8
Labour productivity (real, person employed, y-o-y)	1.4	-0.1	-0.2	0.0	-4.6	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2.3	2.8	-1.8	1.9	1.5	-0.9	-1.0
Real unit labour costs (y-o-y)	-0.7	0.7	-1.6	1.0	3.0	-2.3	-2.2
Real effective exchange rate (ULC, y-o-y)	0.5	0.6	-2.0	-1.7	.	.	.
Real effective exchange rate (HICP, y-o-y)	-0.1	-0.4	-0.7	-2.2	0.6	0.7	-0.9
Net savings rate of households (net saving as percentage of net disposable income)	1.4	-0.5	-6.8	-3.4	.	.	.
Private credit flow, consolidated (% of GDP)	29.4	18.5	1.5	2.7	.	.	.
Private sector debt, consolidated (% of GDP)	244.5	308.6	321.7	259.1	.	.	.
of which household debt, consolidated (% of GDP)	88.5	117.1	116.0	89.5	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	155.9	191.5	205.7	169.7	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	.	8.9	29.8	15.4	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-9.8	2.3	6.4	-0.8	1.6	2.0	1.6
Corporations, gross operating surplus (% of GDP)	23.7	20.0	21.2	20.4	22.9	23.2	22.3
Households, net lending (+) or net borrowing (-) (% of GDP)	-7.7	-5.5	-5.5	-6.9	-7.5	-7.8	-8.5
Deflated house price index (y-o-y)	6.8	-4.9	0.7	2.6	0.7	.	.
Residential investment (% of GDP)	10.9	8.2	4.9	7.9	7.8	.	.
Current account balance (% of GDP), balance of payments	-6.2	-7.7	-3.7	-6.3	-11.9	-11.2	-9.0
Trade balance (% of GDP), balance of payments	-2.2	-6.4	0.9	-1.1	-6.2	.	.
Terms of trade of goods and services (y-o-y)	-0.5	-0.4	-0.1	-1.2	1.6	-0.7	0.1
Capital account balance (% of GDP)	0.1	0.3	0.6	0.1	0.1	.	.
Net international investment position (% of GDP)	-68.2	-123.6	-146.3	-122.3	-141.3	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1)	.	-69.2	-186.2	-159.5	-175.7	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	.	622.7	601.0	505.3	545.0	.	.
Export performance vs. advanced countries (% change over 5 years)	-13.8	-7.5	2.9	11.6	16.2	.	.
Export market share, goods and services (y-o-y)	-5.8	-4.2	2.0	-4.2	0.2	-2.4	2.2
Net FDI flows (% of GDP)	.	9.1	13.4	-23.8	-9.7	.	.
General government balance (% of GDP)	-0.9	-4.1	-4.0	1.5	-5.7	-5.1	-2.0
Structural budget balance (% of GDP)	.	.	1.6	0.0	-4.7	-4.7	-2.4
General government gross debt (% of GDP)	60.4	60.5	101.4	94.0	118.2	112.2	106.6
Tax-to-GDP ratio (%) (3)	32.2	32.3	33.0	35.5	35.4	36.4	35.9
Tax rate for a single person earning the average wage (%) (4)	.	.	.	10.2	9.8	.	.
Tax rate for a single person earning 50% of the average wage (%) (4)	.	.	.	8.3	8.3	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings

Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: EXTERNAL IMBALANCES

Output, demand and sectoral net lending/borrowing

The steep decline in real output in 2020 led to widening of the trade deficit during the COVID-19 pandemic. After six years of roughly matched output and demand (Graph 21.(a)), the COVID-19 shock caused a contraction of real output, while domestic demand (including inventories) expanded somewhat in real terms. As for the segments of domestic demand, gross fixed capital formation and private consumption declined, while public consumption increased. Exports fell more strongly than imports. The trade deficit that widened substantially in 2020 is projected to slowly and gradually narrow over the forecast horizon.

The fiscal deficit in response to the recession last year was the main contributor to the worsening of the aggregate net lending/borrowing position. The general government is estimated to have switched from a small positive position in 2019 to considerable net borrowing, related to the COVID-19 shock and in support of domestic demand (Graph 2.1(b)). This more than offset the improvement in private-sector net borrowing position relative to 2019. ([7]) Notably, household net lending/borrowing remained in negative territory. Overall, the net lending/borrowing position of the total economy is projected to have deteriorated by more than 5 percentage points of GDP. Both the government's position and the total economy's net borrowing is expected to improve gradually over the forecast horizon, albeit only slowly.

External flows dynamics

The current account deficit, which consistently exceeds the trade deficit due to income flows, has further deteriorated in 2020, in line with the negative trade developments. Before the COVID-19 shock, the trade balance reflected large surpluses in services trade, mainly travel, transport and financial services, that broadly covered the goods trade deficit. The co-movement of the current account and trade balances over the recent years (Graph 2.1.(c)), reflects the general stability of the income account deficits which averaged around 5 pp of GDP during recent years. Correspondingly, since 2016, the current account has remained significantly below the trade balance. While the headline current account balance thus had persisted below the levels explained by economic fundamentals (the 'current account norm'), it had managed to reach the current account norm in cyclically adjusted terms in 2018 and 2019 (Table 1). ([8]) Going forward, the current account is forecast to improve only slowly over the next two years, thus remaining below the current account norm and other relevant benchmarks, both in headline and cyclically-adjusted terms (Table 2.1).

A deterioration of trade and current account balances can largely be attributed to the strong tourism decline in 2020. The tourism slump erased the large travel surplus, equal to 6.6% of GDP in 2019, and caused a small deficit in travel balance of -0.9% of GDP in 2020. This reflected the travel restrictions introduced in March 2020 to prevent the spread of the COVID-19 pandemic, which included an entry ban to Cyprus for tourists up to 8 June 2020, as well as continued difficulties for tourists from the UK, Russia and other non-EU countries, which constitute an important revenue source for the economy. ([9]) Overall 2020 foreign tourist arrivals to Cyprus declined by 84% compared to 2019, which is roughly equal to a fall in number of nights spent by foreign tourists of 83%. ([10]) The declining services

([7]) The consistently negative net lending position of the households sector is due to a very low savings rate (reflecting high consumption) and considerable residential construction investment.

([8]) Current account norm is the current account balance that can be explained by fundamentals. It is based on the empirical setup similar to IMF's EBA. Fundamentals are slow-moving variables including: demographics, relative income, natural resources, manufacturing intensity, and reserve currency status. See Coutinho et al. (2018) "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for the description of the methodology.

([9]) The travel restrictions were gradually eased after this date for tourists from specific countries, depending on the epidemiological situation in these countries.

([10]) Tourists are visitors who stay in Cyprus for at least one night. Source: CYSTAT, Press release 18 January 2021 for arrivals and Eurostat for nights spent. This compares to a decline in nights spent of around 71% for the EU27.

trade surplus has only been partly offset by the slightly lower deficit in trade of goods. ([11]) Lower commodity prices contributed to some extent through their impact on the energy trade deficit.

Developments in external stock positions

The large negative net international investment position did not improve further in 2020. From its trough of -164% of GDP in 2014, the net international investment position (NIIP) had improved to -122% by the end of 2019 (Graph 2.1.(d)), mainly driven by the nominal GDP growth and positive valuation changes, and despite the persistent current account deficit. In 2020, the NIIP deteriorated to -141% of GDP, driven by both, current account deficit and negative nominal GDP growth. As regards external net debt components, the NIIP excluding non-defaultable instruments (NENDI) is even more negative than the NIIP, at -174% in 2020. Both the NIIP and NENDI remain far below the fundamental and prudential NIIP benchmarks, which are estimated at -53% and -55% of GDP in 2020, respectively. ([12]) Any recorded and forecast external balances so far remain significantly below the current account and trade balances required to reach the prudential NIIP benchmark within ten years.

The focus on the net external position masks huge gross amounts of external assets and liabilities. These are displayed in Graph 2.2.(a), at around twenty-fivefold of GDP in 2020, down from nearly thirtyfold of GDP in 2015 (for total liabilities). The gross positions consisted to the largest extent of direct investment, which equalled 83% and 77% of total assets and liabilities, respectively. Overall, the Cyprus external balance is characterized by strong exposures towards and from economies outside the EU, notably Russia, as well as an aggregate of territories characterized as 'Offshore' by Eurostat (Graph 2.2.(b)).

Role of special purpose entities

A large portion of the Cypriot external stock position can be attributed to special purpose entities. Overall, the special purpose entities (SPEs) account for 96% of direct investment assets and 90% of liabilities, and for around 71% of (non-inter-company) loan liabilities, which equals 230% of GDP. It is in particular the financial SPEs which account for the bulk of external assets and liabilities. Their large positive net position in direct investment and other equity is counterbalanced by a large negative net position in portfolio securities and other investment (defaultable instruments), leaving the NIIP almost unaffected, but substantially deteriorating the NENDI. The link of financial SPEs to the domestic economy in terms of value added and employment is difficult to determine as they do contract local financial and professional business services for their operations.

The ship-owning non-financial SPEs has a significant impact on the NIIP. They have mainly external financial liabilities, partly in the form of FDI loans and partly in the form of other loans, while their assets consist mostly of ships registered in Cyprus. Such ships constitute non-financial assets and do not contribute to the IIP. The links of such shipping holding and management corporations to the domestic economy remain limited, but they negatively and significantly affect the NIIP (by more than 80 percentage points of GDP). ([13])

Excluding the positions of the special purpose entities, a considerably different picture of external stocks emerges, yet gross external debt remains relatively high. The NIIP excluding SPEs amounted to -52% of GDP end of 2020, and thus stood above but close to both, fundamental and prudential benchmarks. Moreover, the improvement in the total NIIP observed since 2014 has entirely due to improvements in the NIIP excluding the SPEs (Graph 2.2.(c)). The net foreign direct investment position of the economy changes dramatically if SPEs are excluded, and amounts to -118% of GDP in 2020, of

([11]) The statistics on international trade in goods actually suggest a small deterioration of balance of trade in goods in 2020, driven by a decline in exports that slightly exceeded the fall in imports. While share of imports of capital and intermediary goods in GDP have declined, those of consumer goods actually increased in 2020.

([12]) The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

([13]) Their impact on NENDI is much smaller, as around 44% of their liabilities are FDI loans (in Q3 2020).

which a large portion is investment in the real estate. ([14]) The general government NIIP is negative at -95.6% of GDP, consisting mostly of long-term debt securities and loans from ESM. At the same time, the central bank's net position amounted to 70% of GDP (74% including reserves), comprising largely Target2 claims and long-term debt securities. The private sector including MFIs but excluding SPEs, thus, has a considerable positive NENDI. Gross external debt in 2020 amounted to 287% of GDP, excluding SPEs, of which 47% of GDP related to other direct investment. From the remaining 240%, the amount equal to 99.7% of GDP relates to debt of the general government.

Outlook

There are still substantial risks related to the external sector flows and stocks. One should note that although the SPEs have weak links to the host economy, they are also not completely disconnected, as their presence creates economic activity in the related sectors (around 5% of GDP for ship-owning SPEs and unknown for financial SPEs), including transactions with the Cypriot monetary and financial institutions, so that the Cypriot economy would not be fully insulated from potential difficulties in SPEs' business activities. In addition, recently large current account deficits, which widened in 2020 and are projected to remain deeply negative over the forecast period, may quickly lead to the worsening of the NIIP also excluding the SPEs. The current account balance required to maintain the NIIP excluding SPEs close to prudential is estimated at around -1.8% of GDP, substantially above current and forecast balances. While the SPEs' activity, in particular that of the non-financial SPEs, may impact also the current account, ([15]) the effect has mostly been small (within +/- 1 pp of GDP) in recent years. Exceptionally, in 2016 and 2017, the SPEs contributed negatively to the current account balance by more than 3% of GDP (source: Cypriot Central Bank), amid higher net registration of ships and aircrafts (source: CYSTAT).

The NIIP position is likely to deteriorate going forward, due to large projected current account deficits. Graph 2.2.(d) presents the NIIP projections until 2030, both for the overall NIIP and the NIIP excluding the SPEs. The baseline projections rely on the Autumn 2021 ECFIN forecasts up to 2022 and T+10 forecast for the later years, while the scenarios assume improvements in trade and current account balances in 2023 and beyond, relative to the baseline. For the projections without SPEs' positions, the projected current accounts have been adjusted for the impact of SPEs. Still, the NIIP trajectory is strongly negative and moving far beyond the prudential level.

([14]) This has largely been related to the "Citizenship for investment" (CIP programme, which resulted in naturalisation of 2.855 investors between 2013 and 2019, and was related to transactions amounting to 9.7 billion EUR, out of which 6.4 billion was related to real estate sector (source: Study on the Cyprus Investment Programme – Impact on the Economy, September 2020).

([15]) Export and import statistics may be distorted through the registration and de-registration of ships. In years where net registrations of ships (imports-exports) cover the depreciation in the shipping stock there would be no impact on the current account.

Table 2.1: **Selected external indicators, Cyprus**

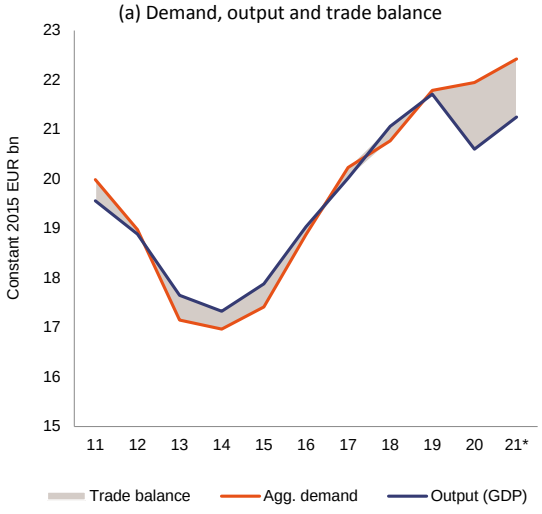
Flows [1]	Source:	2003-07	2008-12	2013-17	2018	2019	2020	2021f	2022f
CA balance as % of GDP, NA	*(b)*	**-15.8**	**-7.7**	**-3.1**	**-3.9**	**-6.3**	**-11.8**	**-11.0**	**-8.9**
CA balance as % of GDP, BoP	*(a)*	-5.2	-7.7	-3.1	-3.9	-6.3	-11.9	-11.2	-9.0
Cyclically adj. CA balance as % of GDP [2]	*(c)*	-13.8	-5.6	-5.7	0.8	-1.1	-8.2	-9.0	-7.3
CA req. to stabilize NIIP above -35% [3]	*(c)*	0.3	2.3	2.0	1.7	1.8	1.7	1.2	1.4
CA explained by fundamentals (CA norm) [4]	*(c)*	-2.2	-2.9	-2.2	-2.0	-2.1	-2.1	-2.3	-2.3
Trade bal. G&S, % of GDP, NA	*(b)*	-1.4	-6.4	1.3	1.5	-1.1	-6.2	-5.6	-3.8
Capital account bal. as % of GDP, NA	*(b)*	**0.5**	**-0.1**	**-2.8**	**0.6**	**0.1**	**0.1**	**0.1**	**0.1**
Stocks									
NENDI as % of GDP	*(a)*	**50**	**-69**	**-209**	**-184**	**-159**	**-176**		
of which: net portfolio debt	*(a)*	27	126	-10	-20	-13	-32		
of which: net mutual fund shares	*(a)*		2	2	3	3	8		
of which: net other investment	*(a)*	-94	-201	-206	-177	-159	-161		
NIIP as % of GDP	*(a)*	**-68**	**-124**	**-149**	**-126**	**-122**	**-141**	**-146**	**-148**
Prudential NIIP/NENDI benchmark [5]	*(c)*	-66	-62	-52	-57	-57	-55	-56	-56
Fundamentally expl. NIIP benchmark (NIIP norm) [5]	*(c)*	-23	-28	-47	-46	-49	-53	-50	-50

NA=National Accounts, BoP=Balance of Payments, CA=Current Account, NENDI= NIIP excluding non-defaultable instruments,TB= Trade Balance.
(1) Flow data refer to national account concept, unless indicated otherwise.
(2) Cyclically adjusted CA is the CA adjusted for the domestic and foreign output gaps, taking into account trade openness.
(3) The average CA needed in order to stabilise the NIIP in 20 years is based on T+10 Ecfin projections.
(4) Current account norm is the current account balance that can be explained by fundamentals. It is based on the empirical setup similar to IMF's EBA. Fundamentals are slow-moving variables including: demographics, relative income, natural resources, manufacturing intensity and reserve currency status. See Coutinho et al. (2018) "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for the description of the methodology.
(5) The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals ('NIIP norm') represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations

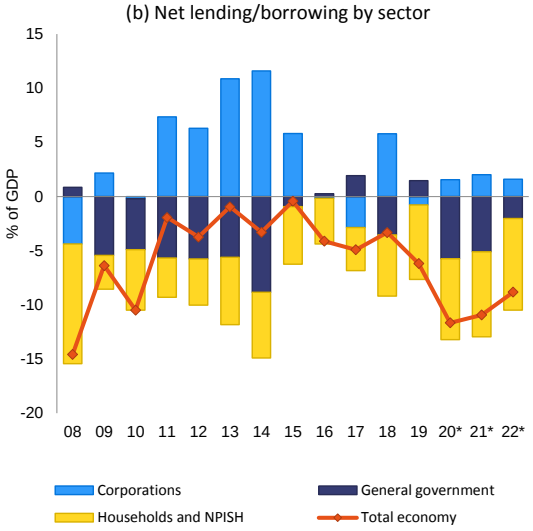
Graph 2.1: **Thematic Graphs: External imbalances**

(a) Demand, output and trade balance



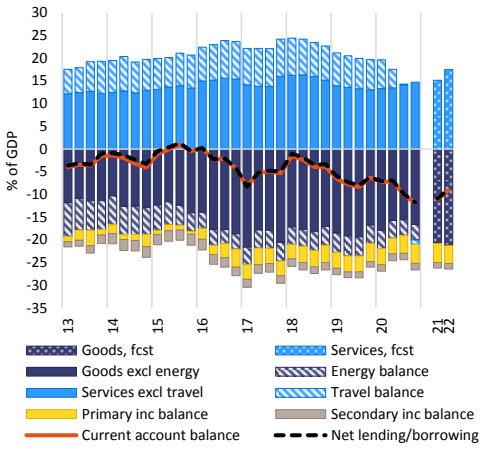
Source: Ameco

(b) Net lending/borrowing by sector



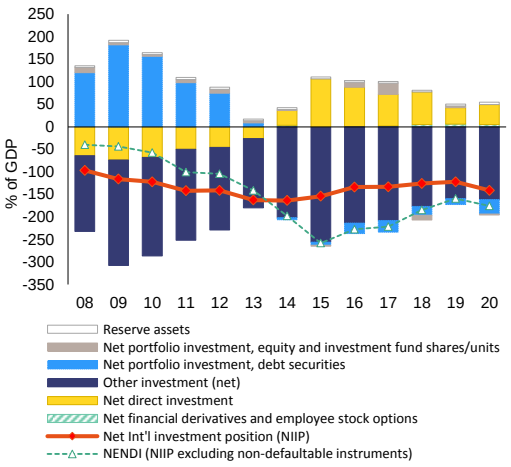
Source: Ameco

(c) Current account decomposition



Source: Eurostat and Ameco

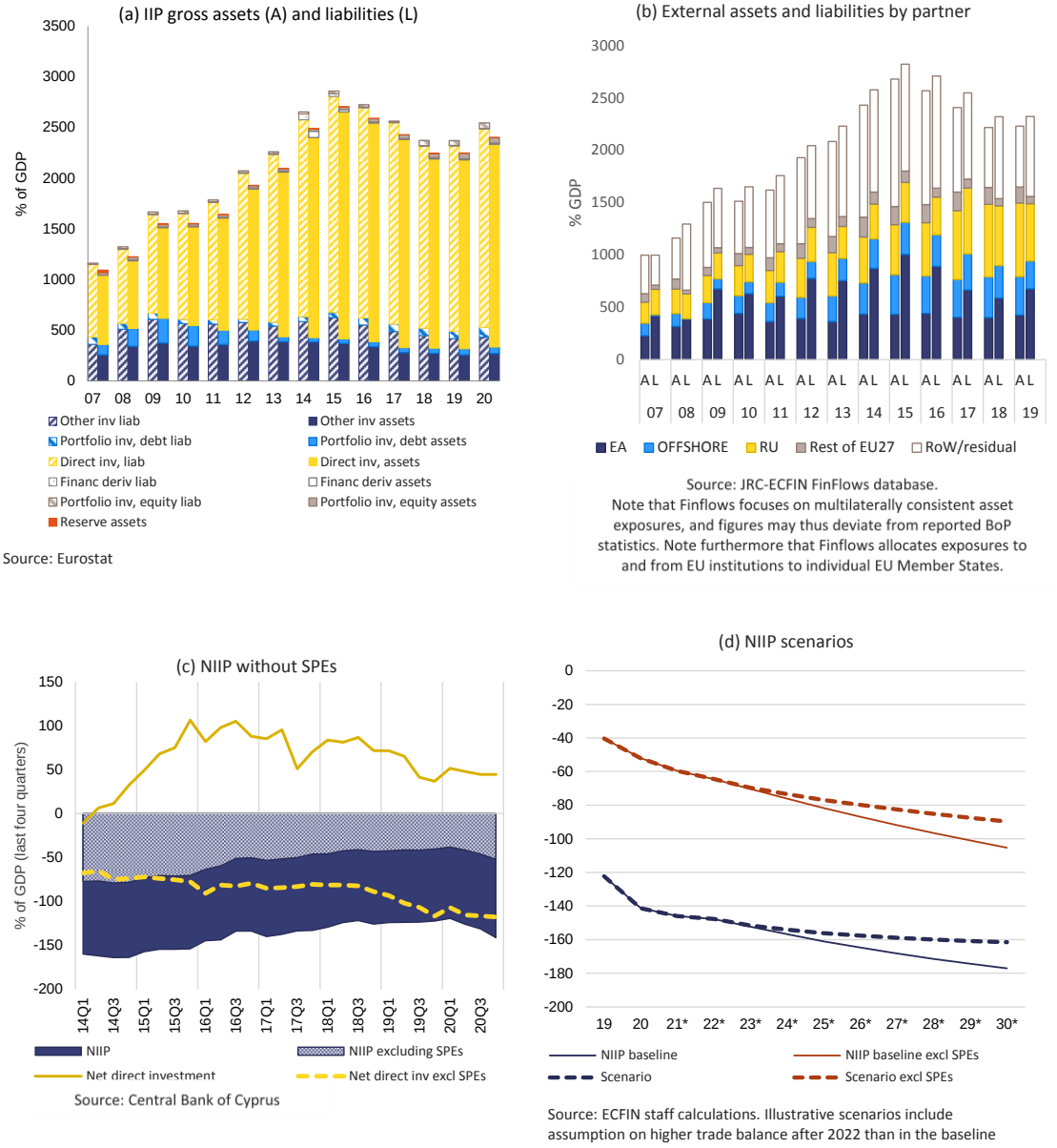
(d) Decomposition of NIIP by instrument



Source: Eurostat

Source: European Commission Services

Graph 2.2: **Thematic Graphs: External imbalances (cont.)**



Source: European Commission Services

3. THEMATIC ISSUE: HOUSEHOLD DEBT

Situation entering the COVID-19 crisis

Household indebtedness in Cyprus has declined since the banking crisis, however deleveraging needs remain. The household debt ratio in 2019, at 89% of GDP, was close to its fundamentals-based benchmark, but is still significantly above the prudential benchmark (Table 3.1 and Graph 3.1(b)). ([16]) Deleveraging has progressed up to 2019, mostly supported by cyclical GDP growth, but also by other changes in debt stock (e.g. write-offs of non-performing loans, debt-to-asset swaps and cash repayments). Households are primarily indebted to the banks, nevertheless in recent years the composition of the liabilities changed. The stock of household debt to the banking sector declined substantially (Graphs 3.1(a) and 3.2(a)), mainly on account of the transfer of bad loans from Cyprus Cooperative Bank to the state-owned asset management company (KEDIPES), taking place in 2018.

While indebtedness is high, on aggregate the household sector holds a significant stock of financial assets, primarily in the form of deposits. The ratio of debt to total financial assets was close to 40% in 2019 (Table 3.1) and households hold a significant share of deposits (Graphs 3.1(f)). On aggregate households have a positive net financial asset position. In the third wave (2017) of the ECB household finance and consumption survey, about 6% of households with mortgage debt showed negative net wealth. ([17])

Despite the relatively comfortable net wealth position, the ratio of household non-performing loans remains high, indicating a significant degree of strategic default and low contract enforcement. The ratio of household non-performing loans in the banking sector remained at close to 35% in 2019, despite a significant decline since peak (Graph 3.1(d)). To address the problem the authorities launched in September 2019 a restructuring and subsidy scheme, ESTIA, aiming to tackle NPLs collateralized by primary residences. ([18]) However, despite the subsidies offered to eligible borrowers, the scheme proved unsuccessful – as completed applications fell short of expectations. ([19]) One of the reasons hypothesized for the very low uptake is the reluctance to disclose financial positions. ([20])

A large share of loans to households are collateralized mortgage loans, with collateral values having recovered less than half way relative to the 2008 peak. One of the motivations for strategic default is the fact that a significant percentage of mortgage loans are likely to be "underwater", i.e. below the current market value of the residence. Prices have slowly started to recover since 2018, but are still less than half-way from peak, and this limits the attractiveness of collateral disposal (Graph 3.2(f)).

Credit developments and repayment capacity

Net bank lending to households has been contained but positive in 2020, supported by interest subsidization of mortgage lending and a moratorium on loan payments. Pure new credit to

([16]) Fundamentals-based benchmarks are influenced by the initial stock of debt (1995 in this case), which was already high in Cyprus (above prudential). For details on the methodologies, see Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1-42 and European Commission (2018), "Fundamentals-based private debt benchmarks: enhanced sample and robustness checks", note to LIME June.

([17])https://www.ecb.europa.eu/home/pdf/research/hfcn/HFCS_Statistical_Tables_Wave_2017.zip?abe541bc76c621a3485e9ae0884c7d68, Table F3.

([18]) ESTIA targeted non-performing loans below certain thresholds for income and wealth, with loans collateralized by primary residence.

([19]) Original estimations projected that more than EUR 3 billion of non-performing (gross book value as of 30 September 2017) would be eligible under the Scheme (see Commission Decision of 03.12.2018 in State aid case SA.49554 (2018/N) – Cyprus – Cyprus scheme for non-performing loans collateralized with primary residences (ESTIA). However, after implementation, the scheme covers about EUR 170 million of NPLs.

([20]) This rational is illustrated by the fact that half of the rejected applications were rejected on the grounds of breaching wealth or income thresholds. Furthermore, only 17% of completed applications were approved and 14% were considered non-viable. The authorities are considering a complementary scheme to help the non-viable borrowers retain their primary residence, with a different burden sharing between borrower, creditor and government.

households in 2020 declined by roughly 10% relative to 2019 ([21]), but net credit transactions have been overall positive but moderate (Graph 3.2(c)), also on account of a relative large take up of the moratorium on loan payments (suspended credit facilities under the first moratorium, which expired in December 2020, represented about 46% of household loans). The cost of borrowing for households has remained broadly stable in 2020 and has been contained by interest subsidization of mortgage loans (Graph 3.2(b)). ([22])

Household debt-to-GDP ratio is estimated to increase in 2020, owning mostly to the cyclical drop in GDP, which could afford a relatively rapid correction as the recovery sets in. The ratio of household debt to GDP is expected to increase to 95% in 2020, from 89% in 2019 (Table 3.1). Most of the increase is attributed to the cyclical drop in growth and negative inflation in 2020 (Graph3.1(c)). Other changes in debt, including write-offs, have continued to contribute to deleveraging in 2020. The negative effects from growth are expected to wear-off as the economy recovers, provided that the COVID-19 pandemic leaves no significant scars in the economy and new inflows of non-performing loans are contained.

Household gross disposable income declined in 2020, however private consumption was rather resilient. Household incomes in 2020, which have been supported by a range of government measures (such as short-time work schemes) are forecast to decline by 4.7% in 2020. The household savings rate is expected to have somewhat increase in 2020, but to remain well below the EU average (Graph 3.1(e)). Household deposits have increased in 2020 (Graph 3.2(d)).

Housing investment declined in 2020, leading to a small and temporary improvement in the negative households' net lending position. Dwellings gross fixed capital formation declined by 7.9% in 2020, implying a reduction in household investment. This contributed to a small improvement in the net lending position of households, which however remains negative (see section 2).

Non-performing loans

There has been progress in reducing the relatively large stock of household non-performing loans in the banking sector, but the progress has been slower than for non-financial corporations. Household non-performing loans in the banking sector declined from 55% of total loans in 2015 to 27% in 2020Q3, according to ECB data and definitions (Graph 3.1(d)). A significant share of the decline was achieved with the transfer of non-performing loans from the Cooperative Central Bank (which stopped operations) to the national asset management company KEDIPEs, while the remainder has been achieved through a combination of debt-write-offs, sale of collateral and loan sales.

A moratorium on loan payments has helped contain new non-performing loans in 2020 and so far there is no evidence that arrears may increase significantly in 2021, although the available data is preliminary. The first moratorium on loan payments, which started in March 2020, had a high take up by households, namely of about 50% of performing loans. In parallel, household deposits have increased indicating that households accumulated some savings in the form of deposits allowing for future payments. As the maximum duration for the suspension of payments is 9 months for each loan, suspensions expire in January 2021 for most loans. From the universe of household credit facilities with payments due in early 2021, 7% registered arrears. A second, more targeted, moratorium will run until end-March 2021 but its take up is limited.

A progressive tightening of credit conditions for households has been observed through 2020 and into 2021. According to the ECB bank landing survey, credit conditions for households have tightened in Cyprus on account of higher risk perceptions and lower risk tolerance by banks (Graph 3.2(e)). So far, unemployment has been contained by government support measures and increased only moderately to 7.6% of the labour force in 2020, significantly below what macro conditions might have implied, but further deterioration could impact negatively on risk perceptions.

Cyprus underwent a significant overhaul of personal insolvency and foreclosure procedures in recent years, but weaknesses remain and even increased in the case of foreclosures. Cyprus

([21]) Central Bank of Cyprus Monetary and Financial Statistics https://www.centralbank.cy/images/media/xls/2ndMFSApril2021eng.xls.
([22]) http://mof.gov.cy/assets/modules/wnp/articles/202102/841/docs/190221_finalscheme_epiepit_neastagdan.pdf

introduced in 2016 specific procedures to address personal insolvency, including a personal insolvency arrangement (PIA) and debt relief order for smaller debts (DRO). The use of these procedures is still limited but increasing. ([23]) The low take up is likely related to reluctance to disclose financial positions and with deficiencies in contract enforcement. Although the foreclosure legislation has been reinforced in 2018, it has been subsequently weakened in 2020, allowing for extended deadlines and more grounds for appeal. Foreclosures have been used by creditors to resolve non-performing loans, but predominantly to dispose of farmland and other land, while its use for residential property has been more limited. During 2020 creditors voluntarily suspended foreclosures between March and August, but activity resumed thereafter. Foreclosures of primary residences and primary business commercial real estate have been further suspended from December 2020 to end-July 2021.

Table 3.1: **Household debt indicators, Cyprus**

		2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
	Source									
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	85	117	118	89	95		92	93	94
Debt, consolidated (% of potential GDP)	*(a,b,d)*	88	117	114	94	93		93	93	92
Prudential threshold (% of GDP)[1]	*(c)*	41	41	40	48	46	46			
Fundamental benchmark (% of GDP)[1]	*(c)*	69	78	97	91	99	97			
Debt (% of gross disposable income)	*(a,b,d)*	130	170	176	136	140		138	139	140
Interest paid (% of gross disposable income) [3]	*(a,b)*	1.4	2.0	2.0	2.0					
Debt (% of gross financial assets)	*(a,d)*	36.3	45.9	47.6	40.5			37.4	36.9	36.3
Share of variable rate loans for house purchase (%)	*(d)*		75.1	93.3	93.5	92.2				
Domestic loans in forex (% of dom. loans)	*(d)*	2.6	4.0	3.2	3.0	2.2				
Flows										
Credit flows (transactions, % of GDP) [4]	*(a)*	12.5	7.6	-1.7	-0.5	0.2	0.1	2.7	3.1	0.2
Benchmark for flows (% of GDP)	*(c)*	5.1	5.1	2.3	2.9	3.1	3.1			
Savings rate (% gross disposable income)	*(b)*	6.0	5.4	0.3	3.1	3.8	3.3			
Investment rate (% gross disposable income)	*(b)*	17.8	14.0	9.8	14.0	13.1	13.2			
p.m. Bank HH NPLs (% of HH loans) [2]	*(d)*			*50.4*						

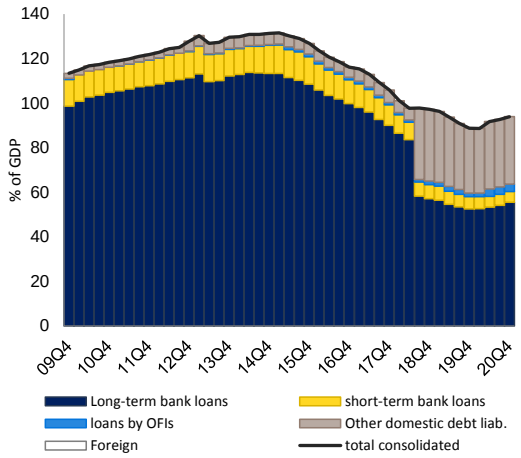
(f) European Commission forecast
(1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows.
(2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households).
(3) Quarterly data is annualized.

Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

([23]) For PIA, 291 applications were received since its inception in 2015 to August 2020, 96 of which were dismissed either by the department of insolvency or by the insolvency practitioner. The total number of applications increased to 387 by end-Aoril 2021. For DRO there have been 1643 applications in total from 2015 to end-April 2021 (Department of Insolvency of Cyprus Statistics http://www.meci.gov.cy/meci/insolvency.nsf/page08_gr/page08_gr?OpenDocument)

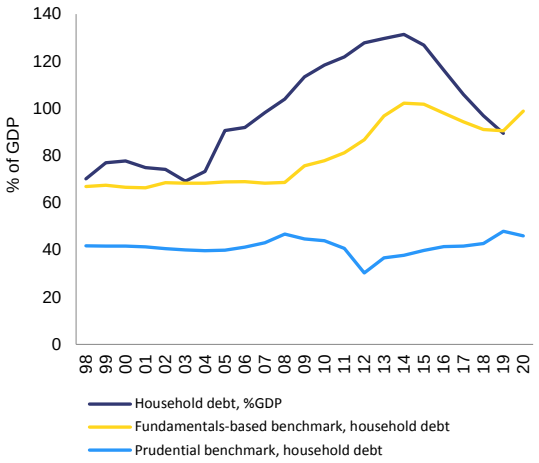
Graph 3.1: **Thematic Graphs: Household debt**

(a) Household debt liabilities by creditor



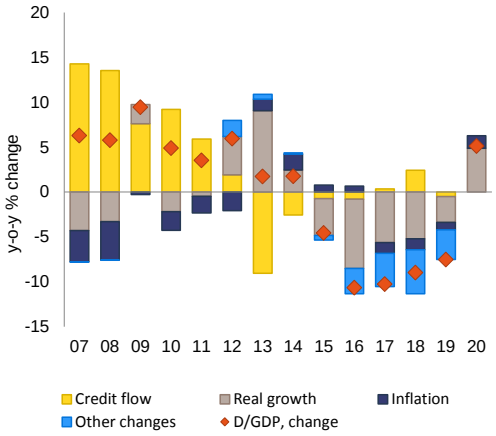
Source: Calculations based on Eurostat and ECB

(b) Household debt and benchmarks



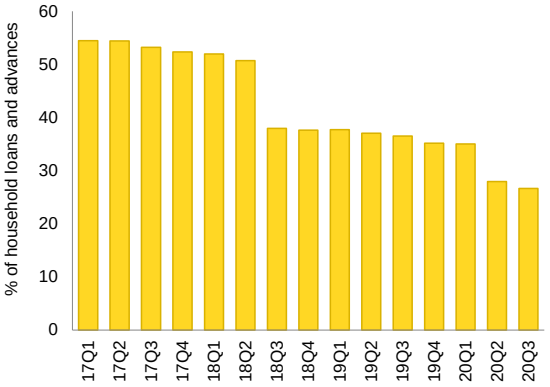
Source: Eurostat and European Commission

(c) Decomposition of household debt flows



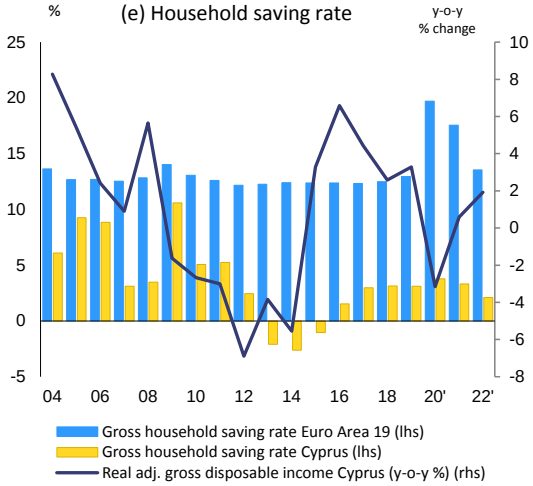
Source: Eurostat and Ameco

(d) Households non-performing loans



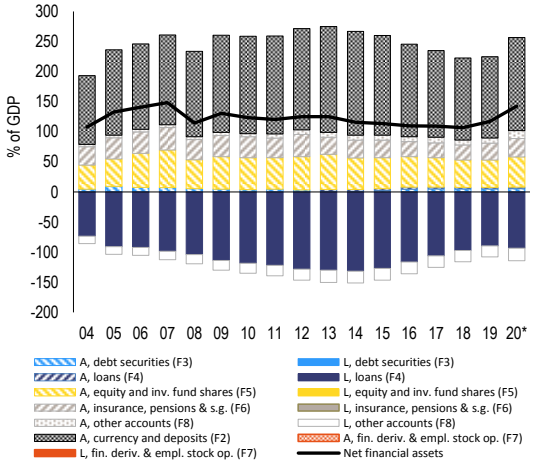
Source: Non-performing loans and advances, ECB consolidated banking data.

(e) Household saving rate



Source: Eurostat

(f) Household balance sheets

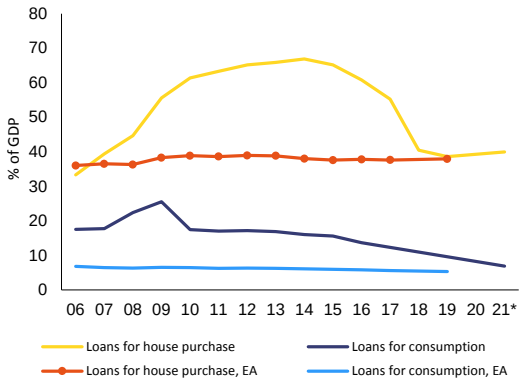


Source: Eurostat

Source: European Commission Services

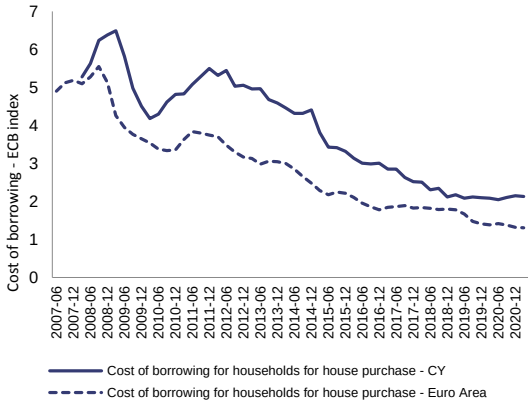
Graph 3.2: **Thematic Graphs: Household debt (cont.)**

(a) Bank loans to households by type



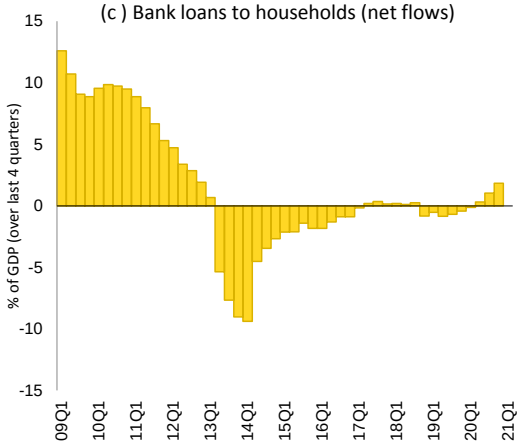
Source: ECB BSI

(b) Households cost of borrowing



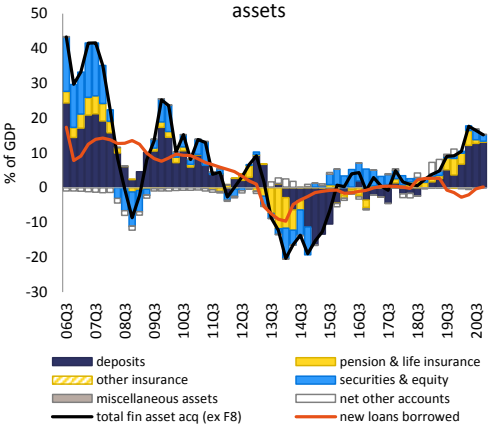
Source: ECB MIR

(c) Bank loans to households (net flows)



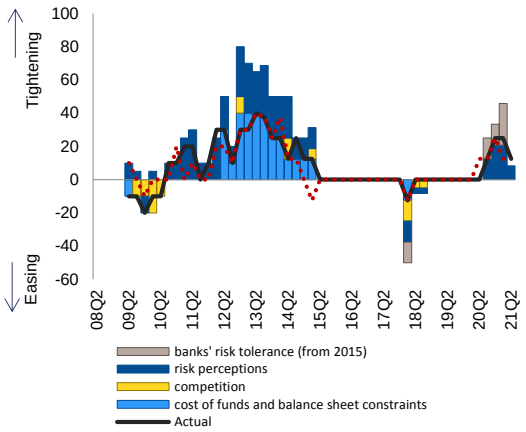
Source: ECB BSI

(d) Households net acquisition of financial assets



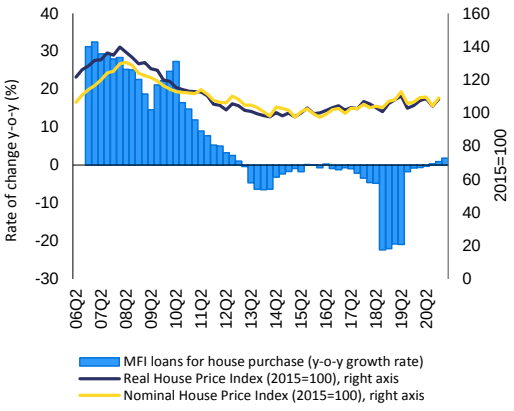
Source: Calculations based on Eurostat

(e) Mortgage credit supply conditions for households



Source: ECB Bank Lending Survey

(f) House prices and mortgage credit growth



Source: ECB Bank Lending Survey

Source: European Commission Services

4. THEMATIC ISSUE: NON-FINANCIAL CORPORATE DEBT

Situation entering the COVID-19 crisis

Non-financial corporations have entered the COVID-19 pandemic with large stocks of debt, even when excluding the foreign debt of non-financial special purpose vehicles (SPEs). ([24]) Non-financial corporate debt in Cyprus is significantly affected by foreign debt of ship-owning special purpose entities (64% of GDP in 2019) registered in Cyprus, which have limited links to the domestic economy. Cross-checking with other data sources, this corresponds roughly to the FDI and other arms lengths loans in Graph 4.1(a). ([25]) The ratio of non-financial corporate debt to GDP, excluding SPEs amounted to 106% of GDP, which stands above the prudential benchmark and the fundamentals based benchmark corrected for SPEs (Table 4.1 and Graph 4.1(b)). ([26])

Deleveraging was taking place pre-pandemic, supported by GDP growth and debt restructuring. There has been considerable deleveraging in corporate debt in since the peak in 2014, despite positive net credit flows (transactions) particularly in 2018 and 2019 (Graph 4.1(c)). This was supported by nominal GDP growth (in large part cyclical) but also other changes in debt, e.g. write-offs and debt-to-asset swaps. Similar deleveraging is observed in debt-to-equity and debt-to-financial assets (Graph 4.1(d)). Debt held by banks has been substantially reduced mostly through loan sales, shifting firms' liabilities to other financial institutions (credit acquiring companies), which gained weight as creditors of non-financial corporations (Graph 4.1(a)). ([27]) In particular, debt of the construction sector held by domestic banks was reduced substantially by the start of the COVID-19 pandemic (Graph 4.2(a)).

On aggregate, the balance sheet structure of non-financial corporations is relatively vulnerable to shocks. On the asset side of the balance sheet of Cypriot non-financial corporations, equity has the largest share, followed by accounts receivable (Graph 4.1(e)). The ratio of volatile assets to total assets in the aggregate balance sheet of the sector exceeds 75%, which is relatively high when compared to other EU countries. ([28]) Liquidity buffers in the form of currency and deposits have been limited, but the aggregation could mask differences across sectors.

Aggregate gross fixed capital formation has been dominated by construction, a significant part of which dwellings, with more productive corporate investment having a smaller share. Productivity-enhancing investment in machinery and equipment and other construction structures tends to be more supportive of higher potential growth, leading to more sustainable corporate debt. Total investment represented 19% of GDP in 2019. It has been dominated by construction investment, with dwellings, which are relatively less growth enhancing, representing 40% of all investment. Net non-financial corporate investment was less than 5% of GDP in 2019, with investment to a significant extent financed by savings since the Cypriot banking crisis (Graph 4.2(d)).

Credit developments and repayment capacity

For non-financial corporations net bank credit flows were low in 2020, with pure new credit to non-financial corporations remaining limited, amid the COVID-19 crisis. Pure new bank credit to non-

([24]) In the case of Cyprus non-financial special purpose entities are ship-owning corporate structures, created for ship registration in Cyprus.
([25]) Graph 1 shows the distribution of Cypriot non-financial liabilities by sector, with domestic bank loans representing less than 50% of these liabilities since 2018, while the exposure of other creditors including other financial institutions having increased.
([26]) Fundamentals-based benchmarks are influenced by the initial stock of debt (1995 in this case). For details on the methodologies, see Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1-42 and European Commission (2018), "Fundamentals-based private debt benchmarks: enhanced sample and robustness checks", note to LIME June. To adjust the fundamentals-based benchmark of 2019 for SPEs, the SPE debt in 1995 as a share of 2019 GDP (about 60%) needs to be deducted for the benchmark. Prudential benchmarks are not affected by the presence of SPE debt.
([27]) Credit acquiring companies have been buying non-performing loans from banks since 2018.
([28]) Volatile assets include equity and investment fund shares or units (F5), financial derivatives (F7) and other accounts receivable/payable (F8). The source is Eurostat.

financial corporations declined by about 30% in 2020 compared to 2019. ([29]) As a result, net bank credit flows to the sector remained low despite the loan moratorium in place, which reduced repayments (Graph 4.2(c)). Bank credit to non-financial corporations continued subdued in early 2021. This has contained the increase in the non-financial corporate debt ratio.

Credit developments reflect in part measures taken by the government to shield companies from liquidity pressures. Companies have been shielded promptly and significantly from liquidity pressures since the start of the COVID-19 pandemic. The government has contributed significantly to wage costs (e.g. through short-time work schemes) and temporarily lowered the tax burden with tax deferrals, while a legislative moratorium on loan payments was in place from March 2020 until the end of the year. No substantial package of loan guarantees for non-financial corporations was adopted. Interest rate subsidies have been put in place, but the take up has been low in the case of corporates. ([30])

The take-up of moratorium on debt repayments has been high among non-financial corporations, particularly among sectors most affected by the COVID-19 pandemic, but also for those where non-performing loans have been high. Credit facilities to non-financial corporations with suspended loan payments corresponded to 52% of non-financial corporations credit facilities. ([31]) Some of the sectors with a high moratorium take-up also represented the largest shares of the 2020 stock of corporate non-performing loans: construction (29%), wholesale and retail trade (22%), and real estate (17%). Non-performing loans in the tourism and accommodation sector, which had the largest moratorium take-up, were more limited (7% of total non-financial corporate non-performing loans in 2020). ([32])

The non-financial corporate debt-to-GDP ratio is forecast to increase in 2020, owning mostly to the cyclical drop in GDP, affording rapid correction if defaults are contained. The ratio of debt-to-GDP of the non-financial corporations sector is forecast to increase in 2020, despite the limited level of net credit transactions, mostly due to the drop in GDP (Graph 4.1(c)). Most of the impact is estimated to be cyclical. However, if the COVID-19 pandemic is to leave more significant scars in the economy, some of the estimated cyclical fall could change into structural.

Aggregate gross operating surplus is estimated to have increased in 2020, supported by measures that helped contain labour costs, allowing for temporarily higher precautionary corporate savings, but there is heterogeneity across sectors. The gross operating surplus of non-financial corporations is estimated to have increase by 4.8%. This allows for an increase in gross savings of roughly 30% on aggregate, while investment is likely to remain subdued as indicated by the ECB bank lending survey (Graph4.2(f)). There is however considerable heterogeneity across sectors. The tourism and accommodation sector is the most significantly affected, with tourism revenues having dropped by around 85%, while the construction sector is more resilient despite the end of the citizenship for investment programme, which will negatively affect the demand for high-end residences.

Non-performing loans

Progress was made in reducing non-performing loans of non-financial corporations in the banking sector, but these are high still and much of the reduction was achieved through sales of loans. Non-performing non-financial corporate loans in the banking sector declined from 60% in 2014 to 18% in 2020Q3 according to ECB data and definitions (Graph 4.1(f)). A part of the reduction was achieved through write-offs and debt-to-asset swaps, which reduce debt stocks, but another part was achieved through sales of loans, which still leave the corporate sector burdened by debt.

It is still early to assess by how much arrears could increase in 2021 and 2022, as facilities coming out of moratorium have varying payment schedules. The first payment moratorium expired for most loans at end-2020 (as there was a limit of 9-month for each facility). From the non-financial corporate

([29]) Central Bank of Cyprus Monetary and Financial Statistics https://www.centralbank.cy/images/media/xls/2ndMFSApril2021eng.xls.
([30]) The take up for interest subsidies was higher in the case of mortgage loans (see section chapter 3).
([31]) The facilities under moratorium representing the largest exposures to banks are those in the sectors of food and accommodation (EUR 1.7 million or 81% of performing exposures), real estate (EUR 1.2 million or 67% of performing exposures), construction (EUR 1.1 million or 88% of performing exposures) and wholesale and retail trade (EUR 0.9 million or 47% of performing exposures).
([32]) The data corresponds to all credit facilities (loans and advances and debt securities).

loans with a payment due up to February 2021, 5% recorded arrears, but it is important to note that in the case of non-financial corporations payment schedules can be quarterly or even bi-annual, hence it is too early to infer a default rate from this data. A new moratorium has been offered until end-March 2021, but is more restrictive and the take up is low. An increase in arrears will slow down the deleveraging process through further delays in repayments and capitalization of interest due.

Credit tightening due to risk and cost factors has been observed in 2020 and moving into 2021. There was further credit tightening for non-financial corporations in 2021, according to the ECB bank lending survey (Graph 4.2(e)). The tightening can be mostly attributed to higher risk perceptions and much lower risk tolerance by banks, but higher costs of borrowing also had an impact. The cost of borrowing for non-financial corporates in Cyprus has been higher than in the EU (Graph4.2(b)). This will make it more difficult for firms to bridge liquidity gaps without government aid.

Cyprus underwent a significant overhaul of its corporate insolvency regime, but the usage of procedures continues to be relatively low to support deleveraging. Restructuring of insolvent or pre-insolvent firms in particular is very limited, with examinership applications amounting to 19 by end-August 2020 since the inception of the procedure in 2015. Bankruptcy cases amounted to 38 in 2019 and declined to 31 in 2020, while liquidation cases increased from 67in 2019 to 77 in 2020. ([33]) Liquidation is still the preferred option of creditors, but also has a limited and slow contribution to the resolution of non-performing loans and deleveraging. ([34]) Insolvency procedures were not suspended for most of 2020, unlike foreclosure (see section chapter 3), and steps to facilitate online procedures have been taken, but their impact will only be observed later in 2021.

The system of issuance and transfer of property titles remains deficient, hampering the sustainability of debt in the construction and real estate sectors and of collateralized debt in general. Cyprus has a particular system where units belonging to a mortgaged real estate development can be sold (usually off-plan) without having a property title, and without knowledge or consent of the mortgage lender financing the development. This creates impediments to the foreclosure of the property in case of shocks that affect the borrowers' inability to make re-payments. It also creates subsequent problems for the issuance and transfer of title deeds. ([35])

([33]) http://www.meci.gov.cy/meci/insolvency.nsf/page08_gr/page08_gr?OpenDocument - Bankruptcy statistics available from the department of Insolvency of Cyprus.

([34]) Voluntary liquidations were higher at 2097 in 2019 and 2235 in 2020, but these involve mostly solvent firms, set-up for a specific purpose and liquidated when the purpose has been achieved (e.g. holding companies).

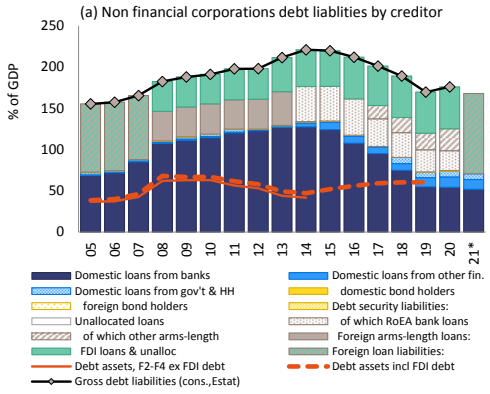
([35]) In such cases, the bank providing the mortgage financing to the developer needs the consent of all the buyers of units already sold to foreclose on the mortgage property in case of default of the developer. Moreover, a cut in financing in case of default of the developer often means that at least part of the project gets unfinished and does not fulfil the requirements for the issuance of final titles and transfer to the final buyers.

Table 4.1: **Non-financial corporations debt indicators, Cyprus**

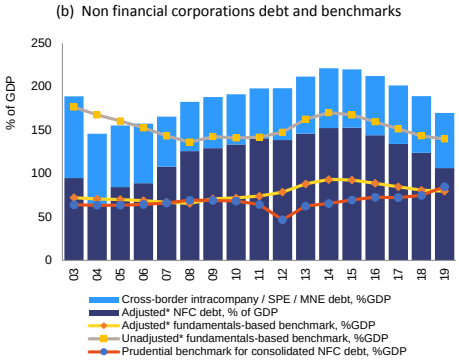
	Source	2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	163	192	209	170	177		175	177	177
Debt, consolidated (% of potential GDP)	*(a,b,d)*	168	192	203	179	174		178	177	174
Prudential threshold (% of GDP)[1]	*(c)*	64	64	70	85	83	83			
Fundamental benchmark (% of GDP)[1]	*(c)*	160	142	159	140	150	145			
Debt, consolidated (% of gross operating surplus)	*(a,b,d)*	669	959	977	830	772		809	796	774
Interest paid (% of gross operating surplus) [3]	*(a,b)*	36.7	32.0	26.6	24.9					
Debt, consolidated (% of gross financial assets)	*(a,d)*	151	127	159	119					
Domestic loans in forex (% dom. Loans)	*(d)*	19.0	16.4	7.6	5.6	4.8		5.0	4.9	4.8
Flows										
Credit flows (transactions, % of GDP) [2]	*(a)*	11.4	10.9	5.5	3.2	-0.7	0.3	1.7	0.5	-9.7
Benchmark for flows (% of GDP)[1]	*(c)*									
Investment (% of value added)	*(b)*	13.3	17.3	14.8	16.2	16.7	15.9			
Savings (% of value added)	*(b)*	13.9	21.0	19.1	11.5	16.4	16.6			
p.m. Banks NFC NPLs (% of NFC loans) [2]	*(d)*			*49.9*	*24.8*					

(f) European Commission forecast
(1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows.
(2) Gross non-performing bank loans and advances to Non-financial corporations (% of total gross bank loans and advances to Non-financial corporations).
(3) Quarterly data is annualized.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

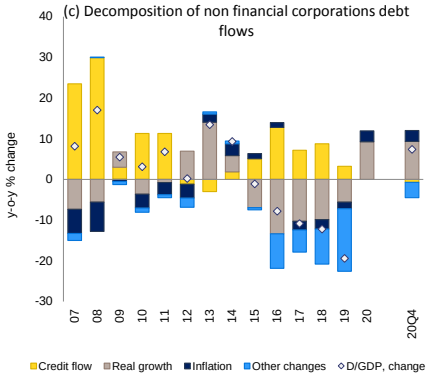
Graph 4.1: **Thematic Graphs: Non-financial corporate debt**



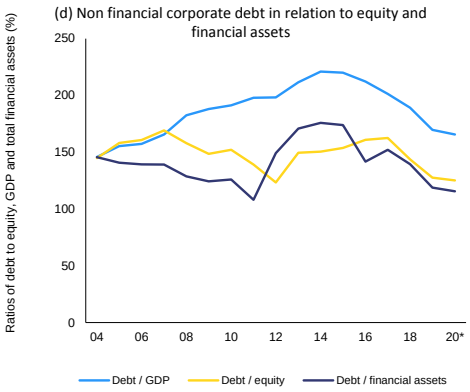
Source: Calculations based on Eurostat and ECB



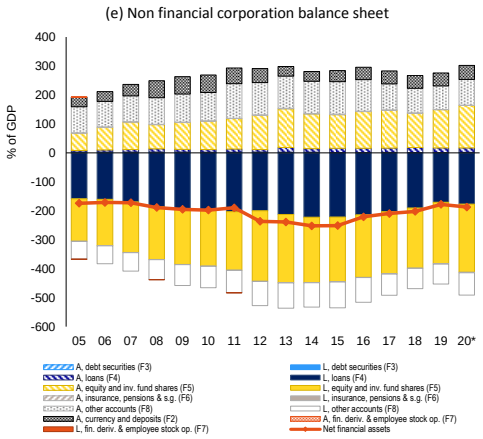
Source: Eurostat and Cyprus Central Bank *SPE debt in the case of Cyprus. "Adjusted" excludes this debt



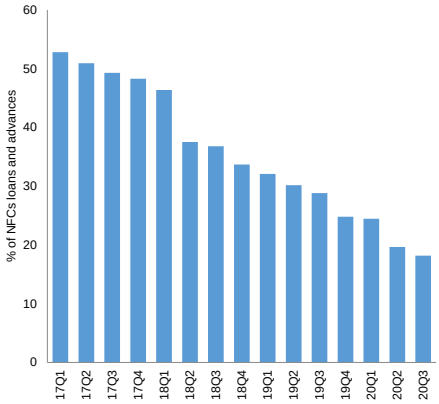
Source: Eurostat



Source: Eurostat



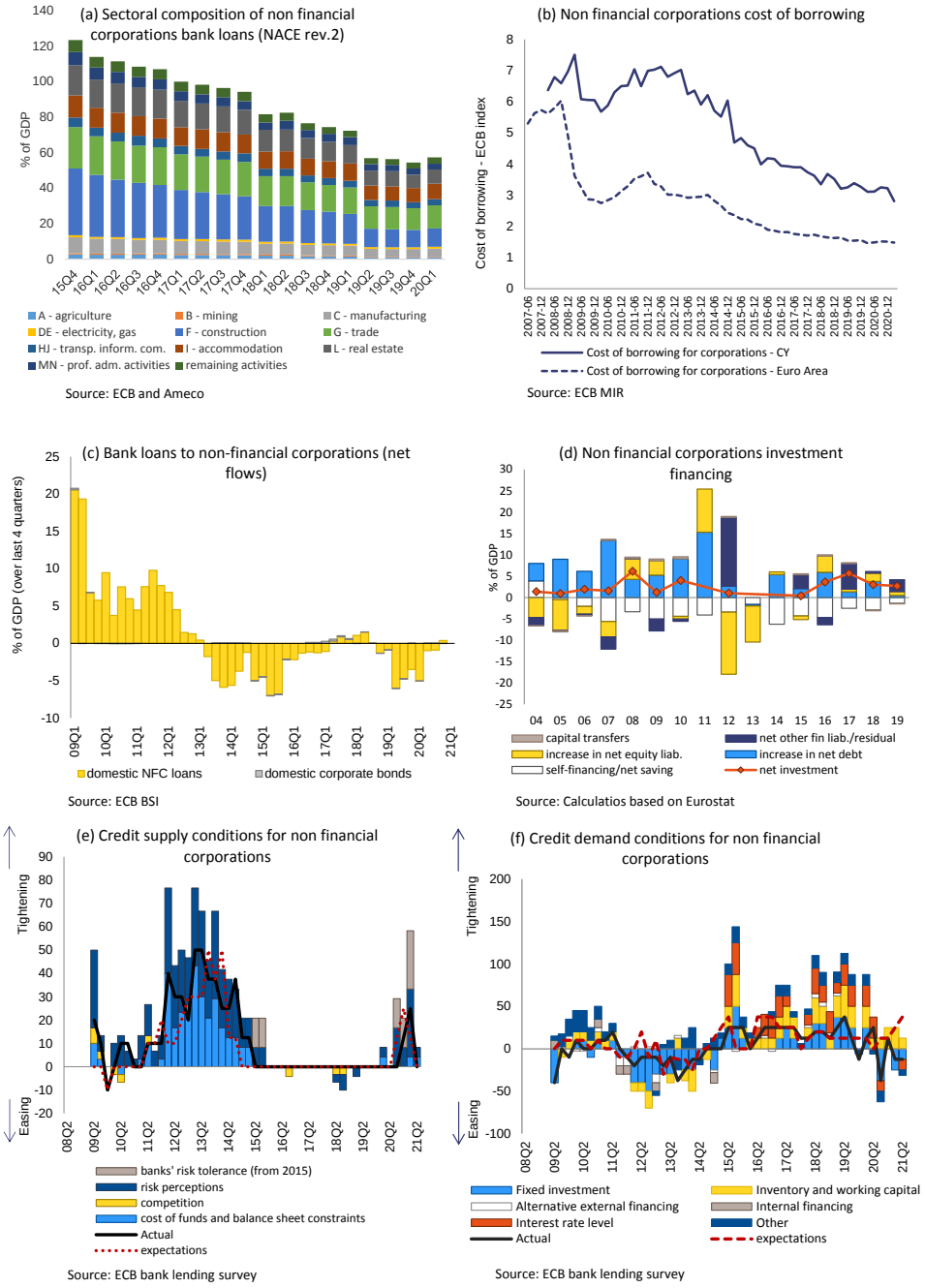
Source: Eurostat



Source: Non performing loans and advances, ECB consolidated data

Source: European Commission Services

Graph 4.2: **Thematic Graphs: Non-financial corporate debt (cont.)**



Source: European Commission Services