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CORRIGENDUM

This document corrects document SWD(2022) 628 final of 23.05.2022.
Correction of figures in table 2.1.

The text shall read as follows:

COMMISSION STAFF WORKING DOCUMENT

In-depth review for Cyprus

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

Accompanying the document

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

2022 European Semester – Spring Package

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On the basis of this in-depth review for Cyprus undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2022 Spring Package" (COM(2022)600 final) that:

Cyprus is experiencing excessive imbalances. Vulnerabilities relate to high government and private debt, large current account deficits and a still high stock of non-performing loans. The government and private debt-to-GDP ratios declined again thanks to a strong economic rebound in 2021. Non-performing loans of the banking sector declined substantially thanks to large sales of such loans to credit acquiring companies but remain high. The current account deficit is large despite an improvement in 2021, and moreover is projected to widen in 2022 and only slowly narrow thereafter, thereby not ensuring a prudent net international investment position over the medium term. Government and private debt-to-GDP ratios are expected to further improve, in part on the back of economic growth. However, the economic outlook for 2022 is surrounded by heightened uncertainty related to the impact of Russia's invasion of Ukraine in view of particularly sizeable trade of services exposures. If implemented timely and effectively, the RRP has the potential to contribute to a significant reduction of vulnerabilities, but additional policy action is warranted.

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1. INTRODUCTION

In 2021, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "excessive macroeconomic imbalances" in Cyprus. ([1]) These imbalances were related to high private-sector, government and external debt, and a high share of non-performing loans that burden the financial sector, in a context of moderate potential growth. The 2022 Alert Mechanism Report concluded that a new in-depth review (IDR) should be undertaken for Cyprus with a view to assessing the persistence or unwinding of imbalances. ([2])

Cyprus experienced a strong economic recovery in 2021, but the economic fallout from the Russian war of aggression against Ukraine is set to negatively impact economic activity. ([3]) The economy grew by 5.5% in 2021, surpassing its 2019 GDP level. This was driven by strong domestic demand, lifted by government support measures and by pent-up demand built up during the pandemic year of 2020, as well as external demand for financial, ICT and professional services. Employment increased by 1.2%, as the situation in the tourism sector gradually improved. Most businesses continued repaying their loans after the moratoria were lifted. When Cyprus entered 2022, the overall economic situation showed promising signs of continued improvement. Russia's unprovoked invasion of Ukraine and the related sanctions, however, are expected to slow economic growth to around 2.3% of GDP, mostly due to missing Russian tourist arrivals and lower exports of professional and financial services. Inflation, which started rising in 2021, is expected to further pick up, and reach 5.2% in 2022, mainly due to significantly higher oil prices as well as secondary effects of exceptionally global energy prices. The assessment of this year's IDR is surrounded by uncertainties around the evolution of the war, the related sanctions and the ability of the economy to adapt and contain their impact, with initial signs pointing to a relatively strong resilience of the Cypriot economy.

This in-depth review presents the main findings for the assessment of imbalances. The assessment is backed by thematic sections on developments of private debt and external imbalances. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, assessments of structural issues made in previous IDRs and in the context of fiscal assessments are also considered if relevant. The MIP assessment matrix is published in the 2022 Country Report for Cyprus. ([4])

([1]) European Commission (2021), European Semester Spring Package 2021, COM(2021) 500 final.
([2]) European Commission (2021), Alert Mechanism Report 2022, COM (2021) 741 final.
([3]) Forecast data are from European Commission (2022), European Economic Forecast: Spring 2022, Institutional Paper 172.
([4]) European Commission (2022), Country Report Cyprus 2022, SWD(2022) 604 final.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

Assessment of gravity, evolution and prospects of macroeconomic imbalances

The stock of legacy non-performing loans (NPLs) in the banking sector has been significantly reduced, although the majority remains on the balance sheets of the credit-acquiring companies, and thus weighs on the real economy as private sector indebtedness remains high. The non-performing loans ratio continued its downward trend and recorded a single digit level for the first time since 2014. The total stock of non-performing loans ([5]) held by the banks stood at 8.1% of gross loans in 2021 (2021Q3), down from 11% of gross loans a year earlier (Table 2.2). The decline was mainly the result of NPL sales (EUR 1.6 billion) and write-offs (EUR 0.4 billion) made by the main banks (Bank of Cyprus and Hellenic Bank) as well as repayments (EUR 0.4 billion). The coverage ratio of non-performing loans and advances decreased from 46% in December 2020 to 43% in December 2021, as the majority of the NPLs sold or written off were more heavily provisioned, driving the average downwards. ([6]) Credit risk remains elevated and it is the most immediate challenge for the banks. The effects from the pandemic are visible through a deterioration of the credit quality of financial instruments. Russia's unprovoked invasion of Ukraine is expected to have a negative impact on tourists' arrivals and on exports of services and may thus have an indirect negative spillover effect on banks through their exposure to these sectors. Despite the significant reduction of the NPLs held by the banks, they continue to weigh on the real economy as they are now on the balance sheets of credit-acquiring companies. With this, the risks have shifted from the banks to the credit acquiring companies in the non-banking sector. With the exception of KEDIPES, the credit acquiring companies are privately owned.

Private debt has declined, but remains at a high level. The private debt-to-GDP ratio declined to 241% of GDP at the end of 2021 after its peak of 352% of GDP in 2014, reflecting strong GDP growth and nominal debt reduction through write-offs of bad loans, cash repayments and debt-to-asset swaps. The decrease in 2021 was primarily driven by GDP developments (denominator effect). The household debt-to-GDP ratio decreased to 88% of GDP in 2021 from 91% of GDP in 2020 (see Table 2.1), despite positive net credit flows, also driven by significantly increased mortgage lending flows (about a quarter higher than in 2019) ([7]) supported by a government interest rate subsidisation scheme. This is still well above the estimated prudential benchmark of 46% for household debt, even though close to the fundamentals-based benchmark (see also the thematic section on household debt). ([8]) The non-financial corporation (NFC) debt-to-GDP ratio stood at 154% of GDP in 2021 or 91% of GDP excluding non-financial special purpose entities (SPEs) ([9]), remaining above the prudential benchmark of 81%, even when accounting for non-financial SPEs foreign debt (see also the thematic chapter on NFC debt). Net credit flows to NFCs turned back positive in 2021 (1.4% of GDP), reflecting a range of policy measures to support the liquidity position of firms during the pandemic, including short-time working schemes, tax deferral, direct support to small businesses and a moratorium on loan payments that expired by end-2020, while an interest rate subsidisation scheme has supported credit also in 2021. These measures have been essentially phased out by end-2021.

Despite an overall reduction of non-performing loans in the private sector, several economically important sectors remain vulnerable due to a persisting high share of NPLs. For NFCs, non-performing loans declined across all sectors of economic activity, but remain high in construction, real

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([5]) The aggregate NPLs figures referred to in this report, unless otherwise indicated, are based on ECBs' data and thus they differ from the figures referred to in the Post-Programme Surveillance Report Cyprus, Spring 2022, that are based on Central Bank of Cyprus' data.
([6]) Post-Programme Surveillance Report Cyprus. European Commission SWD (2022) 703.
([7]) Monetary and Financial Statistics. Central Bank of Cyprus. April 2022.
([8]) In the case of Cyprus, the fundamentals-based benchmark is likely biased upward due to the already high level of debt in the base year (1995). See thematic chapter for further details.
([9]) In Cyprus, the non-financial corporate debt-to-GDP ratio is heavily influenced by non-financial Special Purpose Entities (SPE), which mainly have foreign debt. They are legal entities registered and tax resident in Cyprus with few employees and/or no production, which are controlled by non-resident entities. Excluding SPEs allows a better picture of NFC indebtedness which is nevertheless high. Data on SPEs derived from Central Bank of Cyprus.

estate, wholesale and retail trade, transport and professional business services. The default rate of loans exiting from moratoria has been low, but a significant percentage of these loans has been restructured and should continue to be monitored, particularly in the sectors of accommodation and construction. ([10])

The government debt-to-GDP ratio decreased since the peak of the pandemic and is expected to further decline but to remain nevertheless at a high level. In 2021, Cyprus reduced its public debt ratio to 103.6% of GDP (from 115.0% in 2020), thanks to nominal GDP growth, the use of excess cash reserves accumulated since the beginning of the pandemic through borrowing above financing needs, and an improved primary balance. These factors, combined with the phasing out of pandemic support measures, should also lead to a further decrease in public debt to 88.8% of GDP by end-2023. The Commission's fiscal sustainability assessment shows that Cyprus overall faces medium fiscal sustainability risks over the medium and long term. ([11]) When tapping the international markets in 2021-2022, Cyprus has been supported by favourable financing conditions, bringing down its weighted average cost of debt closer to the EU average, and a high degree of oversubscription. Cyprus continues to benefit from an 'investment grade' ranking by three major rating agencies, with a positive or stable outlook. In July 2021, the fourth agency – Moody's – changed Cyprus' rating upward by one-notch to Ba1, one notch below investment grade. However, even though the immediate effects of the pandemic on public finances have subsided, the fiscal sustainability of the NHS in the aftermath of the reform poses a downside risk to the public finances. Moreover, uncertainty related to the impact of the invasion of Ukraine by Russia and related sanctions also poses significant risks to the budget.

The current account dynamics are not conducive to maintaining the net international investment position (NIIP) at prudent levels in the medium-term. The NIIP deteriorated from -116.1% of GDP in 2019 to -136.2% of the GDP in 2020 and partly corrected to -122.8% in 2021 (see Table 2.1). The deterioration of the NIIP between 2019 and 2021 is mostly due to the negative current account balances in 2020 and 2021, as real GDP recovered to its 2019 level in 2021 and valuation effects were limited. SPEs, mostly ship-owning, contributed significantly to the negative headline NIIP with roughly -80 pp. The impact risks of SPEs for the real domestic economy are reportedly limited, as ship-owning SPEs are mostly funded by foreign financial institutions or other related non-resident entities and own assets located outside Cyprus. ([12]) Therefore, excluding SPEs, the NIIP ([13]) stood at -43.3% of GDP in 2021, which is close to fundamental NIIP benchmark, and above, but close to, the prudential benchmark. The government sector also contributed negatively to the NIIP, with a net position of about -87% of GDP in 2021, as most government debt is held by foreigners. At the same time though, short-term risks related to this are contained as a large part still corresponds to loans granted by official creditors at favourable interest rates.

The current account deficit widened significantly due the collapse of tourism linked to the pandemic and a decrease in net primary income. The current account deficit deteriorated from 5.7% of GDP in 2019 to 10.1% of GDP in 2020 as exports of travel services, mainly tourism, plummeted by around 79% in 2020 (travel services account for around 20% of total exports of services). In 2021, it narrowed to 7.2% of GDP, reflecting also the recovery of the tourism sector. However, this balance is still well below the balance required to maintain the NIIP at prudent levels. ([14]) Since 2016, the primary income account has been posting relatively high deficits, contributing significantly to the overall current account deficit. The primary income deficit ([15]) increased from almost 6% of the GDP in 2020 to 7.4% in 2021. The elevated primary income account deficits can be explained in part by the growing activity of foreign-owned resident companies selling in the domestic market (e.g. investment firms, ICT companies), whose profits are repatriated in the form of dividends or recorded as retained earnings (see also the subsection on sectoral developments and external sustainability in the thematic chapter). In addition, the

([10]) Post-Programme Surveillance Report Cyprus. European Commission SWD (2022) 703.
([11]) See European Commission Country Report on Cyprus for the latest results and the 'Fiscal Sustainability Report 2021', Institutional Paper 171, 25 April 2022 for methodological details...
([12]) For more information see Country Report 2018.
([13]) When excluding non-defaultable instruments such as portfolio equity from the NIIP, the remainder (i.e. NENDI), shows a positive value of 44% of GDP in 2021, reflecting a high stock of FDI in the private sector, of which a large part is related to the real estate sector.
([14]) A current account balance of about -2% of GDP would be required to maintain the NIIP, excluding SPEs, at the current level, close to its fundamentals benchmark (and above prudential), according to simulations.
([15]) Excluding SPEs, it deteriorated from 3.4% of GDP in 2019 to 5.2% of GDP in 2020 and 7.0% of GDP in 2021

interest payments of credit acquiring companies registered in Cyprus on their foreign debt have also contributed, to some extent, to the deterioration in the primary income account.

Cyprus' economy will be impacted by Russia's invasion of Ukraine via a number of channels with consequences for the unwinding of the excessive macroeconomic imbalances (see also box 2.1). The Russian aggression against Ukraine and related sanctions appear to have a limited direct impact on the Cypriot financial sector. ([16]) However, exports of services, i.e. tourism, ICT, business and financial services are expected to be negatively affected. In addition, Cyprus depends heavily on imported oil. All of these are expected to have a negative impact on GDP growth, trade balance, and increase inflation. In the spring 2022 forecast, the Commission revised the GDP growth for Cyprus for 2022 down to 2.3% of GDP (from 4.1% in the winter forecast) and the current account deficit was forecast to widen to 8.8% of GDP. The less positive economic outlook carries downside risks on Cyprus' fiscal position and the debt-servicing capacities of households and businesses. Furthermore, the majority of loans in Cyprus has variable interest rates, representing a vulnerability to interest rate increases. The European Systemic Risk Board has highlighted Cyprus as one of five countries at risk with regards to the household debt servicing ratio. ([17])

Assessment of MIP relevant policies

The Cypriot recovery and resilience plan (RRP) includes a framework and action plan to continue reducing NPLs. In the banking sector, the banks are still working on additional NPLs portfolio sales. However, the majority of the remaining stock of NPLs are either dominated by terminated accounts, are small tickets, or concern SME and household loans collateralised by primary residences and thus making future sale of NPLs increasingly difficult. Outside the banking sector, the government is designing the transformation of KEDIPES ([18]), into a national asset management company, an initiative that has the potential to reduce legacy NPLs collateralised by primary residences in the banking sector. A number of legislative initiatives in the Cypriot RRP are expected to improve the working environment of credit acquirers and credit servicers and result in better NPL management. In addition, the ongoing justice system reform will help reduce the currently very long duration of court proceedings and help resolve NPL-related cases.

Several long-standing reforms and measures to address excessive private debt are included in the RRP. It includes a reform to reinforce the insolvency framework, which would significantly help debt-workouts by promoting the use of insolvency schemes and tools, digitalisation of the systems and training the practitioners. A significant effort will be also spent on reviewing the insolvency proceedings for legal entities under the modernisation of the Companies Law. Further measures aim to prevent excessive private borrowing, such as the creation of a liabilities monitoring register encompassing liabilities other than banking loans, including tax liabilities and contributions to social insurance, and the creation of a System of Exchange of Data and Credit Bureaus. The latter is expected to improve the assessment of credit risk for new lending by the provision of credit scoring and better information for new lending regarding the debtor's financial profile. The RRP also foresees the implementation of a strategy to enhance financial education within the general population to avoid excess borrowing. In parallel, the ongoing improvements in the property transaction system are expected to support deleveraging by helping to liquidate collateral by the private sector and strengthen payment discipline going forward. For the latter, it is also important to improve the legal framework of the enforcement of claims and court decisions. Beyond the measures foreseen in the RRP, safeguarding an operational and effective foreclosure framework is key to enhance payment discipline.

Policy measures are also in place to support the reduction of the government debt-to-GDP ratio. First, the authorities have almost phased out all pandemic support measures. The newly introduced consumer support measures to face increased energy prices are limited in scale and time, and should have only a very limited negative effect on outstanding gross debt in 2022-2023. In addition, the implementation of RRP measures – aiming at improving tax collection, addressing aggressive tax

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([16]) For more information see Post-Programme Surveillance Report Spring 2022. European Commission SWD (2022) 703.
([17]) ESRB (2022), "Vulnerabilities in the residential real estate sectors of the EEA countries", Report, February.
([18]) KEDIPES is the state-owned asset management company established in 2018 as the residual entity of the former state-owned Cyprus Cooperative Bank whose performing part was sold to Hellenic Bank.

planning practices and shoring up healthcare system sustainability – should facilitate public debt reduction and its long-term sustainability.

A number of measures, already implemented or planned, should support external rebalancing. Measures to strengthen productivity growth, to diversify the economy and to lower oil dependence with the roll out of renewables and interconnection with partner countries – which are included in the RRP – should also help to improve the external balance and its resilience to shocks. Measures to enhance payment discipline, as described above, are key to encourage private sector savings and limit excessive borrowing. The post-pandemic phasing out of the government support measures is expected to improve the general government net borrowing position and thus contribute positively to the NIIP.

Conclusion

Cyprus entered the COVID-19 crisis with vulnerabilities linked to high government and private debt, external sustainability and a relatively high, albeit declining, stock of non-performing loans. The pandemic and the resulting sharp drop in GDP have led to an increase in government and private debt-to-GDP ratios and a deterioration of the current account balance in 2020, while improving again in 2021 thanks to a strong economic rebound. The current account deficit is above prudential levels, despite the noticeable improvement in 2021. Private debt stocks declined even during the crisis but much of it is concentrated in sectors with high non-performing loans ratios of which many were sold by banks to credit acquiring companies. Such sales led to a substantial reduction of non-performing loans in the banking system during the pandemic, achieving a single digit ratio. The NPLs sold to credit-acquiring companies, however, remain in the real economy. The large current account deficit is projected to widen in 2022 and only slowly narrow in the medium-term and is expected to remain below what would be needed to ensure a prudent net international investment position over the medium term. Government and private debt-to-GDP ratios are expected to resume their decline from 2021, supported by the recovery of nominal GDP and phasing out of government support measures, but some deleveraging needs remain. The outlook for 2022 is surrounded by uncertainty related to the impact of Russia's military aggression against Ukraine and the related sanctions, in view of trade of services exposures, a weaker economic environment and higher inflation. Possible higher interest rates could impact the debt-servicing capacity of households having mostly mortgage loans with variable interest rates (see also box 2.1).

The adopted policy agenda has the potential to significantly reduce Cyprus' current macroeconomic vulnerabilities. Cyprus has phased out most of its government support measures put in place as a response to the COVID-19 shock. These measures supported employment and household income and have successfully averted an immediate wave of bankruptcies and non-performing debt. Addressing long-standing structural issues, the Cypriot RRP includes a number of important reforms aiming to boost the sustainability of government debt in the medium term, to limit excess borrowing by the private sector, to diversify the Cypriot economy – also diversifying exports – and to further resolve non-performing loans in and outside the banking sector. The timely implementation of adopted measures and the continuation of efforts to close the remaining policy gaps will contribute to a clear reduction of the macroeconomic vulnerabilities faced by Cyprus.

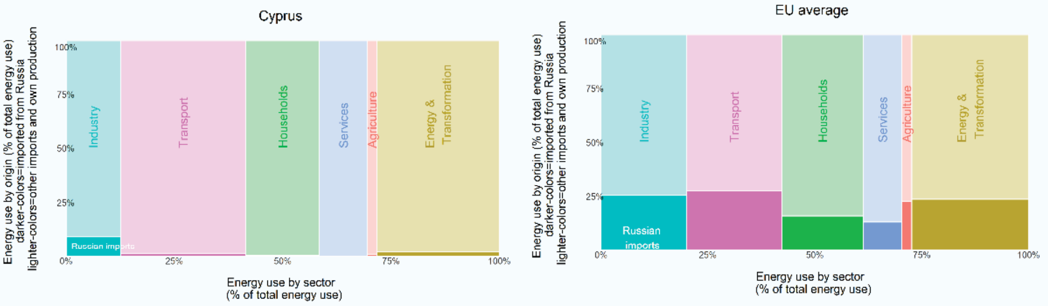
Based on the findings in this in-depth review, the Communication "European Semester – 2022 Spring Package" ([19]) sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Cyprus, in line with Regulation 1176/2011.

([19]) European Commission (2022), European Semester Spring Package 2022, COM(2022)600 final.

Box 2.1: **Exposures to the commodity price surge, and to Russia**

This box summarizes risks and exposures regarding the commodity price surge, and the importance of direct links with the Russian economy. The surge of commodity prices since 2021 had been aggravated by the Russian military aggression against Ukraine. This box shows the exposures of Cyprus to energy imports from Russia, to gas and oil price shocks and to sanctions on Russia. Exposure to sanctions on Russia are the highest in the EU. Cyprus' energy dependency on imports from Russia is minimal (Table b.1.1). Trade and financial links to Russia and the commodity price surge are expected to affect external balances in the short run. They may also lead to uncertainty and repercussions for the Cypriot economy over the medium term, as around 3% of Cyprus value-added is estimated to derive from Russian final demand, related to tourism, financial and business services (see Table b.1.1).

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia

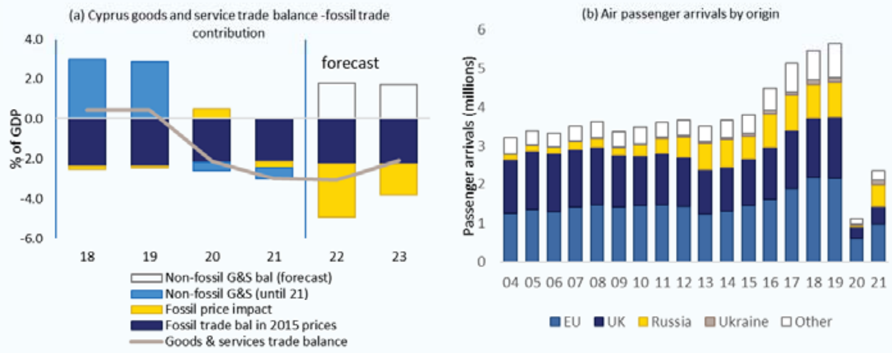


Notes: The left panel displays the distribution of primary energy usage in Cyprus according to Eurostat energy balances. The horizontal axis displays the relative importance of energy-consuming sectors. The vertical axis displays the importance of energy from Russia in satisfying that need. Note that this dependence on Russia differs according to sector's use of natural gas vs oil and coal. For comparison, the right-hand panel displays the same concept for the EU aggregate. Russian imports include oil and petroleum products,natural gas and solid fossil fuels.
Sources: Eurostat and European Commission services calculations

The Cyprus energy mix is dominated by petroleum products, which account for 86% of its primary energy usage. Cyprus has a service-oriented economy, and thus devotes less energy to the industry sector than the EU average, with construction and construction materials accounting for the most energy-intensive part of its industry sector (Graph b.1.1). Available data suggests that production destined to satisfy domestic demand, mainly transport, seems more energy-intensive than production to generate export revenue (ICT, financial and business services, and tourism). The transport sector thus accounts for a significantly larger share of inland energy consumption than in most other EU economies. ([1])

The oil price and Russia's invasion of Ukraine with related sanctions are likely to weigh on the current account deficit during 2022 and 2023. Oil and other fossil fuel imports are one of the major items of the Cyprus trade balance, and normally account for ca. 4% of GDP each year (and 12% of imports destined for home consumption)(see Graph b.1.2). This exposes external balances to the current terms-of-trade shock. Due to increased oil prices, importing the same amount of oil as in previous years, which has been rather stable, may cost Cyprus an additional 3 pp of GDP on aggregate during 2022. Some of this may be partially offset by an expansion of exports of services (tourism and non-tourism) expected for 2022 (see the forecast for the non-fossil trade balance in Graph b.1.2). It is important to note that the expansion forecast for travel and non-travel services exports has been revised down since the introduction of sanctions related to the invasion of Ukraine by Russia, which are expected to significantly affect tourism from Russia and also, to some extent, non-travel services to Russia.

Graph b.1.2: Cyprus goods and service trade balance and air passenger arrivals



Notes: (1) The graph displays the trade balance as % of GDP, and highlights net trade of petroleum products, natural gas and solid fossil fuels (mainly coal), in 2015 import prices. The 'fossil price impact' component details the impact of price changes on the (also changing) real trade balance. 2022 and 2023 figures reflect central assumptions of the Commission spring forecast, notably combining the forecasted fossil price evolution with broadly forecasted import quantities of fossil energy sources.
(2) The graph displays the trade balance as % of GDP, and highlights net trade of petroleum products, natural gas and solid fossil fuels (mainly coal), in 2015 import prices. The 'fossil price impact' component details the impact of price changes on the (also changing) real trade balance. 2022 and 2023 figures reflect central assumptions of the Commission spring forecast, notably combining the forecasted fossil price evolution with broadly forecasted import quantities of fossil energy sources.

The direct exposures towards Russia are characterised by substantial "reverse" direct investment of Russian-owned entities. Due to reporting asymmetries, sources differ somewhat in detailing the exact amount of financial links between Cyprus and Russia (Graph b.1.3 shows a significant share of unallocated exposures – ROW residual). Among assets identified, Cypriot FDI liabilities towards Russia accounted for 475% of GDP in 2020 (Table b.1.1). Available data suggests that a significant part of these cross-border equity holdings are related to financial special purpose entities (SPEs) and are insulated from the domestic economy, and that their potential disruption should have limited effect for the Cypriot economy. Russian residents also account for significant non-FDI assets in Cyprus, estimated at 71% of GDP in 2020. Total exposures towards Russia grew significantly since 2004 (Graph b.1.3). Real estate assets held by Russian residents form an important part of these net liabilities (2) vis-à-vis Russia and are estimated to amount to ca. 18 pp of GDP. (3) As regards the domestic banking sector, exposures to Russia are of minor importance. (4)

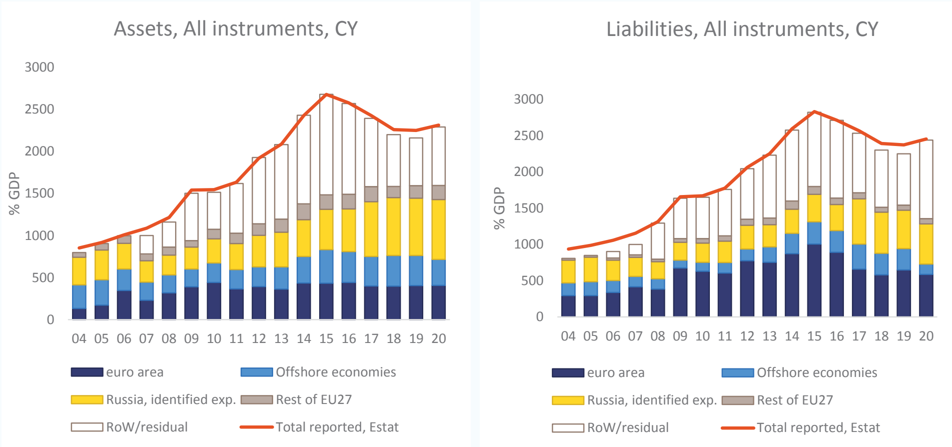
Table b.1.1: Selected exposures

Trade & financial exposures	unit	CY	EU
Domestic value added embodied in exports to Russia	% of GDP	2.8%	0.4%
Non-energy Russian import content in final demand	% of GDP	2.2%	0.4%
Russian tourist nights spent	% of total 2019	23.7%	2.7%
FDI assets held in Russia	% of 2020 GDP	685.9%	2.5%
Portfolio & other inv. assets held in Russia	% of 2020 GDP	27.4%	0.9%
FDI liabilities towards Russia	% of 2020 GDP	475.8%	1.2%
Portfolio & other inv. liabilities towards Russia	% of 2020 GDP	76.5%	1.1%
Consolidated banking exposures towards Russia	% of 2021 GDP		0.5%

Energy mix	unit	CY	EU
Solids fossil fuels (incl. peat)	% of Gross inland consumption 2020	0.6%	10.8%
Oil and petroleum products	% of Gross inland consumption 2020	85.6%	32.7%
Natural gas	% of Gross inland consumption 2020	0.0%	24.4%
Renewables and waste	% of Gross inland consumption 2020	13.8%	19.0%
Nuclear	% of Gross inland consumption 2020	0.0%	13.1%
Commodity exposures	**unit**	**CY**	**EU**
Net petroleum imports from all countries	% of GDP 2021	0.9%	1.2%
Crude oil imports from Russia '20	% of oil imports	-	25.7%
Net gas imports from all countries	% of GDP 2021	0.1%	0.6%
Gas imports from Russia '20	% of gas imports	0.0%	43.6%

Notes: data source Eurostat for commodity exposures, European Commission Figaro for value-added exposures, BIS for consolidated banking exposures, European Commission FinFlows for other financial exposures. Energy gross inland consumption excludes net imports of electricity and derived heat.

Graph b.1.3: International investment position, asset and liabilities vs direct counterparts



Notes: The graph displays total Cypriot external assets and liabilities excl. financial derivatives, as reported by Eurostat, and their repartition with respect to direct counterparts as reported by the FinFlows database. 'Offshore economies' represents the group defined as 'offshore' by Eurostat, plus several other non-EU economies (see Nardo et al., 2017, Finflows: database for bilateral financial investment stocks and flows : manual for a joint database DG-ECFIN & DG-JRC).

(1) Note that energy destined for 'maritime bunkers', i.e. international shipping, is not a part of gross inland consumption, and is thus not represented in the transport sector usage above. In the case of Cyprus, the usage of maritime bunkers accounted for 12% of all oil imports in 2020.

(2) According to Balance of Payments guidelines (BPM6 manual), real estate property held by foreign residents is accounted for in direct investment.

(3) See Cyprus Post-Programme Surveillance Report, Spring 2022. The weight of Russian property buyers in total real estate sales has declined since the end of the Cyprus citizenship for investment programme (CIP). Non-EU property sales accounted for 18% property transactions in Cyprus in 2021 (data source: Cyprus DLS). Non-EU buyers have been mostly British and Russian residents.

(4) The Cyprus banking sector also comprised RCB bank, which had been a subsidiary of the sanctioned Russian VTB bank. Yet RCB bank had been of minor importance for external assets and liabilities in 2020, and its exit from the banking sector is unlikely to affect aggregate exposure figures. See Cyprus Post-Programme Surveillance Report, Spring 2022.

Table 2.1: **Selected economic and financial indicators (Part 1), Cyprus**

								forecast	
all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	2022	2023
Real GDP	4.5	0.1	1.3	5.7	5.3	-5.0	5.5	2.3	3.5
Potential growth (1)	3.7	2.0	0.3	3.2	3.3	2.8	2.4	2.6	2.7
Contribution to GDP growth:									
Domestic demand	6.0	-1.1	1.6	2.9	4.3	-0.8	2.7	2.9	2.8
Inventories	-0.2	0.4	-0.2	0.7	1.5	-2.3	-0.6	0.0	0.0
Net exports	-1.4	0.5	-0.2	2.2	-0.5	-1.9	3.4	-0.6	0.7
Contribution to potential GDP growth (1):									
Total Labour (hours)	1.3	0.9	-0.1	1.3	1.1	0.7	0.6	0.9	0.9
Capital accumulation	1.9	1.4	0.4	1.0	1.0	1.0	0.7	0.8	0.9
Total factor productivity	0.5	-0.4	0.0	0.9	1.1	1.1	1.1	1.0	1.0
Output gap (2)	3.1	0.4	-4.8	3.7	5.6	-2.3	0.6	0.3	1.1
Unemployment rate	4.6	7.0	14.2	8.4	7.1	7.6	7.5	7.8	7.3
Harmonised index of consumer prices (HICP)	2.5	2.7	-0.4	0.8	0.5	-1.1	2.3	5.2	2.7
GDP deflator	3.0	2.0	-0.5	1.0	1.1	-1.1	2.7	4.5	3.2
External position									
Current account balance (% of GDP), balance of payments	-6.2	-7.7	-3.1	-4.0	-5.7	-10.1	-7.2	-8.8	-7.2
Trade balance (% of GDP), balance of payments	-2.2	-6.4	1.3	1.3	0.2	-2.5	1.1	.	.
Primary income balance (% of GDP)	-4.7	-0.3	-2.3	-3.6	-4.7	-5.9	-7.4	.	.
Secondary income balance (% of GDP)	0.7	-1.0	-2.0	-1.7	-1.2	-1.6	-0.9	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-2.0	-2.6	-1.9	-1.8	-1.8	-1.9	-2.1	-2.0	-2.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	0.3	3.0	1.1	-0.1	0.0	0.1	-0.6	-0.3	0.1
Capital account balance (% of GDP)	0.1	0.3	0.4	0.6	0.1	0.1	0.7	.	.
Net international investment position (% of GDP)	-68.2	-123.6	-150.0	-125.6	-116.1	-136.2	-122.8	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	.	-69.2	-208.9	-181.4	-167.0	-169.8	-141.2	.	.
Net FDI flows (% of GDP)	.	9.1	28.6	-25.6	0.4	-17.9	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	2.3	2.8	-2.6	1.1	2.9	1.4	0.4	2.7	2.8
Nominal compensation per employee	4.5	2.7	-2.0	1.5	4.4	-3.2	4.7	4.1	4.5
Labour productivity (real, hours worked)	1.6	0.1	0.9	1.0	1.4	1.6	1.6	-0.8	1.6
Real effective exchange rate (ULC)	0.5	0.6	-2.8	1.3	-0.6	.	.	.	.
Real effective exchange rate (HICP)	-0.1	-0.4	-1.2	1.7	-2.2	0.5	-0.3	.	.
Export performance vs. advanced countries (% change over 5 years)	-13.8	-7.5	-0.6	19.2	21.0	29.1	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	247.1	308.6	334.4	282.9	249.9	259.7	241.3e	.	.
Household debt, consolidated (% of GDP)	84.7	117.1	121.9	96.4	86.0	90.7	87.6e	.	.
Household debt, fundamental benchmark (% of GDP) (6)	69.0	78.5	98.8	90.5	88.0	97.0	93.1	.	.
Household debt, prudential threshold (% of GDP) (6)	40.9	41.2	39.5	43.0	47.1	44.9	45.6	.	.
Non-financial corporate debt, consolidated (% of GDP)	162.5	191.5	212.5	186.5	163.8	169.0	153.7e	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	155.6	141.1	160.9	141.1	134.4	145.7	137.2	.	.
Corporate debt, prudential threshold (% of GDP) (6)	64.3	63.4	68.5	75.2	82.6	80.5	81.2	.	.
Private credit flow, consolidated (% of GDP)	22.6	18.8	2.1	11.5	1.7	-2.5	3.5e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-5.9	2.3	5.1	5.4	-2.1	-1.2	-0.7	-1.5	-1.0
Households, net lending (+) or net borrowing (-) (% of GDP)	-7.5	-5.5	-5.1	-5.3	-4.7	-3.1	-4.8	-7.0	-6.0
Net savings rate of households (% of net disposable income)	0.7	-0.5	-7.5	-3.0	-0.3	1.8	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

Table 2.2: **Selected economic and financial indicators (Part 2), Cyprus**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	2022 (forecast)	2023 (forecast)
Housing market									
House price index, nominal	8.2	-2.4	-1.0	1.8	3.7	-0.2	-3.5	.	.
House price index, deflated	5.2	-4.9	-0.1	0.5	2.6	0.7	-5.5	.	.
Overvaluation gap (%) (7)	3.3	4.9	-1.7	-6.7	-7.1	-6.2	-13.6	.	.
Price-to-income overvaluation gap (%) (8)	6.3	1.4	-1.3	-9.6	-12.2	-8.4	-14.2	.	.
Residential investment (% of GDP)	10.3	8.2	4.2	6.5	7.6	7.6	6.6	.	.
Government debt									
General government balance (% of GDP)	-1.9	-4.1	-2.6	-3.6	1.3	-5.8	-1.7	-0.3	-0.2
General government gross debt (% of GDP)	61.1	60.5	103.2	98.4	91.1	115.0	103.6	93.9	88.8
Banking sector									
Return on equity (%)	.	-48.2	-34.9	8.2	2.9	-3.2	.	.	.
Common Equity Tier 1 ratio	.	7.7	14.1	15.4	18.3	18.4	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances)	.	8.9	34.0	17.4	15.4	9.1	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	35.2	20.2	18.1	11.0	8.1	.	.
Cost of borrowing for corporations (%)	.	6.7	4.8	3.5	3.3	3.2	2.9	.	.
Cost of borrowing for households for house purchase (%)	.	5.3	3.6	2.1	2.1	2.2	2.2	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

3. THEMATIC CHAPTER: PRIVATE DEBT

Households

Household non-performing loans in the banking sector have declined further despite the pandemic, but remain at a relatively high level. Households reduced their domestic bank liabilities, which represented about 58% of total household liabilities at the end of 2021. Total household debt liabilities amounted to 88% of GDP in 2021 (Table 3.1). The reduction of household non-performing loans in banks’ balance sheets from 35% of total household loans in 2019 to 24% in 2020 and 20% in 2021Q3 (Graph 3.1(d)) has been achieved mostly through the sale of loans to credit acquiring companies. Some NPL reduction has also been achieved through a combination of debt-write-offs, collateral sales and other organic reductions. There has been no significant restructuring of household loans that exited from the 2020 moratorium (about 3% only by end-2021) and loans at least one day past due amounted to 6.3% of the moratorium portfolio, by end-2021. The share of household loans in stage 2 increased temporarily to 14% in December 2020, but declined again to the pre-pandemic ratio (9%) by end-2021. ([20]) Outside the banking sector, other financial and domestic institutions hold 42% of household debt liabilities. This includes notably the KEDIPES public asset management company and other private credit acquiring companies (see Graph 3.1(a)). The majority of the loans held by credit-acquiring companies, including KEDIPES, is non-performing and about half of banks’ total non-performing loans in 2021Q3 ([21]) originates from households. Resolving all household non-performing debt, not only within the banking sector, would bring the household debt stock to close to its prudential threshold of 46% of GDP.

Net credit flows to household were positive in 2020, supported by government measures, and remained positive in 2021. After showing negative net credit flows in 2019, households borrowed again more than they repaid in 2020 and 2021. These positive net credit flows were supported by a range of policy measures, most of which have been phased out by March 2022 (see Box 3.1) and have remained moderate. Household credit flows amounted to 1.3% of GDP in 2020 and around 2.1% of GDP in 2021, below the fundamental benchmark for flows (see Graph 3.1(b) and Table 3.1). The increase is likely to be linked to boosted mortgage lending.

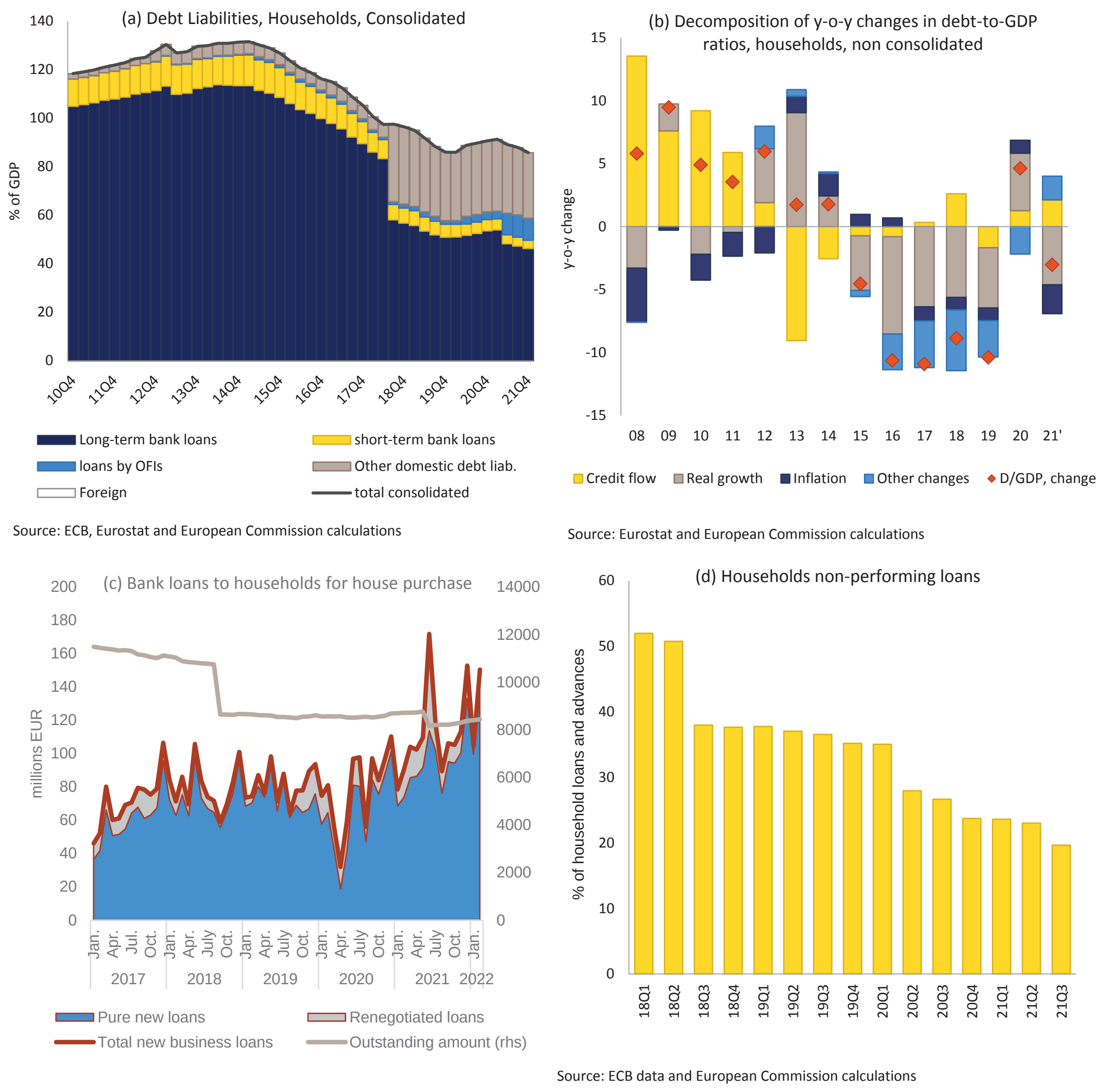
New mortgage lending accelerated in 2021 compared to recent years, but the effect could be temporary. Pure new loans for housing purposes reached around 5% of GDP in 2021, the highest level for the available data (Graph 3.1(c)), and could be a result of the government interest rate subsidisation scheme with applications open from March 2020 to December 2021. In 2020, 48% of loans, and in 2021, even 60%, benefitted from the scheme (EUR 296 million and EUR 668 million respectively). The significant increase in mortgage loans in 2021 could be linked to buyers anticipating their purchase in order to benefit from the scheme, but close monitoring of further developments in 2022 is warranted. Other policy measures which incentivise demand for mortgages include low property transfer fees and the abolition of the immovable property tax in 2017. Even though the increase in the overall house price index has been contained and house prices are not assessed as overvalued, these policies drive up demand and prices, which have increased faster in coastal areas. Banks in Cyprus are particularly exposed to the property market, directly via their exposure to real estate, acquired through debt-to-asset swaps and by the foreclosure process, but also indirectly through mortgage lending, which combined for NFCs and households amounted to 77% of GDP in 2021Q3, well above the level 53% for the euro area. ([22])

([20]) Figures on the performance of exposures that exited the moratoria schemes, the asset quality and volumes of loans under the government interest rate subsidisation scheme were obtained in the Post-Programme Surveillance Mission March 2022. Central Bank of Cyprus.

([21]) Banking figures quote here and in Chapter 2 refer to ECB consolidated banking data for banking groups including foreign controlled subsidiaries and branches, unless stated otherwise. See also Bank of Cyprus, Aggregate Cyprus banking sector data on NPLs, December 2021.

([22]) ECB and European Commission calculations.

Graph 3.1: Household debt and balance sheets



Source: European Commission services

The already weak financial position of indebted households in Cyprus could be put under pressure by higher interest rates. On aggregate, the ratio of total household debt to unconsolidated household financial assets declined to 34.7% in 2021 (Table 3.1) and currency and deposits represent a significant share of aggregate household assets. Compared to the EU average, the median Cypriot household with mortgage debt possesses less financial assets and the median indebted Cypriot household has less liquid assets but significantly more debt, which is amongst the highest ratio in the EU. In addition, they require a higher share of income to repay their mortgage debt. ([23]) Confirming these vulnerabilities, the ESRB highlighted Cyprus in February 2022 as one of five countries at risk with regards to the debt servicing

([23]) According to the third wave (2017) of the ECB household finance and consumption survey, the ratio between median financial assets of households with mortgage debt and median outstanding mortgages was 15% (below the EU ratio of 21%). According to the same survey, the median ratio of net liquid assets to income for indebted households was 1.7%, compared to 17% for the same ratio for the euro area. In addition, the median debt to income ratio of indebted households in Cyprus, according to the survey, was 209%, above the same ratio for the euro area (71%) and the highest among euro area countries. In the survey, the mortgage debt service to income ratio of households with mortgage debt was 26%] in Cyprus compared to 15% for the same ratio for the euro area. Source: Household Finance and Consumption Survey 2017, Table F1, https://www.ecb.europa.eu/home/pdf/research/hfcn/HFCS_Statistical_tables_Wave_2017_May2021.zip?078368a4438f4d94712367f6615445aa.

ratio ([24]), stemming from a possible rise in interest rates affecting floating-rate mortgages, which accounted for =more than 90% of new mortgages since 2014 (see Table 3.1).

([24]) ESRB (2022), "Vulnerabilities in the residential real estate sectors of the EEA countries", Report, February.

Box 3.1: Policy support to Households and NFCs

Moratoria on loan payments: The most significant loan moratorium run from March to December 2020 and covered about EUR 11.8 billion or 43% of all loans and advances. The moratoria was applicable to a maximum of 9 months for each borrower and borrowers in principle had to be performing prior to the pandemic. A second loan moratorium, with considerably stricter eligibility requirements, ran from January to June 2021, with a very small uptake (covering only EUR 59 million of loans).

Interest rate subsidies: Applied to new housing from March 2020 to December 2021 (deadline for last applications). It covered around EUR 1 billion in new mortgage loans from March 2020 -December 2021. Applications may be processed until March 2022.

Subsidies: One-off subsidies to micro and small enterprises and self-employed persons to cover part of their operating costs in 2020.

Short-time work (wage subsidies) scheme: Wage compensation to employees of firms forced to suspend their operations, provided the firm has not dismissed any employee as from 1 March 2020, for the period that the company is in the scheme plus one month.

Tax deferrals: VAT payments could be delayed by few months on a rolling basis.

Suspension of insolvency and foreclosures: In March 2020, foreclosure actions were suspended for three months, subsequently extended until the end of August. Foreclosures resumed in September, but in December 2020 an act of parliament suspended them again. In May 2021, Parliament voted for a further suspension until 31 July 2021. This was subsequently extended until the end of October 2021 with a narrower scope, but did not enter into force, as it was referred by the President to the Supreme Court (a hearing took place on January 2022).

Non-Financial Corporations

The pandemic interrupted the deleveraging process of non-financial corporations (NFC) in Cyprus. In 2020, NFC' debt as a share of GDP rose for the first time since 2014, mostly due to the sharp drop in real GDP, despite negative credit flows (-3.8% of GDP). However, it is expected to resume its previous declining trend in 2021 thanks to a recovery of nominal GDP growth, while credit flows turned positive (Graphs 3.2(a) and 3.2(b)). The NFC debt stock at 154% of GDP at the end of 2021 (and about 91% excluding non-financial SPEs) is expected to remain above, but much closer since its peak in 2014, to its prudential benchmark of 81% (which is unaffected by the presence of SPEs) and to its fundamentals benchmark (137% of GDP and, excluding SPEs, 80% of GDP). These developments indicate much reduced, but still remaining, deleveraging needs. ([25])

Net credit flows to NFCs have been positive but moderate in 2021, supported by pandemic-related government measures. In 2020, net credit flows to NFCs were negative, but turned positive in 2021 to around 1.4% of GDP (Table 3.2). This is below the fundamentals-based benchmark for flows (2.3% of GDP), and new bank credit to NFCs (pure new loans) in 2021 was below the levels observed in 2019 (EUR 1.5 billion in 2021 versus EUR 2 billion in 2019). ([26]) In 2020 and 2021, net credit flows to NFCs have been supported by a range of policy measures, most of which have been phased out by 2022Q1 (see Box 2.1). Interest payments continue to weigh significantly on the expenses of NFCs (see Table 3.1 and Graph 3.2(c)).

([25]) 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 2021 for SPEs, the SPE debt in 1995 as a share of 2021 GDP (about 57%) needs to be deducted for the benchmark. Prudential benchmarks are not affected by the presence of SPE debt.

([26]) Figures reflect Central Bank of Cyprus Monetary and Financial Statistics.

NFCs' non-performing loans continued to decline during the pandemic but monitoring developments is warranted. Following the lifting of the 2020 moratorium, the adverse effects on asset quality have been contained, with the ratio of NFC exposures at least one day past due at the end of December 2021 being 3.1%. The share of bad loans as a share of total NFCs loans even declined from 25% in December 2019 to 12% by 2021Q3, of which a substantial part of the decline in banking sector NPLs has been achieved through the sale of loans. The situation, however, warrants continuous monitoring, as 22% of NFCs moratorium loans have been renegotiated between March 2020 and December 2021 (independently of whether this was due to distress or not) and stage 2 NFCs loans have increased from 10% in 2019 to 21% in 2021. ([27])

Domestic NFC bank debt is concentrated in a few sectors, some with still relatively high NPL ratios. NFC debt in 2021 was concentrated in the sectors of construction and real estate (25%), manufacturing (19%), accommodation and food services (17%), wholesale and retail trade (16%) and transport and storage (10%) (Graph 3.2(d)). Among these sectors, the highest NPL ratios registered in December 2021 were in the construction and real estate sector (24.7%), in the wholesale and retail trade sector (12.5%) and in transport and storage (14.7%). In the manufacturing and in the accommodation and food services sectors NPLs are comparatively lower, and stood at 2.1% and 2.3%, respectively, in 2021Q4. In particular, sectors with high NFC debt and NPL ratios, such as tourism and construction, are vital to the Cypriot economy, and have been and continue to be negatively affected by the pandemic, exacerbated by uncertainties related to Russia's invasion of Ukraine and associated sanctions (for exposures to Russia, see also Box 2.1). It is therefore worth taking a closer look at developments in these key sectors in the two following sub-parts.

Developments in the tourism sector

The tourism sector, which is associated with a substantial share of NFC debt, has been significantly affected by the pandemic. The sharp reduction in international tourism led to a drop in revenue and profit of the accommodation and food services sector by 63% in 2020, with the real value added declining by 44% in 2020. The sector represents 17% of domestic bank credit to NFCs. Besides the tourism sector itself, it has also significant effects on the wholesale and retail trade sector, the transport sector and the construction sector.

Government support measures helped firms to withstand the pandemic and to partially recover in 2021. In addition to the loan moratoria and tax deferral, the government provided support to the tourism sector mainly in the form of short-time work schemes. Moreover, to support all the hotels heavily affected by the pandemic, the regular scheme running every winter in support of employment in hotels in coastal areas was extended. The government measures also included state aid to tourist operators under the state aid temporary framework. In 2021, foreign tourist arrivals reached almost 49% of 2019 levels, while revenues recovered to 56.4% of its 2019 level, performing relatively well compared to other EU tourist destinations and given the reliance on aviation for tourist arrivals. The real value added of the food and accommodation sector increased by 38% in 2021, recovering a significant share of the 44% loss in 2020, and the bankruptcy filings in the sector have been limited. ([28]) In addition, the sector NPL ratio in 2021Q4 was lower than prior to the pandemic, due to a decline in the stocks of NPLs (by 73% or EUR 153 million) combined with an increase in the stock of loans (by 16% or EUR 344 million) relative to end 2019. ([29]) About 37% of bank exposures to the sector of accommodation and food services exiting from moratoria have been renegotiated between March 2020 and December 2021 (irrespective of distress status) and are worth monitoring. ([30])

The expected impact of Russia's unprovoked invasion of Ukraine and related sanctions on the Cypriot economy increase the risks to the debt-servicing capacity of NFCs, in particular in the tourism sector. Russia is the second biggest tourism market of Cyprus, making up about 20% of total tourist arrivals and revenues each year, with Ukrainian arrivals previously accounting for around 5% (see Box 2.1). Despite significant government efforts to redirect those shares from other markets, the sector will most likely be negatively affected. Furthermore, a prolongation of current high energy prices is likely

([27]) See footnote 20.
([28]) Post-Programme Surveillance Report Cyprus. European Commission SWD (2022) 703.
([29]) Bank of Cyprus, Aggregate Cyprus banking sector data on NPLs, December 2021.
([30]) One reason being that for 18% of exposures the repayment schedule had not begun by end-2021.

to also negatively affect demand for holidays from other markets and to squeeze profits of firms in the sector.

Developments in construction and other key sectors

In 2021, the construction sector recovered almost fully from the pandemic hit. Construction, which represents above 6% of total gross value added, remains a key sector in the Cypriot economy, even though it lost much importance since the peak in 2007. In 2021, construction accounted for around 63% of total gross fixed capital formation, and residential construction (dwellings) represented 63.1% of total construction activity (or 6.6% of GDP) in 2021, among the highest shares in the EU. The sectors' gross value added (GVA) had been recovering since its trough in 2015, before the pandemic hit, affecting it due to lockdown measures and supply bottlenecks, resulting in a decline of its real value added by 6.4% in 2020. However, the sector recovered by 6.3% in 2021, attaining a real value added very close to its 2019 level.

Construction and real estate combined represent a large share of bank credit to NFCs in Cyprus and still have the highest NPL ratio. The stock of bank credit to the construction and real estate sector was 25% of total NFC credit in 2021Q3 (10% for construction and 15% for real estate) ([31]). The NPL loan ratio amounted to 16.2% in the construction sector and 8.5% in the real estate sector. These ratios, however, have declined since the start of the pandemic, reflecting mostly NPL sales to credit-acquiring companies. Despite this progress, it should be noted that 44% of exposures under the moratorium in the construction sector and 15% in the real estate sector have been renegotiated from March 2020 to end-2021 (independent of distress status) and warrant further monitoring.

Contracts of property sales recovered to 2019 levels, despite the end of the citizenship for investment scheme in October 2020. Contracts of sale declined significantly in 2020 (by 23%) due to lockdown measures. In 2021, there has been a significant drop in sales to non-EU citizens after the end of the Cyprus citizenship for investment programme (CIP). This drop had been more than compensated by sales to Cypriot nationals and EU citizens, which increased above their 2019 levels (by 13% and 20%, respectively). ([32]) As a result, total sales in 2021 recovered to close to 2019 levels. Market shares have changed, with Cypriot nationals representing 64% of the market in 2021 (up from 57% in 2019), EU nationals representing 18% of the market (up from 15% in 2019) and non-EU nationals representing 18% of the market (down from 28% in 2019). ([33])

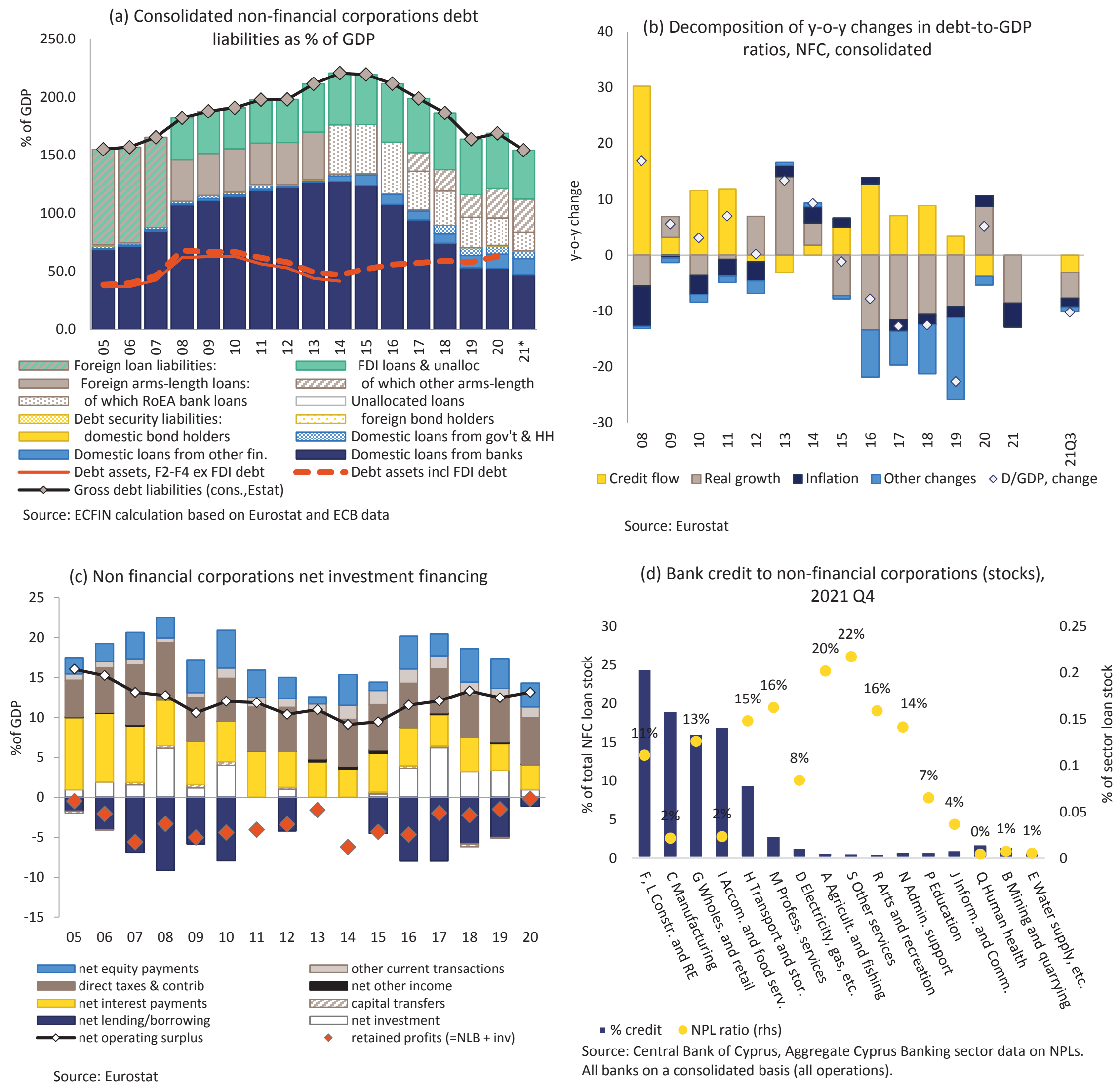
The impact of Russia's invasion of Ukraine may not affect the real estate market but soaring prices for construction material may affect the construction sector. Over the last ten years, Russians have been active in the real estate sector in Cyprus, however, showing a decreasing trend. In 2021, the share of FDI in real estate from Russia accounted for around 6% of the total value of transactions of immovable property in Cyprus. At the same time, the domestic market for real estate has grown in 2021 as a result of the mortgage subsidisation scheme. In addition, the loss of Russian buyers could be substituted by the increasing trend of the demand over the last years from other markets. However, the construction sector is expected to be negatively affected by the exceptionally high prices of construction material, which already increased by almost 18% in the first quarter of 2022 y-o-y. ([34])

The sector of professional, scientific and technical activities accounts for a non-negligible amount of NPLs and could also be affected by the consequences of the Russian invasion of Ukraine. The sectors of professional, scientific and technical activities, and administrative services, combined, represent about 11% of the total gross value added and about 15% of NFC bank deposits ([35]). At 16% combined, the NPL ratios are relatively high in these sectors. Sanctions following the invasion of Ukraine by Russia could impact in particular the turnover in the sector of professional, scientific and technical

([31]) According to Central Bank of Cyprus aggregate banking sector data on NPLs, December 2021.
([32]) Accordingly, FDI inflows related to construction declined from about EUR 500 m. to EUR 130 m. after the end of the CIP.
([33]) Calculation from statistics on registrations of contracts of sale available from the department of land surveys https://portal.dls.moi.gov.cy/en-us/data-files/Pages/default.aspx. The foreign market is concentrated in coastal areas, with the highest share in Paphos for Europeans (37% of sales to foreign EU nationals in 2021) and in Limassol for non-EU nationals (36% of sales to non-EU nationals in 2021). Prior to 2021, Paphos had a slightly higher market share than Limassol also for non-EU nationals.
([34]) Post-Programme Surveillance Report Cyprus. European Commission SWD (2022) 703.
([35]) The sector of professional activities alone accounts for 11% of NFC bank deposits.

activities. Overall, around 3% of Cyprus value-added is estimated to derive from Russian final demand, related to tourism, financial and business services (see Box 2.1). There are, however, indications of demand from Russian, Ukrainian and Belarusian companies for relocating to Cyprus with their employees, in order to continue their business from a safer business environment. This could support professional services in the next couple of years.

Graph 3.2: **NFC debt and investment financing**



Source: European Commission services

Policy measures to resolve and prevent private sector excess borrowing and facilitate deleverage

The Cypriot recovery and resilience plan includes measures that are expected to facilitate a further reduction of private indebtedness. Cyprus underwent a significant overhaul of its corporate and personal insolvency regime in 2015, but the use of the various procedures has been limited to support deleveraging and to serve as an early warning against excessive borrowing. Work to amend the Companies Law (which may include a reform of restructuring procedures) and the reorganisation of the Department of Insolvency (necessary for improving its operations and increase its efficiency) are now included in Cyprus's recovery and resilience plan. The modernisation of the Companies Law, which includes a law review of the insolvency proceedings ([36]), and the strengthening of the insolvency

([36]) The reform consists of modernising the Cyprus Companies Law by (i) using best practices from other common law jurisdictions to provide a foundation of knowledge and clarity in the form of case law and literature, to assist in interpreting and applying the framework ([37]) aiming at the effective functioning of the Department of Insolvency ([38]) could help a higher participation of borrowers in the insolvency framework and facilitate debt workouts. However, delays in the legislative process risk a potential breach of the obligation to transpose into Cypriot law the Directive (EU) 2019/1023 on preventive restructuring by its deadline of 17 July 2022.

Implementation of planned reforms and preventing excess borrowing will be key, and needs to be combined with measures that strengthen contract enforcement. In addition to strengthening the conditions for efficiently resolving existing debt, the RRP foresees a number of measures expected to help preventing excess borrowing. This includes the creation of a liabilities monitoring register encompassing liabilities beyond the debt owed in the form of loans, including liabilities and arrears such as tax liabilities and contributions to social insurance. ([39]) To improve the assessment of credit risk for new lending by providing better information regarding the debtor's financial profile, a System of Exchange of Data and Credit Bureaus is to be set up by end-2024. ([40]). In addition, the RRP includes a strategy for combating financial illiteracy, which aims at enhancing financial education within the general population. This reform shall improve financial decision making, correct wrong attitudes and biases and support more informed and financially responsible decisions. ([41]) To improve the payment discipline in Cyprus, these measures need to be complemented by measures that enhance contract enforcement, including the revision of the Civil Procedure Law and the effective application of the foreclosure framework.

The timely implementation of the reform of the system for issuance and transfer of property rights will further facilitate the liquidation of collaterals and support contract enforcement. Cyprus's RRP includes a reform in the system of issuance and transfer of property titles. The current system has important weaknesses (see Cyprus Country reports 2016-2019) and has thus contributed to the over indebtedness of the construction and real estate sectors. Until now, irregularities, such as final buyers with mortgages not possessing property titles and vendors maintaining mortgages on properties already sold, have hampered the application of the foreclosure and insolvency legislations and exposed the Cypriot housing market to risks related to money laundering. ([42]) It is essential to implement the reforms, expected by end-2023, for guaranteeing an efficient and transparent system for the issuance and transfer or property titles in order to improve the Cypriot business environment and enable a good functioning of the foreclosure and insolvency legislation. ([43])

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law in practice, (ii) reviewing the accompanying Companies Rules, (iii) assigning a team of legal experts to undertake the project for advisory and drafting services of the new Companies Law and Regulations, and (iv) reviewing the insolvency proceedings under the Companies Law, which are Liquidations, Receivership and Examinership, all to be completed by end-2025. Reform C3.3R3 in the RRP.

([37]) Reform C3.5R6 in the RRP.

([38]) This reform shall include actions such as digitalisation of systems (enhancement of existing systems and introduction of new ones), training delivered to the staff of the Department of Insolvency, implementation of a Customer Service line and a web portal for customers, and full implementation of the regulatory framework for Insolvency Practitioners, all to be completed by mid-2025.

([39]) Reform C3.5R5 in the RRP, to be completed by end-2024.

([40]) Reform C3.5R4 in the RRP.

([41]) This reform consists of (i) identifying the pockets of financial illiteracy, (ii) reviewing the international literature on the topic, (iii) providing a detailed action plan for implementation, and (iv) the full implementation of the short-term measures of the strategy, all to be completed by end-2023. Reform C3.5R7 in the RRP.

([42]) See MoneyVal (2029), "Cyprus Fifth Round Mutual Evaluation Report", Council of Europe. The report highlights a number of weaknesses related to the prevention of money laundering in real estate transactions, and calls for significantly enhancing the supervision of the real estate sector and for increasing the level of compliance of real estate agents with preventive measures.

([43]) Reform measures include: (i) the examination and issuance of property titles that are still pending; (ii) the extension of the new planning and building permit policy; (iii) the review of the Streets and Buildings Regulation Law to introduce incentives for the supervising engineer to prevent any irregularities that may block the issuance of the title deed; and (iv) the amendment of the Sale of Property (Specific Performance) Law. The amendment of the Sale of Property (Specific Performance) Law aim to ensure that any mortgage that the vendor has on the property is cleared before the contract of sale is registered in the land department and the transfer of the property title is made as soon as the buyer fulfils all his/her contractual obligations. This will be achieved by having the buyer pay the purchase price to the "project account", where any prior mortgages on the property are linked to, to ensure that the bank will release these prior mortgages. The deadline for the implementation of the reform is end-2023. Reform C3.5R3 in the RRP.

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

	Source	2003-07	008-12	013-18	2019	2020	2021f	21Q1	21Q2	21Q3	21Q4
Total private sector											
(Households and Non-financial corporations)	Source										
Stocks											
Private debt level (% of GDP)(1)	*(a,d)*	247.1	308.6	325.8	249.9	259.7	241.3	260.7	252.6	248.8	241.3
Private debt level (% of potential GDP)(1)	*(a,b,d)*	255.0	309.4	313.5	263.9	253.6	242.8	250.4	248.4	246.3	242.8
Prudential threshold (% of GDP)	*(c)*	105.0	104.7	109.7	129.7	125.4	126.8				
Fundamental benchmark (% of GDP)	*(c)*	228.8	219.6	255.0	222.4	242.7	230.3				
Flows											
Private credit flows (transactions, % of GDP)(4)	*(a)*	22.6	18.8	3.7	1.7	-2.5	3.5	7.0	0.0	7.2	0.4
Private credit flows (transactions, % of potential (	*(a,b)*	23.6	19.2	3.9	1.8	-2.5	3.5	6.7	0.0	7.1	0.4
Benchmark for flows (% of GDP)	*(c)*										
Households (HH)											
Stocks											
HH debt level (% of GDP)	*(a,d)*	84.7	117.1	117.6	86.0	90.7	87.6	91.3	89.1	87.9	85.8
HH debt level (% of potential GDP)	*(a,b,d)*	87.5	117.3	113.0	90.9	88.5	88.2	87.7	87.6	87.1	86.3
Prudential threshold (% of GDP)	*(c)*	40.8	41.2	40.1	47.1	44.9	45.6				
Fundamental benchmark (% of GDP)	*(c)*	69.0	78.5	97.5	88.0	97.0	93.1				
Debt (% of gross disposable income)	*(a,b,d)*	129.4	169.7	176.0	129.5	132.5	135.0	131.9	132.5	132.5	132.1
Interest paid (% of gross disposable income)	*(a,b)*	1.4	2.0	2.0	1.7	1.6					
Debt (% of gross financial assets)	*(a,d)*	36.3	45.8	46.9	39.4	36.7		35.1	34.7	34.7	34.7
Share of variable rate loans for house purchase (%	*(d)*		75.1	93.3	93.5	92.2	97.8				
Domestic loans in forex (% of dom. loans)	*(d)*	2.6	4.0	3.2	3.0	2.2	1.9				
Flows											
HH credit flows (transactions, % of GDP)(4)	*(a)*	10.3	7.6	-1.7	-1.7	1.3	2.1	1.2	1.8	3.6	2.2
HH credit flows (transactions, % of potential GDP)	*(a,b)*	10.7	7.8	-1.5	-1.8	1.2	2.1	1.1	1.8	3.6	2.2
Benchmark for flows (% of GDP)	*(c)*	5.0	5.2	2.3	2.9	3.1	3.2				
Savings rate (% gross disposable income)	*(b)*	6.1	5.4	0.4	5.7	8.0	5.3				
Investment rate (% gross disposable income)	*(b)*	17.8	14.0	9.7	13.2	12.7	11.7				
p.m. Bank HH NPLs (% of HH loans) (2)	*(d)*			50.4	0.0	0.0	0.0				
Non-financial corporations (NFC)											
Stocks											
NFC debt (% of GDP)(1)	*(a,d)*	162.5	191.5	208.2	163.8	169.0	153.7	169.4	163.5	160.8	155.5
NFC debt (% of potential GDP)(1)	*(a,b,d)*	167.5	192.0	200.5	173.0	165.1	154.6	162.7	160.8	159.2	156.5
Prudential threshold (% of GDP)	*(c)*	64.2	63.4	69.6	82.6	80.5	81.2				
Fundamental benchmark (% of GDP)	*(c)*	159.8	141.1	157.6	134.4	145.7	137.2				
Debt (% of value added)	*(a,b,d)*	310.9	377.7	407.5	319.6	331.3	302.7	324.4	318.5	313.5	306.3
Interest paid (% of gross operating surplus)	*(a,b)*	36.7	32.0	25.6	22.7	18.8					
Debt (% of gross financial assets)	*(a,d)*	152.3	129.8	159.5	122.6	116.2					
Domestic loans in forex (% dom. Loans)	*(d)*	19.0	16.4	7.6	5.6	4.8	5.6	5.0	5.0	5.2	5.6
Flows											
NFC credit flows (transactions, % of GDP)(4)	*(a)*	12.3	11.1	5.4	3.4	-3.8	1.4	5.8	-1.7	3.6	-1.8
NFC credit flows (transactions, % of potential GDF	*(a,b)*	12.8	11.5	5.4	3.5	-3.7	1.4	5.6	-1.7	3.5	-1.8
Benchmark for flows (% of GDP)	*(c)*										
Investment (% of value added)	*(b)*	13.3	17.3	15.4	17.9	14.2	12.4				
Savings (% of value added)	*(b)*	13.8	21.0	19.6	10.9	11.6	10.8				
p.m. Banks NFC NPLs (% of NFC loans) (3)	*(d)*			49.9	24.8	14.6					

(f) European Commission forecast, . (1) Quarterly data is non-consolidated. (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) Gross non-performing bank loans and advances to Non-financial corporations (% of total gross bank loans and advances to Non-financial corporations). (4) Quarterly data is annualized.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

4. THEMATIC CHAPTER: EXTERNAL IMBALANCES

External sustainability

Restrictions in international travel linked to the pandemic had a significant negative impact on the Cypriot current account in 2020 and 2021. The collapse of tourism exports (exports of travel services fell by 79% in 2020) in combination with a lower decline in imports, contributed to the deterioration of the current account to -10.1% in 2020, from -5.7% in 2019 (Graph 4.1(a)). In 2021, tourism receipts recovered to 56.4% of the 2019-level, ([44]) but a further deterioration in the primary income deficit resulted in the current account deficit remaining considerable at 7.2% of GDP in 2021. Net exports of services other than tourism and travel, have increased in recent years and contributed positively to the current account balance also throughout the pandemic, as these were only partly offset by any primary income outflows they generate. Excluding SPEs, the overall current account developments are similar; ([45]) a widening from -5.8% of GDP in 2019 to -9.7% of GDP in 2020, followed by -8.6% of GDP in 2021.

Current account deficits over the last few years have been increasingly driven by deficits in the primary income account. Excluding SPEs, which reportedly have limited links to the real economy, the primary income account deteriorated from -3.4% of GDP in 2019 to -7.0% of GDP in 2021. Credit-acquiring companies in Cyprus have been affecting the current account negatively from 2019 onwards, mostly through the payment of interest on their foreign debt. In addition, other foreign-owned companies in Cyprus (e.g. investment firms, ICT companies) also have a negative impact on the current account, through the repatriation of profits in the form of dividends or retained earnings. For some of these service companies, such as ICT, profits have not been significantly affected by the pandemic. The future developments of these flows are likely linked to the evolution of gross value added in the services sectors other than tourism in Cyprus.

The very negative current account balance also reflects the low savings rate of the domestic economy and is expected to persist. The government sector moved into sizeable deficit in 2020, but its net borrowing is expected to narrow by 2023 (Graph 4.1(b)). The net lending position of corporations has been relatively volatile up to the pandemic, improved with the pandemic and is forecast to be slightly negative in 2022 and 2023. The household savings rate increased mildly after the pandemic to 8% in 2020 (from 6% in 2019), but is still considerably below the euro area rate, which increased to 19% in 2020 and is forecast to converge to 13% in 2023 (Graph 4.1(c)).

The impact of Russia's invasion of Ukraine and the increase in energy prices are expected to weigh on the current account deficit and the NIIP. Although surrounded by uncertainty, the sanctions on Russia are expected to decrease exports of tourism and other services, in particular financial and professional services to Russia (for developments in tourism and professional services see thematic chapter: private debt on sectoral developments). Concerning exports of financial services, these are set to be negatively affected, as the sanctions are expected to impact the Russian SPEs and their transactions through Cyprus, affecting the volume of associated services provided. As for trade in goods, soaring energy prices are expected to affect the current account balance negatively in 2022 and 2023, given the strong dependence of Cyprus on imports of oil. The current account deficit is expected to increase to around 8.8% of GDP in 2022 up from 7.2% in 2021 and to narrow again in 2023, to around 7.2%.

On the financing side, currently Cyprus is a net investor in Russia. FDI outflows amounted to 13.3% of GDP on average between 2018 and 2020 and inflows from Russia have also been significant at 8.1% of GDP on average for the same period, the latter split between: (i) real estate purchased in Cyprus (which declined subsequently with the end of the citizenship for investment programme), (ii) transfer of

([44]) Post-Programme Surveillance Report Cyprus, Spring 2022. European Commission SWD (2022) 703.
([45]) The activities of non-financial SPEs (ship-owning) affect the current account to the extent that net ship registrations do not cover depreciation.

funds by special purpose entities (SPEs) and (iii) transactions of non-SPE financial firms. ([46]) There is significant uncertainty on how these flows will be affected. The overall stock of Cypriot assets in Russia amounted to 713% of GDP in 2020 (of which FDI accounts for 686 pp), while the stock of its liabilities to Russia amount to 552% of GDP (most of which are FDI liabilities at 476% of GD). The vast majority (above 90%) of external assets holdings with Russia are related to SPEs. ([47])

The current and projected current account balance is not conducive to maintaining the Cypriot NIIP at prudent levels. Simulations of the NIIP evolution show that, under plausible assumptions, current account balances for Cyprus, actual and forecast, are not conducive of maintaining the NIIP within prudent levels over the next ten years (Graph 4.1(d)). The current account deficit currently forecast for 2023 is still 7.2%. This is considerably below the current account balance of around -2% of GDP, required to maintain the NIIP, adjusted for SPEs, at the current level, close to its fundamentals benchmark (and above the prudential threshold). Similarly, to stabilize the NIIP above the MIP scoreboard benchmark of -35% over 20 years, a current account balance, adjusted for SPEs, of -1.6% of GDP would be needed. Given primary income account developments, this would require a trade surplus of slightly over 4% of GDP.

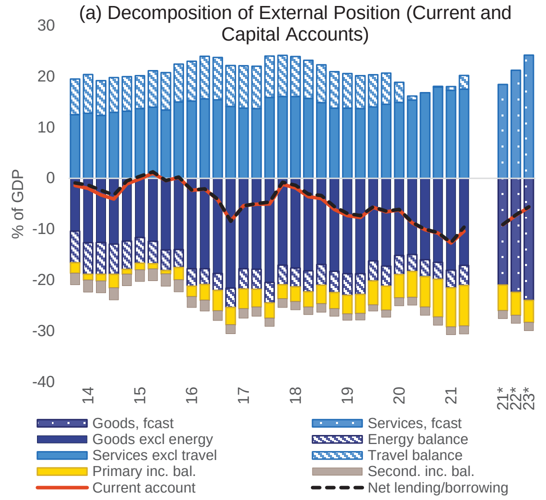
Policy measures to strengthen competitiveness

The Cyprus RRP includes measures to strengthen the tourism sector, lower energy import dependency, further diversify the economy and prevent excessive borrowing. Cyprus implements a tourism strategy with a shift towards more sustainable tourism, developing strong agri-tourism, sustainable hospitality infrastructure and attracting health and wellness tourists through several grant schemes included in the RRP. Furthermore, the authorities are continuing efforts to increase demand for tourism during low seasons and to broaden their tourist markets reducing over dependence on a small number of markets. The long-term growth strategy aims to further diversify the economy into other export-oriented services, such as professional services, tertiary education, health and fintech, as well as light manufacturing and agriculture. The targeted expansion of renewables should further alleviate the over-reliance of the economy on oil imports. Measures to strengthen the enforcement of contracts and court judgments, related in particular to the seizure of mobile property, complemented by RRP measures aiming to prevent over borrowing by the private sector, explained in detail in chapter 3, combined with effective insolvency and foreclosure frameworks, are key to enhance domestic savings and ensure the sustainability of the external debt.

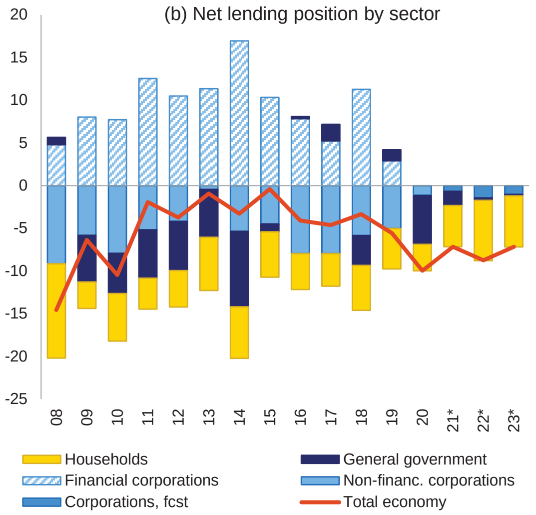
([46]) See also the Cyprus Post Programme Surveillance Report, Spring 2022. European Commission SWD (2022) 703.

([47]) FinFlows database updated and maintained by the European Commission (JRC and DG ECFIN). For more information see: https://data.jrc.ec.europa.eu/dataset/807d5d4f-2d73-4f17-81db-7ba2171bab83. If these positions with Russia were to be written down on both sides of the balance sheet, the Cypriot NIIP would deteriorate by around -160 pps. of 2020 GDP, but the NENDI (NIIP excluding instruments that cannot be subject to default) would improve by 56 pps of GDP. However, if write-downs are one-sided, the NENDI could deteriorate by up to 216 pps. of GDP.

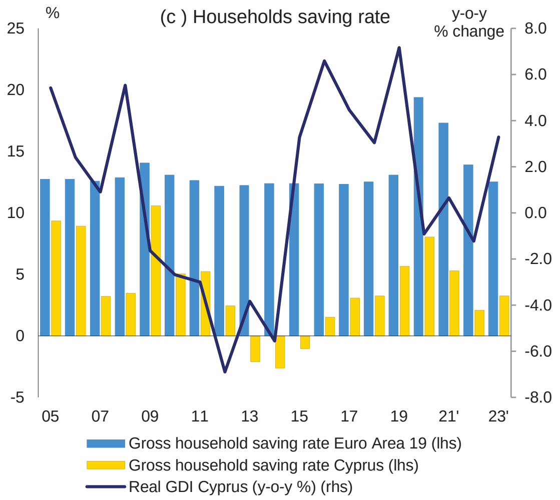
Graph 4.1: **Thematic graphs: External imbalances**



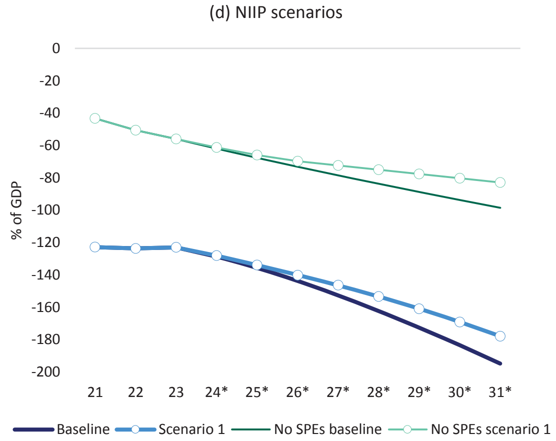
Source: European Commission calculations based on Eurostat and Comext. * EC forecast.



Source: Eurostat and Ameco. * EC forecast.



Source: Eurostat sectoral accounts. ' EC forecast.



source: European Commission calculations
Notes: Scenario 1: higher trade balance on account of fiscal consolidation and increased export competitiveness driven by the RRP. Scenario 2: lower trade balance amid higher fiscal deficits combined with lower exports competitiveness due to lower RRP absorption.

Source: European Commission services