INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/125

CYPRUS

June 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

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

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

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

Selected Issues

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

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IMF Executive Board Concludes 2021 Article IV Consultation with Cyprus

FOR IMMEDIATE RELEASE

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

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

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

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

Executive Board Assessment[2]

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

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

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

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

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

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

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

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

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

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

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

Cyprus: Selected Economic Indicators, 2018–2022

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

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

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CYPRUS

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

April 30, 2021

KEY ISSUES

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

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

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

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

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

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

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ANNEXES