CYPRUS

Highlights

- **The economy is being severely hit by the Covid-19 pandemic.** A deep recession is under way in 2020 as key sectors such as tourism, shipping and construction are particularly affected by the pandemic and associated restrictions.
- **The authorities have responded to the crisis with a significant package of support.** Key measures introduced so far include value-added tax (VAT) deferrals, payment holidays and subsidies, along with enhanced use of European Investment Bank instruments to support enterprises.
- **The digitalisation agenda has advanced.** Measures have been introduced to accelerate and improve the level of access to digital services, both within the government and between the government, the public and businesses.

Key priorities for 2021

- **Targeted support for businesses will be needed as Cyprus enters the recovery phase.** The challenge will be to provide support to the most affected businesses and vulnerable groups without endangering the hard-earned stability of public finances.
- **Renewed efforts are needed to reduce non-performing loans (NPLs) once the economy picks up.** NPLs have come down steadily in recent years but remain well above average European Union levels. Further reductions will require the pursuit of existing plans as soon as the market environment permits, along with support to the banking sector via the Central Bank of Cyprus (CBC) where needed.
- **Accelerating reforms to improve the governance of state-owned enterprises (SOEs) and public administration remain a priority.** The pandemic has accelerated the reforms on digitalisation, such as the implementation of the e-justice system, but a number of reforms regarding the governance of SOEs and public administration have advanced only slowly in recent years and need to be accelerated.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	4.8	4.2	3.9	3.2	-7.5
Inflation (average)	-1.2	0.7	0.8	0.5	-0.5
Government balance/GDP	0.1	1.7	-4.4	2.7	-1.8
Current account balance/GDP	-4.2	-5.1	-4.4	-6.7	-10.6
Net FDI/GDP [neg. sign = inflows]	-10.7	-6.9	-34.5	-14.1	-13.2
External debt/GDP	1,147.8	1,074.5	990.9	972.2	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	218.3	194.4	139.6	114.0	n.a.

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Covid-19: macroeconomic implications

The robust economic performance of recent years has been halted by the pandemic. Strong GDP growth over several years, including 3.2 per cent in 2019, has shifted in 2020 into a deep recession. In the first quarter of 2020 GDP grew by just 0.8 per cent year-on-year as the effects of the virus started to take hold. The severe lockdown (schools and all non-essential businesses shut) implemented between March and May 2020 to limit the spread of the virus affected virtually all sectors of the economy, and GDP fell by 11.9 per cent year-on-year in the second quarter of 2020. Economic sentiment plummeted from 111.7 points in January 2020 to 72.9 points in May 2020 (the lowest point since 2013) and has increased to just 80.6 points since then (September 2020). However, government measures have supported household income and unemployment so far has remained close to pre-Covid-19 levels, at 6.9 per cent in July 2020.

Tourism has been particularly affected by the crisis. In 2019, the travel and tourism sector accounted for 13.8 per cent of GDP, according to estimates from the World Travel and Tourism Council. During January to May 2020, overnight stays in Cyprus were down by more than 80 per cent relative to the same period a year previously, as lockdown and quarantine measures in key source countries took a major toll on the sector. The shipping sector (7 per cent of GDP) has also been hit by the crisis.

Public finances are being stretched by the pandemic. Recent years have seen major improvements in the public accounts after the financial and economic crisis in 2013; in 2019, the headline government budgetary balance recorded a surplus of 1.7 per cent of GDP, and the ratio of public debt to GDP fell below 100 per cent of GDP (at 95.5 per cent) by the end of 2019. However, a substantial budget deficit in 2020, along with a corresponding rise in public debt, is inevitable in light of falling GDP and government revenues and rising spending to mitigate the negative effects of the pandemic. Access to funding is not an issue so far, as the government retains investment-grade level among the main international sovereign credit rating agencies.

The recession in 2020 should be followed by a partial recovery. We forecast GDP to fall by 7.5 per cent in 2020, followed by growth of 4.0 per cent in 2021 on the back of a general pick-up of economic activity next year and a return of tourism to something closer to normal levels. However, risks are weighted to the downside, with any recovery likely to be delayed if there is a resurgence of the pandemic.

Policy response to Covid-19

The authorities have responded to the crisis with a significant package of support. Since March 2020, the government introduced a set of financial support measures worth €899 million (4.5 per cent of GDP), including specific support to the health sector, tourism and shipping. The package includes a VAT deferral for most companies until November 2020, a general nine-month payment holiday on loans for those who have been affected by the Covid-19 pandemic, and the introduction of subsidies, especially targeted at micro- and small- and medium-sized enterprises (MSMEs). Households are also being supported by leave allowances, and workers by unemployment allowances. The government package also includes financing and guarantees/financing of credit facilities (up to €1.7 billion) via the Pan-European Guarantee Fund.

Further crisis-response measures are supported by the CBC. In March 2020 a set of additional measures was announced, including: a release of capital and liquidity buffers for banks directly supervised by the CBC (up to €100 million), the simplification of documentation requirements for new short-term loans and other credit facilities, and the simplification of approval processes for loan restructuring. Applying favourable interest rates to new loans and newly restructured loans is also encouraged by the central bank.

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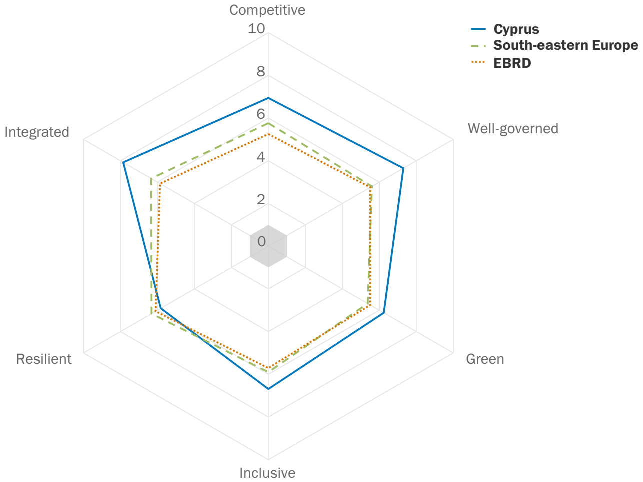
Assessment of transition qualities (1-10)



Structural reform developments

NPL reduction has slowed. In recent years, Cyprus had managed to improve significantly its banking system, after a deep crisis in the sector erupted in 2013. NPLs at one point accounted for more than half of all loans, but efforts to reduce the total have brought down the level significantly, to 27.8 per cent of total loans as of the end of April 2020. The banking sector was also significantly strengthened in 2019, with operations aiming at improving the balance sheets of the two major banks of the country (Cyprus Cooperative Bank and the Bank of Cyprus) and transferring NPLs to the state-owned management company KEDIPES. However, further sales envisaged in 2020 have had to be postponed given the challenge to determine the value of assets as well as the uncertainty about investors' appetite in the current pandemic. KEPIDES is not yet fully operational as the organisation set-up and governance framework have not been finalised, and the implementation of a business plan has not yet started. In addition, the take-up of ESTIA – the state support scheme for NPLs collateralised by primary residences – has been lower than expected.

The pace of digitalisation reforms has increased. In March 2020, a new Deputy Ministry on Research, Innovation and Digital Policy was established with the goal of improving digital access both within the government and between the government and the public and businesses. Some initiatives are focused on responding to the lockdown challenges of public administration and tracking. The implementation of digital services and electronic tools for the submission of applications by citizens, workers and SMEs regarding the support measures and grants announced by the government, has been introduced by the Ministry of Labour, Welfare and Social Insurance. Similarly, e-Banking credentials can now be used by citizens to access the government's systems and transact with the government. Existing initiatives have been accelerated, with for example the start of the tendering of the e-Justice system. Lastly, other initiatives are at the early stages of development, such as support to the development of e-Health initiatives and a new information system for the Cyprus Tax Department.

Reforms to the governance of SOEs and public administration are advancing slowly. Regarding the governance of SOEs, draft legislation pending since April 2015 was withdrawn in 2019, although a number of provisions were integrated in measures adopted by the government such as the application of the Code of Public Governance by SOEs. A new Action Plan for Better Regulation (2019-22), proposed in November 2019 and focusing on the reduction of administrative burdens and improved public sector efficiency, includes a number of ambitious objectives such as the modernisation of the tax department.