MEDIUM-TERM PUBLIC DEBT MANAGEMENT STRATEGY 2021-2023

REPUBLIC OF CYPRUS
MINISTRY OF FINANCE
PUBLIC DEBT MANAGEMENT OFFICE

Nicosia - Cyprus
OCTOBER 2020

MEDIUM TERM DEBT MANAGEMENT STRATEGY 2021-2023

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This document has been prepared based on data available up to 30 September 2020.

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I. Introduction

A strong public debt management strategy constitutes a basic element of sound fiscal management. Through the implementation of the current Medium-Term Debt Management Strategy (MTDS) 2020-2022 a more robust public debt portfolio has been achieved, increasing the visibility of the EMTN issued by the Republic of Cyprus in the international markets and completing the Cyprus bond yield curve. In the context of the target of a portfolio with low risk at a reasonable cost, the basic strategy followed in the previous year, will be continued during the period 2021-2023 with the main targets being the continuation of what has been achieved taking into consideration new conditions that have been created.

Pursuant to the selected strategy, the fixed rate EMTN remains the most realistic option and is therefore considered as the tool to achieve the best possible outcome under an acceptable cost-risk level. Assuming normal market conditions, the financing operations will be implemented within a framework consisting of three pillars:

i. Refinancing risk: The main objective of the Public Debt Management Office (PDMO) is to maintain a balanced debt maturity profile with manageable gross financing needs as a percentage of GDP. In addition, in order to reduce both the interest rate risk and the exchange rate risk due to the exchange rate variations, the majority of the new loans will be primarily in the form of fixed interest rates and in euro. The cash buffer will continue to be maintained at a level that meets the gross financing needs throughout the year, as defined in the MTDS 2021-2023 and the relevant decisions of the Council of Ministers.

ii. Development of the government securities market: The stock of government securities will continue to grow in the following years through the international bonds issuances since they will replace debt maturing in different types such as loans. The development of the government securities market will continue to be a strategic objective for the next three years, focusing on two sub-objectives: (a) In the primary market, a benchmark bond issue on a regular basis through the EMTN program will be targeted and (b) In the secondary market, the enhancement of the pricing mechanism, the transparency and the liquidity of the Cyprus bond markets will be targeted through the operation of the international bank group.

iii. Development of investor relations: The PDMO will continue its efforts to maintain contacts with existing investors, find new investors in order to extent the investor base and diversify it geographically. The overall objective will be to further extend the demand for Cyprus government securities to more and less correlated investors.

The above guidelines are interrelated, and a single action can contribute to the satisfaction of multiple guidelines at the same time. In conclusion, the above pillars are expected to contribute positively to the minimization of the debt portfolio cost and containment of financial risks.

In addition to the broader guidelines, quantitative benchmark targets are set in order to concretize the cost-risk appetite. It is noted that, spaced is allowed for flexibility to facilitate response to unusual market conditions or adverse economic events.

The second chapter that follows, analyzes the institutional framework of the MTDS and the objectives of the strategy. The third chapter, presents the macroeconomic-fiscal developments and the risk factors for the economy.

In the fourth chapter, the financing needs of the State for the period 2021-2023 and the main borrowing tools are presented. The fifth chapter, illustrates the review of the implementation of MTDS 2020-2022 and the sixth chapter presents the strategic framework of the new strategy 2021-2023.

Finally, in the seventh chapter, the final provisions related to the proposed strategy 2021-2023 are described.

II. Legal Framework and objectives

A. Legal and Institutional framework

Pursuant to paragraph 1 of Article 9 of the Public Debt Management (PDM) Laws of 2012 to 2016, the MTDS, which covers a time horizon of three to five years, is prepared and revised at least once a year on a rolling basis by the PDMO.

Pursuant to paragraph 2 of Article 9 of the PDM Laws of 2012 to 2016, the strategy and its updates are submitted by the Minister of Finance, after informing the Parliamentary Committee, namely 'Finance and Budget' of the House of Representatives, to the Council of Ministers, for approval, which is given no later than the end of October at the year preceding the launch of the strategy. After final approval, borrowing and other operational functions are planned based on the strategy. The actions for each calendar year constitute an integral part of the Annual Funding Plan (AFP) which should, as far as possible, be consistent with the MTDS.

The PDMO was established under the same Law of 2012 within the Ministry of Finance with its main responsibilities to be:

- the execution of public debt management operations,
- the management of government cash reserves,
- lending transaction risk assessment and
- the preparation of any legislation regarding the regulation of public debt management operations.

B. Ultimate objective of public debt management and the scope of strategy

The ultimate objective of public debt management is to ensure that financing needs are always met in time and that the cost of borrowing is the lowest possible in the medium term, within the framework of an acceptable level of financial risk.

The analysis covers the Central Government debt which comprises almost 100% of the debt of the General Government. In terms of the range of financing needs analyzed, sources of risk, such as government guarantees, or potential revenues, are included in the strategy only to the extent that they are incorporated in the budget forecasts.

The MTDS 2021-2023 is a policy paper, describing the direction and actions of public debt management during this period. The design of the new strategy was based on the existing strategy, with its basic guidelines remaining the same.

The objective of the strategy is dual:

- the definition and explanation of the strategic pillars for the State financing actions and the continuation of the development of the Cypriot bond market,

- the implementation of a framework with quantitative and qualitative objectives in order to implement the strategy pillars.

In addition, the existing cost-risk ratio of the portfolio, the expected market conditions and the macroeconomic framework were considered in the design of the strategy.

III. Basic macroeconomic assumptions and risk factors

In 2020, the growth rate of the economy is projected to decline by 5.5% due to the negative effects of the outbreak of the Covid-19 pandemic. The negative GDP growth rate is mainly due to the contraction of economic activity in various sectors of the economy, namely in Hotels and Restaurants, Manufacturing, Construction, Transport, Storage and Communications, Wholesale and Retail, Motor Vehicle Repair, Arts and Entertainment, and Other Service Activities.

The economy is projected to recover with the growth rate recording a positive sign approaching 4,5% in 2021 and in the medium term at 2,8% in 2023, a percentage close to the potential growth rate of the Cyprus economy. Even though the forecasts are positive, there are various internal and external risks such as the possibility of a second wave of the Covid-19 pandemic, geopolitical factors, deteriorating confidence, the high percentage of non-performing loans and the speed at which the tourism sector will recover.

Consumption and investments will continue to contribute positively to the growth rate of the Cyprus economy. The largest drivers to growth are expected to remain the Retail, Tourism, Professional Services - mainly Financial, Shipping and IT services - and the Construction sector. The Tourism sector, even though not projected to recover and return to the levels of previous years in 2021, nevertheless its impact will be significant in the medium term. In addition, the implementation of major infrastructure projects such as the completion of the casino, is expected to have a positive impact on the growth and diversification of the Cyprus economy.

Inflation is expected to return to a positive sign and range at 1% in 2021 and gradually approach 2% in 2023. Unemployment is projected to decline, approaching 5,2% in 2023.

The fiscal balance of the General Government is projected to enter negative territory in 2020 due to the negative effects of the Covid-19 pandemic approaching -4,5% of GDP. For the coming years, the fiscal balance is projected to improve from 2021 onwards, approaching -0,7% in 2021 and gradually -0,1% in 2023.

Government debt is projected to increase in 2020 reaching around 115% of GDP, again due to the negative effects of the Covid-19 pandemic, and will gradually improve to around 98% in 2023. It is worth noting that, at the end of 2020, cash reserves are projected to account for 14% of GDP, implying that the Government will proceed with early debt repayments of approximately € 1,2 billion. The percentage will meet the target of the MTDS to cover the financing needs of the next 9-12 months.

The systemic domestic banking institutions have improved their ability to absorb losses with the CET1 capital ratio comparing favorably with the European average. Asset quality has improved significantly since non-performing loans decreased in absolute terms by 68% from 2014 (€28,4 billion) to April 2020 (€9 billion), of which 57% are covered by provisions. For the coming years, the priority is to improve further the quality of assets given the high percentage of non-performing loans, which is close to 28%. Although the banks' cash liquidity is at a very satisfactory level, nevertheless the new lending in 2020 was limited in view of the freezing of economic activity as a result of the Covid-19 pandemic. Banks' profitability is under intense pressure in view of the low interest rate environment. Although there has been an increase in economic activity following the gradual easing of restrictive measures, the effects of the global pandemic remain uncertain, affecting economic activity. To mitigate the effects of the pandemic, the European Central Bank (ECB) has announced a package of measures to support the banks' capital position and ensure favorable financing conditions by limiting potential future losses, stemming from the crisis.

IV. Financing needs and funding sources

Financing needs

The strategy period 2021-2023 is characterized by manageable financing needs, despite the impact of the Covid-19 pandemic on public finances. The years 2021-2023 are characterized by low to moderate financing needs, with the fiscal deficit remaining at low levels for the years 2021-2022 and disappearing in 2023, with the result that the financing needs of that year also decrease. In relation to the size of the economy, gross financing needs will range between 6% and 11% of GDP over the three-year period.

Table 1: Central government gross financing needs

In bn EUR	2021	2022	2023
Long term debt redemptions	2,1	1,9	1.4
Fiscal (deficit)/surplus[1/]	(0,2)	(0,2)	(0,0)
Gross financing needs	**2,3**	**2,1**	**1,4**

1/= The fiscal balance projections are based on the data available to date and may differ in view of the high level of uncertainty surrounding the effects of the Covid-19 pandemic.

Financing sources and instruments

The European Medium-Term Bonds (EMTN) will continue to be the main source of borrowing to meet the government's financing needs under the MTDS 2021-2023 for strategic reasons since issuers can attract investors, beyond the domestic market, through the international market, thus expanding the investment base in size, geographically and by category. It is noted that these bonds are issued through the Euro Medium Term Note Program, are governed by English law and are listed on the London Stock Exchange. The bond clearing is preformed through the Euroclear / Clearstream repositories.

The domestic market will continue to be used as an additional source of funding to meet the State's financing needs. For the reporting period, priority will be given to the issuance of retail bonds to individuals for a period of 6 years on a monthly or quarterly basis, a financial tool available to cover the special characteristics of individuals as investors.

Treasury Bills remain the main short-term financial instrument, aimed at improving the management of government cash reserves and reducing the weighted average cost of government debt. As for the European Commercial Papers Program, although it can be used as an alternative source of financing in the short term by attracting funds from abroad, it remains inactive since the end of 2014, although it is not ruled out that it can be used again in near future.

Another financing tool is the borrowing from international banks for new projects or the continuation of ongoing infrastructure projects, which combine low borrowing costs and long repayment periods. Both government bills and bonds to individuals as well as bilateral loans, constitute a small part of the State's annual funding.

Table 2 presents an overview of the available marketable and non - marketable borrowing instruments of the Republic of Cyprus.

Table 2: Characteristics of borrowing instruments

Market instruments				
Security	**Maturity**	**Interest rate type**	**Governing Law**	**Investors Base**
Treasury Bills	Up to 12 months	Zero coupon	Cyprus law	Domestic Monetary Financial Institutions
Euro Commercial Papers	Up to 12 months	Zero coupon	English law	International and /or institutional foreign investors
Domestic Retail Bonds	6 years	Step-up structure	Cyprus law	Domestic natural persons
Domestic Bonds	Beyond 12 months	Fixed only	Cyprus law	Mainly domestic banks, small domestic institutional investors
Euro Medium Term Notes (EMTNs)	Beyond 12 months	Fixed only	English law	International and /or institutional foreign investors
Non-market instruments				
Type	**Maturity**	**Interest rate type**	**Governing Law**	**Creditors**
Foreign Loans	Typically more than 10 years	Fixed or variable	English law, Cyprus law or other law	European Investment Bank, Council of Europe Development Bank, EE, Domestic market

V. Review of the implementation of MTDS 2020-2022

This section focuses on the overview of public debt management and the events that affected the current Public Debt Management Strategy 2020-2022 objectives, which was approved by the Council of Ministers and published in September 2019.

A. Review of debt management operations

The impressive progress achieved in 2019 with the fiscal surplus and primary surplus approaching 3% and 5,5% of GDP respectively combined with the satisfactory level of cash reserves at the end of 2019, which covered the financing needs of the next 9 months, allowed, among other things, the early repayment of the IMF loan, eliminating therefore the foreign exchange risk.

In January 2020, PDMO issued a 10-year and a 20-year EMTN, totaling €1,75 billion, thus contributing to the completion of the bond yield curve of the Republic of Cyprus, and the improvement of cash reserves and financial risks related to the management of public debt.

Favorable market conditions and progress achieved, were reversed in March 2020 due to the outbreak of the Covid-19 pandemic, which had multiple socio-economic impacts on a global level. European countries, including Cyprus in an effort to restrain the spread of the Covid-19 pandemic proceeded to "lock-downs", resulting in a significant contraction in economic activity and GDP. The fiscal implications due to the need to support jobs and the economic activity in Cyprus in general, combined with the high uncertainty of the economic impact of the Covid-19 pandemic, have made it imperative to frequently revise the fiscal projection and therefore the AFP 2020 (see attached I).

In view of the above, in April 2020 the PDMO issued two EMTNs totaling €1,75 billion and a 52-week Treasury Bill of €1,25 billion to boost government cash reserves according to the PDM Laws, to cover the loss of fiscal revenues in view of the financial impact of the pandemic as well as to finance measures to support the economy and manage refinancing risk.

In addition, in July 2020, the PDMO proceeded to a new lending of €1 billion through tap issues on two existing EMTNs, a 5-year and a 20-year bond, taking advantage of the favorable conditions prevailing in international markets. The transaction was aimed, among other things, at boosting government cash reserves in the event of a new pandemic wave in the Autumn, improving the liquidity of existing bonds and ability to execute portfolio liabilities transactions at the end of the year in order to smoothen the debt maturity schedule and reduce refinancing risk.

In summary, the total financing for the period January - August 2020 amounted to approximately €6 billion, of which €4,5 billion was raised through the international bond market. In addition, the Government is expected to raise additional funding of €479 million from its participation in the European temporary Support instrument to mitigate Unemployment Risks in an Emergency (SURE), aimed at funding government employment support schemes, of which €230 million will be raised in 2020.

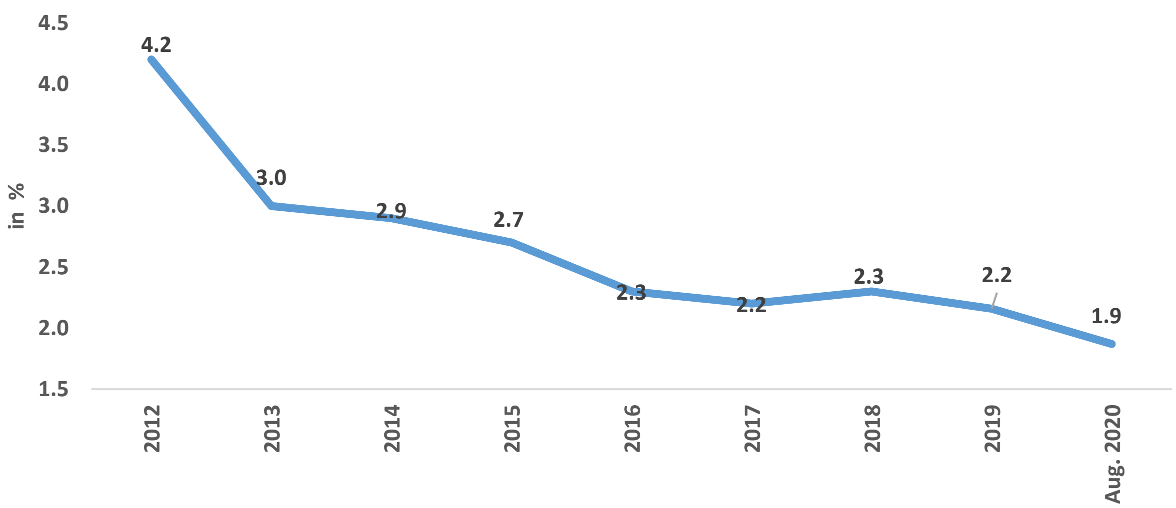
Public debt management operations have been extended beyond financing, and to portfolio liability transactions and on scheduled debt repayments. In February 2020, the early repayment of the loan to the IMF of €717 million and a 10-year EMTN bond of €668m took place, while in December 2020 a domestic bond of the order of €750mn is expected to be paid, being part of the agreement for the sale of the Cooperative Bank of Cyprus to Hellenic Bank.

B. Cost Outcome

B1: Cost of the debt portfolio

The weighted average debt portfolio cost, as shown in Figure 1 below, is on a downward trend approaching 1.9% at the end of August 2020 compared to 4.2% in 2012 and 2.2% in 2019. The downward trend of the weighted average cost of public debt is reflected in the reduction of interest paid by the Republic of Cyprus. The main reasons for the reduction of public debt service are the improvement of the credit rating of the Republic of Cyprus, the environment of low interest rates in the European market and the new low-cost issues replacing existing debt carrying a higher interest rate.

Figure 1: Weighted average cost of public debt



(Source: PDMO)

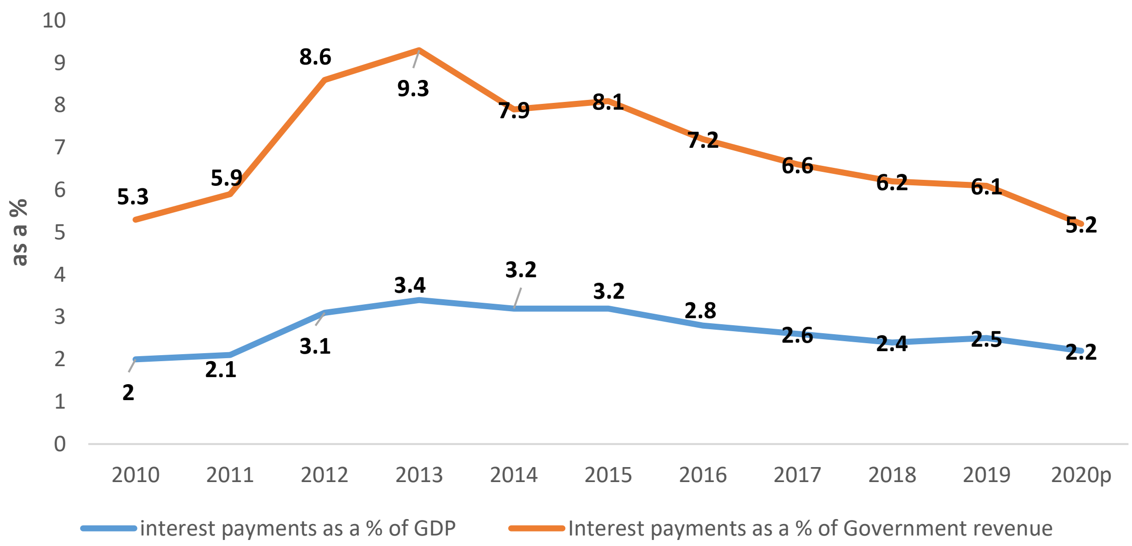
B2: Debt affordability

Interest paid as a percentage of GDP and government revenue has been declining since 2013, as shown in Figure 2 below.

Interest payments as a share of government revenue declined from 9.3% in 2013 to 6.1% in 2019 and are projected to further decline to 5.2% at the end of 2020. The projected reduction in interest as a share of government revenue is due to reduction of interest paid in absolute numbers mainly due to the early repayment of the Russian loan in 2019 and the loan to the IMF in February 2020.

Interest as a percentage of GDP, which is a predictor of public debt sustainability, declined from 3.4% in 2013 to 2.5% in 2019 and is projected to further decline to 2.2% by the end of 2020. Improvement is due to the reduction of interest in absolute numbers (numerator effect).

Figure 2: Share of interest to GDP and government revenue



(Source: PDMO)

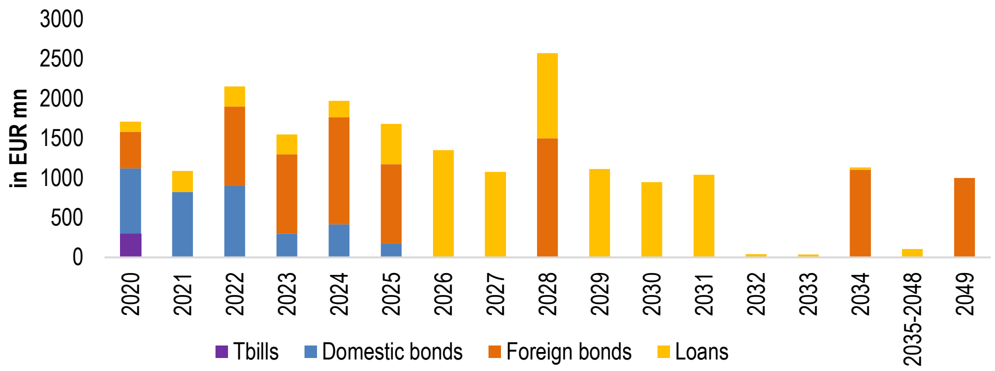
C. Risk Indicators Outcome

C1: Refinancing risk

Debt settlement smoothing and lengthening the average remaining debt maturity were at the epicenter of debt management activities. The results were apparent in all indicators reflecting the refinancing risk. Figures 3 and 4 show the changes in the repayment schedule between 2019 and August 2020.

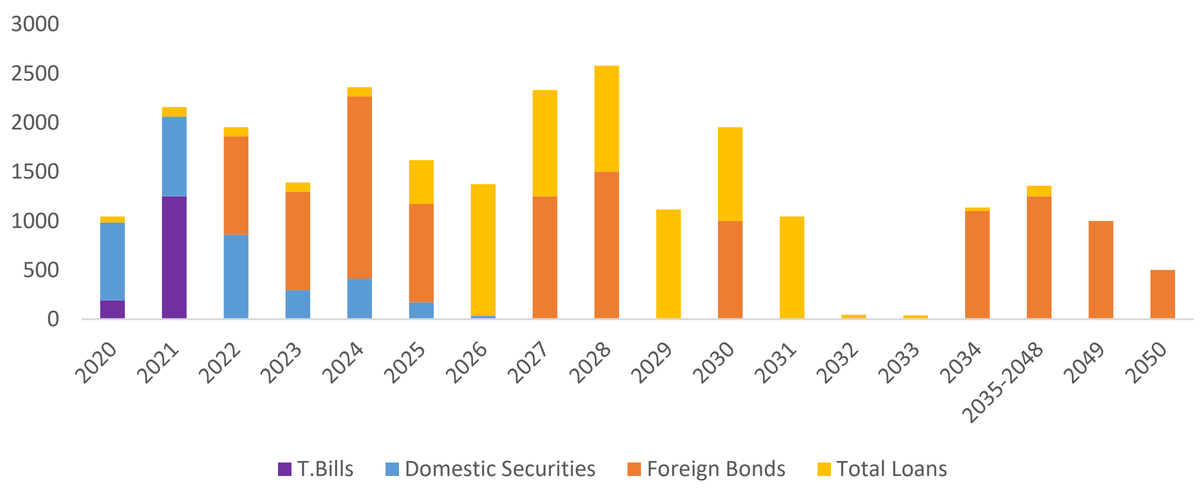
At the end of August 2020, the debt repayment schedule extended until the year 2050, following the issuance of the 30-year EMTN and increased the long-term annual debt maturity in the years 2024, 2027, 2030, 2040 as a result of bonds issued during the current year. In addition, there is a temporary increase in short-term debt in 2021 due to the issuance of the 52-week Treasury Bill in April 2020 in order to strengthen the State’s cash reserves and address the financial impact of the Covid-19 pandemic.

Figure 3: Public debt maturity profile, end 2019



(Source: PDMO)

Figure 4: Public debt maturity profile, end August 2020



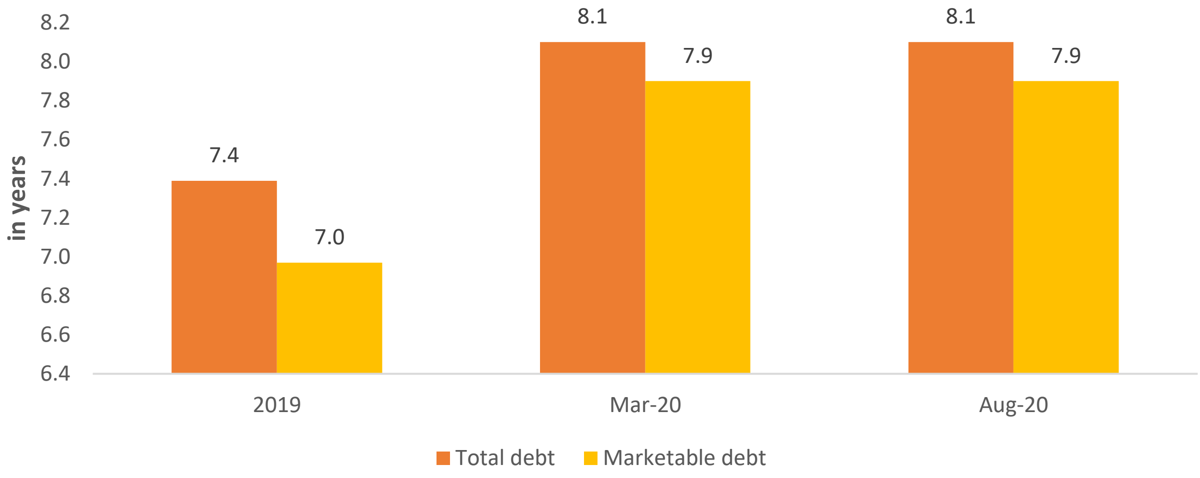
(Source: PDMO)

Other commonly used indicators for refinancing risk are the average remaining maturity of marketable debt and the ratio of debt maturing within one year and five years. Figure 5 and 6 below show these indicators at the end of August 2020 compared to the end of 2019.

The average remaining maturity of marketable debt recorded a significant improvement in 2020 approaching 7,9 years compared to 7,0 years at the end of 2019, due to the long-term debt issues in the current period. The corresponding total debt ratio reached 8.1 years, approaching the average remaining duration of total debt of the euro area countries.

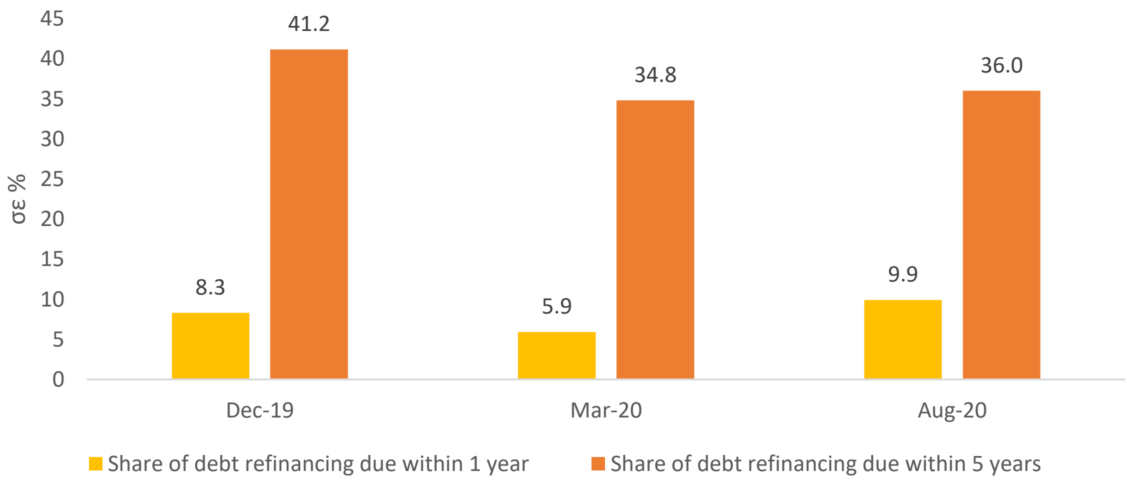
The ratio of debt maturing within one year and five years followed a downward trend in the first quarter of 2020, approaching 5,9% and 35% respectively, reflecting the positive impact of early repayment of the IMF loan of €717mn in February 2020. Following the outbreak of the Covid-19 pandemic in China and its worldwide spread, the Republic of Cyprus's AFP was revised in order to strengthen the State's cash reserves and deal with the fiscal impact of the Covid-19 pandemic. As a result, the PDMO proceeded to issue bonds in international markets in April and July 2020 and a 52-week Treasury bill, affecting both the one-year debt ratio and the five-year debt-maturity ratio in August 2020.

Figure 5: Average remaining maturity of debt



(Source: PDMO)

Figure 6: Share of debt due within one and five-year

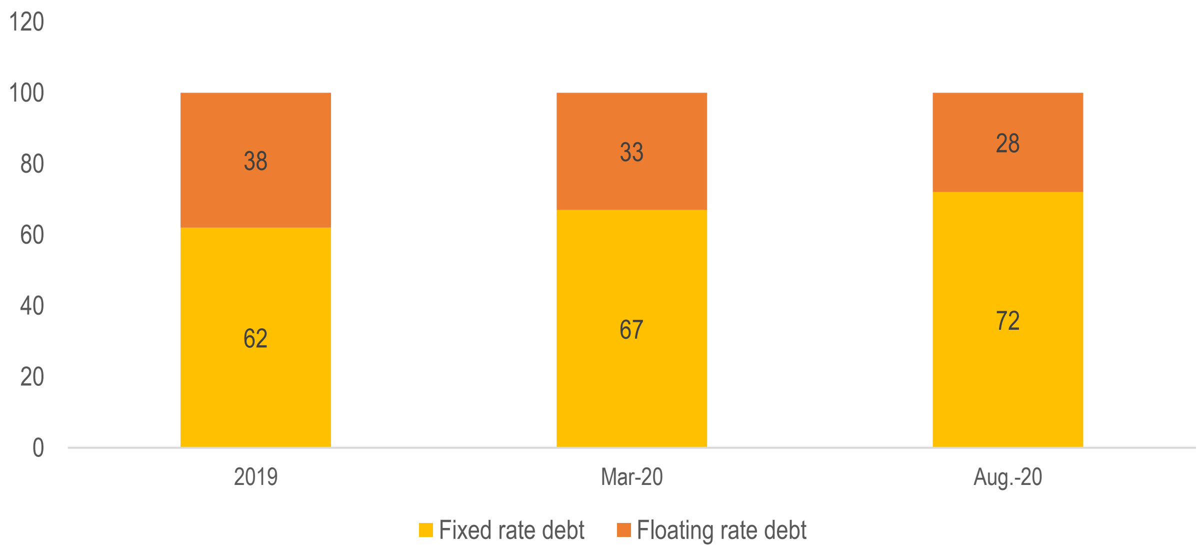


(Source: PDMO)

C2: Interest rate risk

The share of debt in floating interest rate against total debt followed a downward trend in 2020 as shown in the Figure below. This is mainly due to the early repayment of the IMF loan, which had a floating interest rate, and to a lesser extent, to borrowing at a fixed interest rate, in line with the objectives of the existing MTDS 2020-2022. The reduction of the floating rate debt will continue to be a priority in the new MTDS 2021-2023.

Figure 7: Share of floating-rate debt against total debt

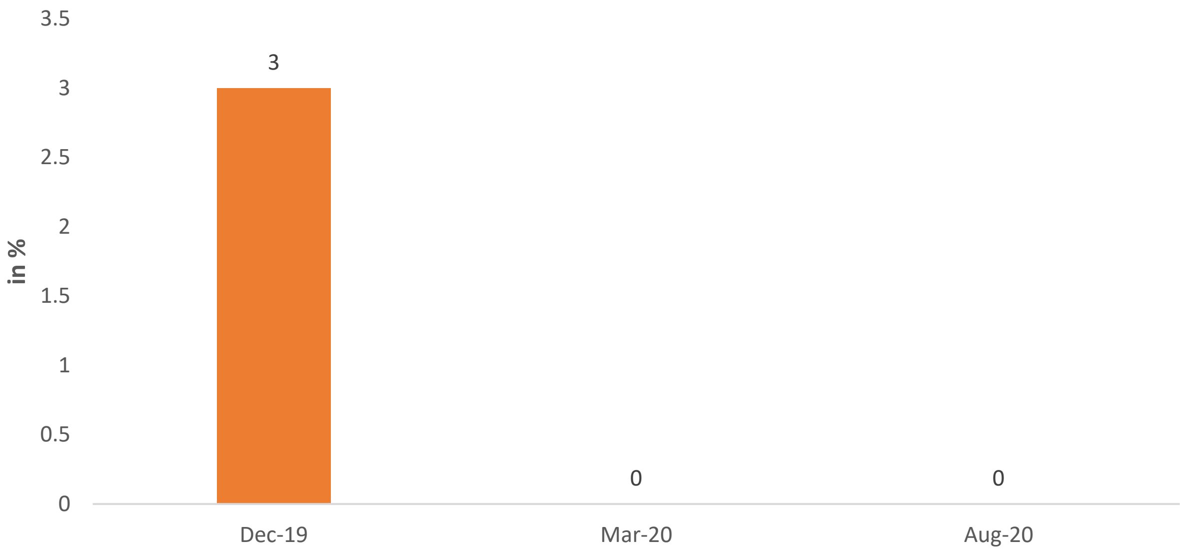


(Source: PDMO)

C3: Currency risk

Figure 8 below shows the evolution of foreign currency debt against total debt, which has been zero since March 2020 after the early repayment of the IMF loan, eliminating both foreign exchange and interest rate risk. It is noteworthy that the outstanding debt to the IMF at the end of 2019 was approximately €704 million and two months later when it was repaid, it amounted to €717 million, reflecting the risk of exchange rate fluctuations.

Figure 8: Share of foreign-currency debt against total debt



(Source: PDMO)

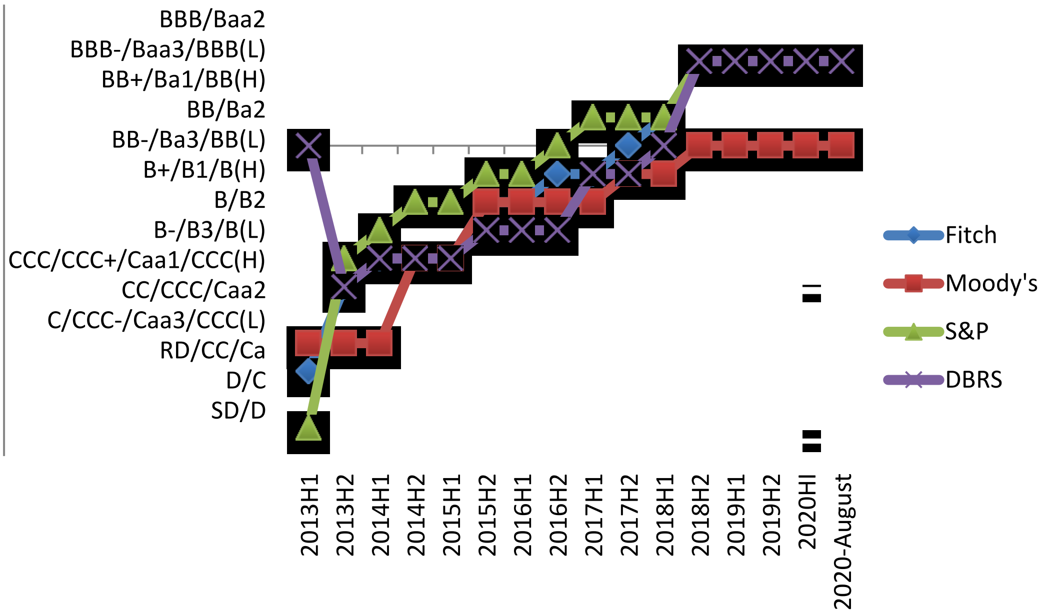
C4: Liquidity Risk

The MTDS objective of maintaining cash reserves to meet the financing needs of the next 9-12 months, has been met throughout 2020 with cash reserves at the end of August 2020 amounting to €4,8 billion, an amount which exceeds the financing needs of the next 12 months. It is noteworthy that the increase in debt by €4.4 billion at the end of August 2020 compared to the end of 2019 is offset by the increase in the State's cash reserves by €3.8 billion in the corresponding period, in order for the Republic of Cyprus to be able to deal with potential fiscal implications of a new outbreak of the Covid-19 pandemic in autumn 2020.

D. Evolution of credit rating, credit spreads and investor base

The credit rating of the long-term debt of the Republic of Cyprus was maintained in the investment category in 2020 compared to 2019 by the rating Agencies DBRS, Fitch and S&P, with the outlook from DBRS and Fitch Agencies, changing from positive to stable, while S&P retained a stable outlook. Moody's maintained the rating of the long-term debt of the Republic of Cyprus in 'Ba2' with a positive outlook in 2020. Figure 9 below shows the historical development of the ratings of the Republic of Cyprus during the period 2013-2020.

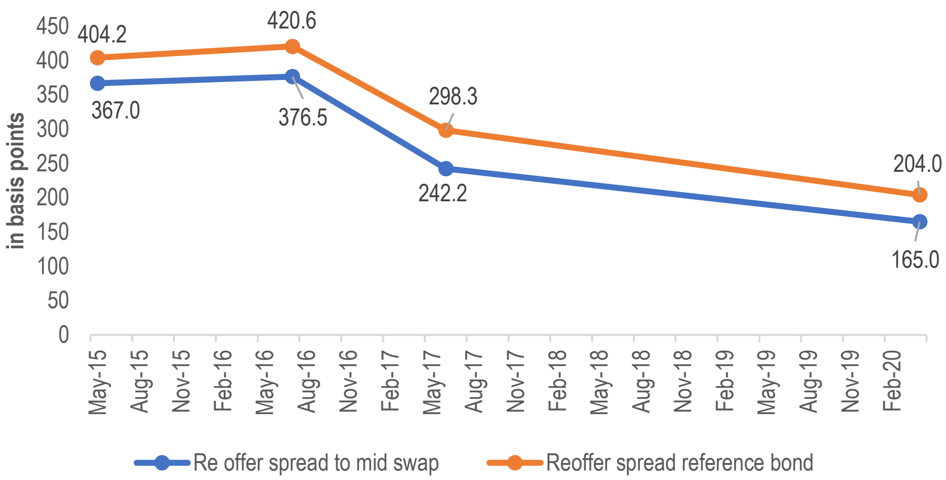
Figure 9: Long-term credit rating of the Republic of Cyprus 2013-2020



(Source: PDMO)

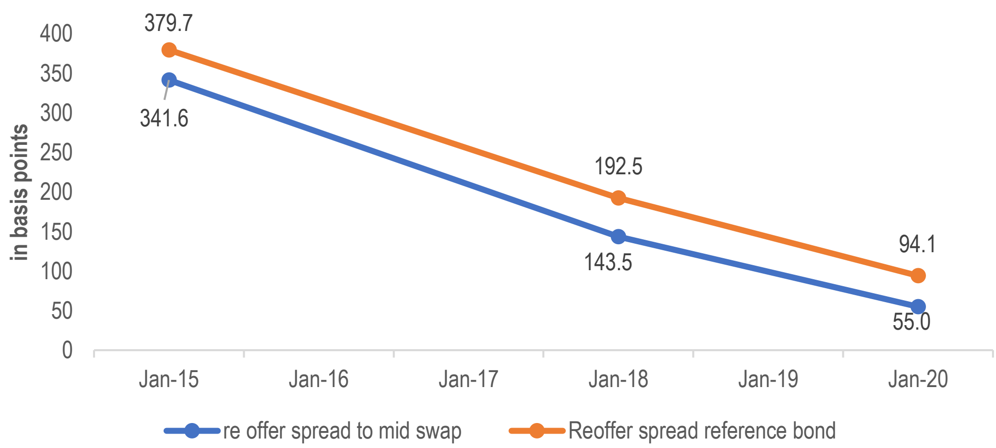
The improvement of the credit rating of the Republic of Cyprus in recent years in combination with maintaining investment grade by three rating Agencies and the positive outlook by one rating Agency were, amongst others, factors for easy access to international markets, enriching and improving the bonds yield curve and reducing government financing costs. Re offer spreads decreased in line with the evolution of the credit rating, as shown in Figure 10, for both the 7-year bond and the 10-year bond.

Figure 10: Evolution of credit margin (spread) of 7- year EMTN, at issuance



(Source: PDMO)

Figure 11: Evolution of credit margin (spread) of 10-year EMTN, at issuance

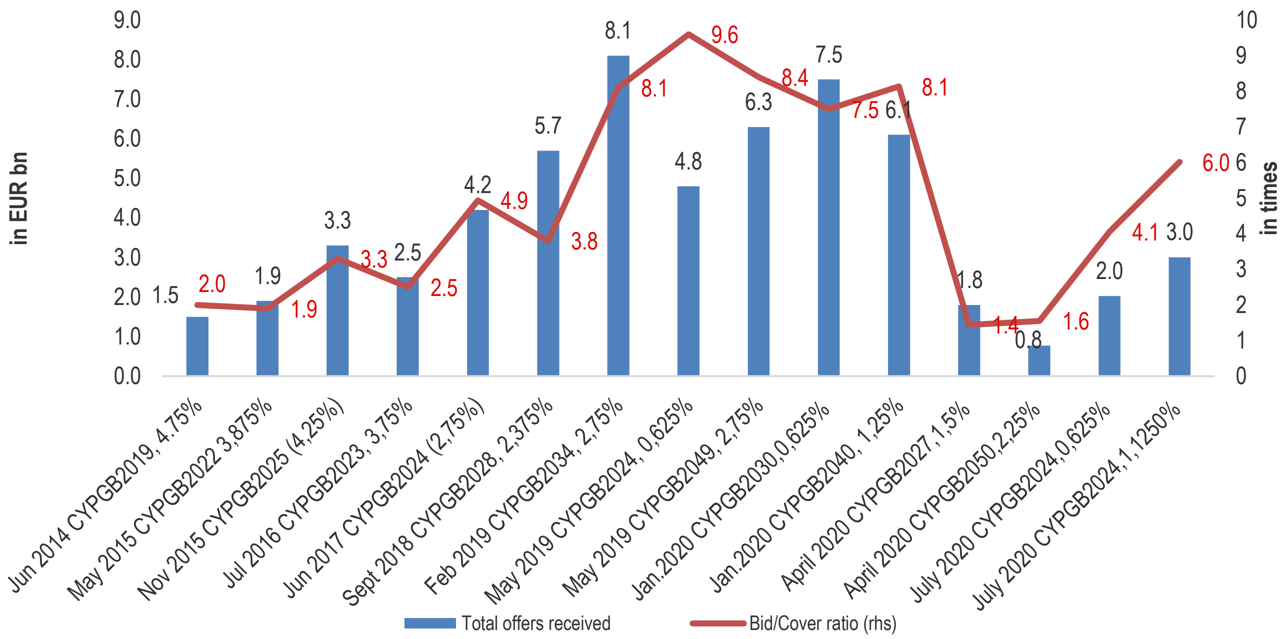


(Source: PDMO)

Figure 12 below shows the historical evolution of the order book in conjunction with the investor coverage ratio for the EMTN issued by the Republic of Cyprus for the period 2014-2020. As shown in the Figure below, the coverage ratio of bond issues is at a very satisfactory level, mainly as of the year 2018, reflecting the great interest of investors to participate in the bond issues of the Republic of Cyprus.

An exception is the month of April 2020, during which the bond coverage ratio recorded a significant decrease. This is an isolated case and is due to the great uncertainty that preceded the first wave of the pandemic and the waiting for EU decisions to address the economic impact of the Covid-19 pandemic.

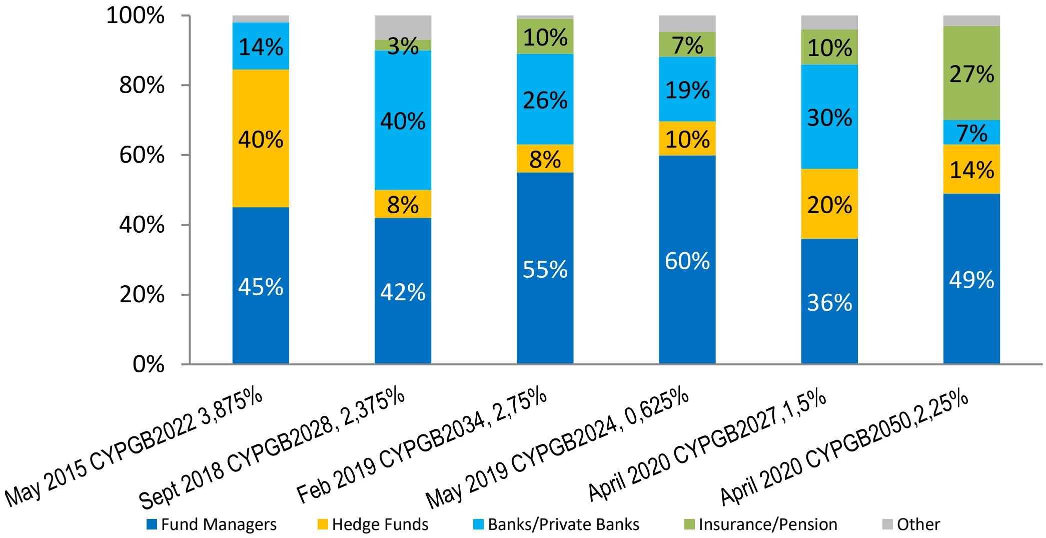
Figure 12: Orderbook size



(Source: PDMO)

The distribution of investors by type shows a significant improvement in recent years, reflecting the improvement of the credit rating of the Republic of Cyprus, namely the restoration of its credit rating in investment grade by S&P in September 2018 and by other Agencies in subsequent ratings. As shown in Figure 13 below, the increased share of the Hedge Funds in the May 2015 issue was followed by a significant contraction of this type of investors with the majority of them in the final distribution in the primary market coming from Fund Managers and Central Banks.

Figure 13: Investor allocation in the primary market (EMTN)



(Source: PDMO)

Note: This figure does not present all the EMTN issuances.

VI. Strategic Framework 2021-2023

A. Selected issuance strategy

The main financing tool for the aforementioned strategic period will be international bond issuances given the large size of the aforementioned market in order to continue with the progress made on the strategic targets of debt management over the past years.

These bonds are under English Law and listing may occur in more than one stock exchange. The method of issuance is through syndication.

All other available instruments will complement the international bond issuances. Domestic bonds, issued under Cyprus law and listed at the Cyprus Stock Exchange will be used to a lesser extent should opportunities arise. Additionally, the retail segment of the domestic market will be tapped in regular intervals through retail bonds. In the short-term spectrum, Treasury Bills and Commercial Papers will be used, giving priority to Treasury Bills issued through auctions. Finally, non-market financing will be pursued from supranational institutions for long-term financing either for new projects or ongoing projects.

The specific features of the newly assumed debt will be chosen in accordance with the guidelines set on risk management, development and expansion of the market and investor base, and under the condition that risk mitigation generally precedes cost minimization.

B. Guidelines and strategic objectives

B1: Risk mitigation

Reduction of Refinancing risk

Smoothening of the maturity profile has been the main focus of the MTDS concerning the periods 2016-20 and 2020-2022, leading to positive results. Efforts towards the same direction will continue under the new strategy 2021-2023 so as to maintain a fairly balanced redemption schedule as well as an ample average remaining maturity profile in order to reduce the refinancing risk. Nonetheless, the international bonds issued at a minimum benchmark size by small-scale issuers according to international best practice, cause rather sizeable remaining maturity peaks. Targets are set as follows:

(i) **Target: Maintaining average remaining maturity of marketable debt to 7 years minimum.**

Rationale: The reasoning for maintaining remaining maturity levels greater than 7 years is to enable the State to proceed with redesigning its strategy should that be required in order to ensure that borrowing is contained within acceptable and manageable risk levels.

High concentration of debt with a medium-term horizon could undermine the objective of the public debt management especially given the high level of uncertainty that currently exists in public finances due to the unforeseeable economic consequences of the Covid-19 pandemic which seems likely to continue in 2021 as well.

(ii) **Target: The outstanding short-term debt, with initial issuance maturity up to 12 months, will not exceed 5% of the cumulative government debt for the period 2021 to 2023.**

Rationale: Preserving short term debt within these levels ensures the minimization of refinancing cost and contains interest rate risk, particularly at times of strong interest rate volatility. At the same time, there should be sufficient room left for long term issuances in order to improve liquidity of Eurobond issuances and develop the long-term yield curve.

Principles/Actions: Regular auctions will be pursued, preceded by the publication of an auction calendar.

(iii) **Target: Maintaining adequate liquid funds to cover financing needs of the next 9-12 months for the period 2021 to 2023.**

Rationale: Substantial prudential liquidity allows more room for executing main financing operations in case unfavorable conditions disrupt or delay market access.

Principles/Actions: Cash management may be utilized to minimize the cost of carry.

(iv) **Target: The maturity of issuances will be chosen so that the annual gross financing needs do not exceed 10% of the respective GDP for the years up to 2030**.

Rationale: The target aims to ensure that financing needs are comfortably met under normal market conditions. According to the IMF risk assessment framework countries with gross financing needs up to 15% of GDP are assessed as 'low scrutiny'. A prudent limit is set for the case of Cyprus, to account for the lower liquidity in the market which can exacerbate investor behavior in times of market stress. While there is a growing investor base and while recent issuances have shown that an issuance volume of more than 10% of the GDP is feasible, this cannot be reliably ensured in case unfavorable market conditions prevail.

Principles/Actions: Liability management transactions may be applied in order to comply with the strategy target.

Interest rate risk

Following the borrowing of official loans under the EU-IMF Adjustment Programme in the period 2013-2016, the share of debt carrying floating interest rates increased significantly. While total floating rate debt has been following a declining path approaching to 28% at the end of August 2020 given the early repayment of the IMF loan, the floating rate debt will substantially decline as of 2025 onwards. This is expected to occur through the redemption of ESM loans and through the assumption of long-term project loans with fixed interest rate (nominator effect) and the reduction of the total outstanding debt from 2021 onwards (denominator effect).

Target: Debt carrying floating interest rates should not exceed 35% of outstanding debt in the period 2021 to 2023.

Rationale: This target aims in reducing fluctuations of interest paid on an annual basis due to floating interest rates. The share of debt with floating interest rate concerns mostly the ESM loans. Furthermore, this target aims to improve forecasts of public finances and evidently government cash reserves. With respect to projects financed by loans, priority will be given to those carrying fixed interest rates within the next three-year horizon.

Principles/Actions: The use of derivatives will be assessed and may be applied to ensure compliance of the debt structure with the strategy. Priority will be given to fixed-interest loans in order to contribute positively to the target set under the strategy.

Foreign exchange risk

Cyprus has not issued long term marketable debt in foreign currency to date, with the exception of the IMF loan which has been prepaid in 2020. The fact that the euro market is sufficiently large and diverse covers Cyprus' financing needs.

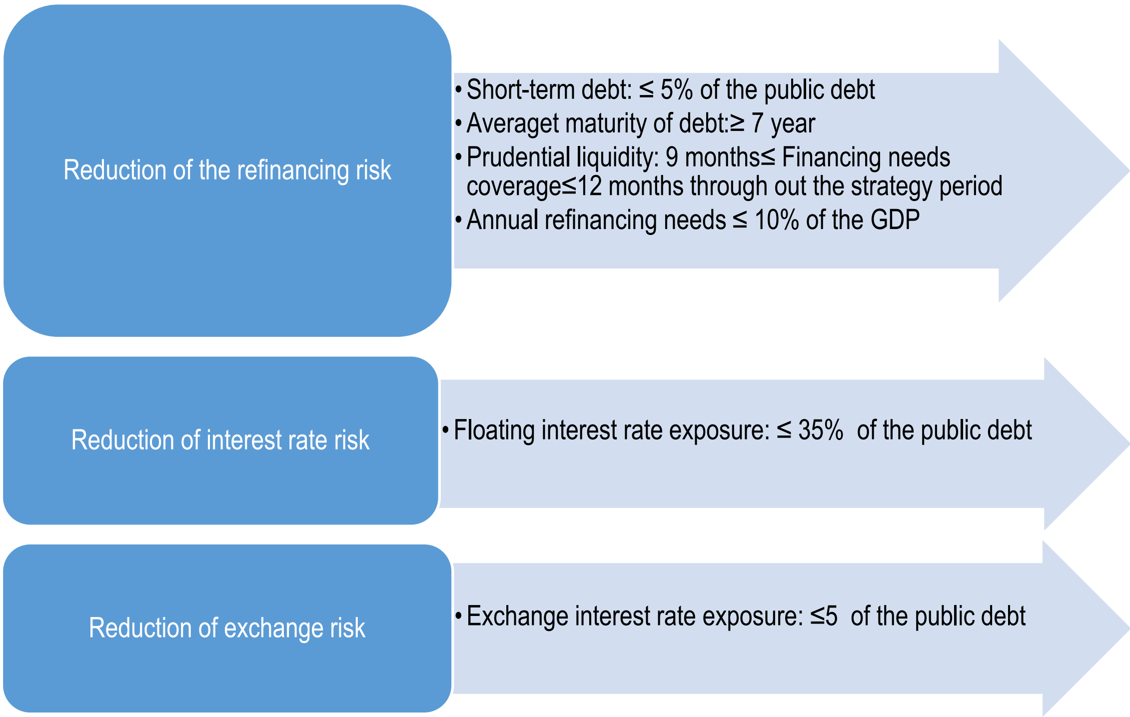
Target: Debt denominated in foreign currency should not exceed 5% of outstanding debt.

Rationale: While opportunities in foreign currencies may arise from time to time, these should be evaluated in relation to the development of government securities market, mitigation of exchange risk and the objective of cost minimization.

Principles/Actions: The use of derivatives will be assessed and may be applied to ensure compliance of the debt structure with the strategy.

The strategic targets serve as benchmarks and are a management tool for the government to steer its risk tolerance with respect to refinancing and market risk. An overview of the key risk benchmarks is illustrated in Figure 14.

Figure 14: Key risk benchmarks for debt management 2021-2023



B2: Development of government securities market

Primary market

Background: The Cypriot sovereign debt market is naturally constrained by its small size therefore primary market activity is vital in maintaining the functioning of the market. However, market fragmentation has been reduced post-crisis with the concentration of financing needs in single benchmark international bonds and absence from domestic bond issuances.

Target: The population and extension of sovereign yield curve with international benchmark bond issuances.

Rationale: Significant improvement has been achieved in building up the sovereign yield curve which has been extended up to a 30-year tenor. However, the whole process for further enhancement is ongoing so that at any one point there are enough available pricing points to evaluate possible issuing opportunities.

Principles/Actions: Communication of general financing plans to the market and transparency, predictability and consistency of actions to the extent permitted by market conditions and major economic developments. Regular, benchmark-sized, issuance under the same instrument, the EMTN Programme. In this way, consistency of issuance characteristics in terms of currency and interest rate type is maintained.

Secondary market

Background: The appearance of the Covid-19 pandemic and the significant impact it had on public finances along with the existing high degree of uncertainty have led the PDMO to proceed with regular updates of its AFP in order to finance the additional funding requirements and to enhance the liquid assets required to cover the financial needs of the next 9-12 months. Government funding stemmed mainly from Eurobonds and as a result there has been a significant shift in the composition of the debt structure for the year 2020. More specifically, the share of Eurobonds increased to 49% during the month of August 2020 compared to 40% at the end of 2019. This resulted in costly debt being replaced by lower cost debt and contributed to the reduction of the weighted average cost of debt. Furthermore, short term debt has been increased to 6% in August of 2020 compared to 1% at the end of 2019.

The above development has contributed to the proper functioning of the market and it is expected to bring forward an even more important issue which relates to the financing of the private sector from the markets[1].

Following the formation of a bank group to support the Cyprus government bond market the management of relations with the financial institutions has become more formal. With the introduction of MTS, electronic trading platform, towards the end of 2019 secondary market transactions began to take place, thus enabling primary dealers to trade electronically and enhancing transparency and efficiency in the Eurobond market.

Target: A more liquid and transparent secondary market.

Rationale: A functioning secondary market, within the limitations of a small issuer, will strengthen demand in the primary market.

Principles/Actions:

i. A group of market-making banks acting as dealers in the secondary market, will initially be maintained within an underlying operational infrastructure on a voluntary basis. The performance of the banks will be evaluated and properly communicated. The assessment will take place during the strategy period in order to evaluate whether conditions are mature enough to proceed to a full primary dealership system.

ii. The investor support in the secondary market trading will be a driver for primary market allocation.

[1] Additionally, the sovereign yield curve can have a benchmark role in corporate capital market financing since issuance activity in the wholesale capital markets is likely to grow in the coming years due to regulatory requirements for banks, namely the Minimum Requirement for Own Funds and Eligible Liabilities.

iii. Transparency in the processes and decisions, clear communication of privileges and obligations on behalf of the banks. Timely communication for the appraisal of the banks' activities.

B3: Investor relations

Background: Given the small and relatively infrequent debt issuances of Cyprus, when compared to the rest of the Eurozone, with the exception of the year 2020 when the Government issued six EMTN for the reasons referred to before, there is a need to counterbalance with actions that enhance visibility and presence in the market. In the last few years, efforts to increase visibility have intensified with regular roadshows in core and peripheral European financial centers, as well as the US east coast. The PDMO has expanded its list of investor entities to a multiple of the contacts a few years ago. Investor communication takes place through teleconferencing and through the PDMO's website, as well as through regular publications involving information on public debt management and economic developments in Cyprus.

Target: A larger, more diversified and less correlated pool of investors

Principles/Actions:

i. Maintaining regular communication with existing investors whilst intensifying efforts to bring in new investors in order to expand the investor base and the geographical distribution. Efforts for swift responses to opportunities with new investors as a result of credit rating or market changes will be aimed at. Overall as broad an investor base as possible will be targeted.

ii. Communication with investors through:

- Regular publication of reports and statistics about the Cypriot economy and on debt management developments with the aim of facilitating the information spread on a regular basis (See Box)
- Roadshows and meetings with investors on a regular basis
- Participation of the PDMO in main international conferences and fora
- Maintenance of the stand-alone website and of a mailing list which investors can subscribe to.

Box: Disclosure of information to market participants

All publications are prepared by the Public Debt Management Office with the aim of maintaining information flow towards the investor community and international financial institutions. All publications are posted on the PDMO website.

Medium Term Public Debt Management Strategy
Designed on a three to five-year basis, provides the outline of government policy for financing and public debt related matters, projected gross financing needs and the desired cost-risk outcome of the debt portfolio. It is approved by the Council of Ministers through submission by the Minister of Finance.

Annual Public Debt Management Report
Communicated by the Minister of Finance to the Budget and Finance Committee of the Parliament, it includes the following:

- Developments in Cypriot and eurozone capital markets
- Debt structure
- Debt operations of the year in review
- Risk management and risk indicators
- Review of annual actions and operations towards MTDS targets

Auction Calendar
Calendar for monthly Treasury Bill auctions published twice in a year.

Quarterly debt bulletin
Overview of the quarterly debt management operations, auction results, secondary market yield developments and main statistics, compared to previous quarters.

Quarterly statistics
Lists concerning the central government debt by instrument and the maturity profile.

Bi-annual risk indicators
Time series of main indicators for refinancing, currency and interest rate risk.

Newsletter on economic developments
Main events and data on all recent developments in macro economy, banking, fiscal and public debt management of Cyprus. Published at least quarterly.

Investor Presentation
Published at least quarterly, it includes the latest information and forecasts on the macro economy, public finances, financial sector and public debt management.

C. Comparison with the MTDS 2020-2022

The main pillars for MTDS 2021-2023 remain the same as those of the previous strategy, as their consistent implementation has obviously contributed to achieving the objective of public debt management. The chosen strategy for the period 2021-2023 corresponds and is based on the benchmarks achieved during the previous period.

For the refinancing risk reduction guideline, four quantitative targets were set. The short-term debt should not exceed 5% of the total outstanding debt for the period 2021-2023. The second quantitative target, which existed in the MTDS 2016-2020, concerns the average remaining maturity of marketable debt. In view of the fact that the main source of financing for the coming years will be the international bond market through the issuance of EMTN, the maintenance of the average remaining maturity of the marketable debt at not less than 7 years, acquires special importance in combination with the next quantitative indicator that refers to the reduction of the gross financing needs to below 10% of GDP by the end of 2030. The fourth quantitative target, which was one of the most important indicators for the reduction of the refinancing risk, in view also of the outbreak of the Covid-19 pandemic in March 2020, is to maintain cash reserves to meet the financial needs of the next 9 -12 months.

The guideline for the development of the public debt market includes two objectives, which were also present in the MTDS 2020-2022. The first objective concerns the development of the primary market of government securities and the second objective focuses on the development of the secondary market with higher liquidity and transparency. In the field of the secondary market, the intended efforts will concern the continuation of the evaluation of the work carried out by the group of international banks in order to increase the efficiency of the secondary market and the evaluation of the operation of the electronic trading platform of Cypriot government bonds and its contribution in the increase of the liquidity of the bonds of the Republic of Cyprus.

In general, the guidelines on investor relations remain the same. PDMO will continue to seek regular contact with existing investors, while trying to find new investors in order to achieve a more diversified and a less correlated investment base.

D. Potential risks in the implementation of the Strategy

Although the credit rating of the Republic of Cyprus is maintained in the investment category by three Rating Agencies with a rating of BBB-/BBB (L), nevertheless the outlook from these Rating Agencies remains stable, signaling the risk of a change in outlook and a move to the non-investment category, in case of the derailment of public finances mainly due to the Covid-19 pandemic. It is worth noting that any change in the outlook and/or investment rating category or even non-investment rating will have a significant impact on the cost of borrowing of the Republic of Cyprus and exclusion of Cyprus from any European Central Bank' support measures to the capital markets.

In addition, a possible increase in the annual gross financing needs may affect the amount of capital borrowed from international markets and borrowing within an acceptable and manageable risk framework. Consequently, this may necessitate the raising of funds from the domestic market with probably higher borrowing costs and a negative impact on effective demand and purchasing power.

Although it seems unlikely at this stage, the possibility of ending the public sector's debt market program and the pandemic emergency bond market program may affect the demand for the Republic of Cyprus bond market, as well as the cost of borrowing.

VII. Final provisions

The PDMO may deviate from the Strategy, with the approval of the Minister of Finance, if significant market conditions or economic developments render it a necessary or appropriate action. Although the Strategy allows for some flexibility, accountability and transparency of action and decision-making will be pursued at the same time.

With the adoption of the Strategy for 2021-2023, the MTDS 2020-2022 becomes void.

Funding Instrument	Initial AFP - 2020 (Dec 2019) Upper Borrowing Limit	First revised AFP - 2020 (March 2020) Upper Borrowing Limit	Second Revised AFP - 2020 (July 2020) Upper Borrowing Limit	Third Revised AFP - 2020 (August 2020) Upper Borrowing Limit
Domestic 3-month Treasury Bills	€300 mn	€300 mn	€300 mn	€300 mn
Government Bonds (EMTN)	€1,85 bn	€3,75 bn	€4,50 bn	€4,50 bn
Domestic Retail Bonds	€100 mn	€100 mn	€100 mn	€100 mn
Loan from Supranational Institutions (EIB, EBRAD, CEDB)	€100 mn	€100 mn	€100 mn	€100 mn
New Domestic 12-month Treasury Bills	---	€1,25 bn	€1,25 bn	€1,25 bn
Funding from European programme - SURE	---	---	---	€500 mn
Total approved maximum borrowing amount Jan. – Dec. 2020	**Up to €2,35 bn**	**Up to €5,5 bn**	**Up to €6,25 bn**	**Up to €6,75 bn**