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**Country Report Cyprus 2018  
Including an In-Depth Review 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 AND THE  
EUROGROUP**

**2018 European Semester: Assessment of progress on structural reforms, prevention and  
correction of macroeconomic imbalances, and results of in-depth reviews under  
Regulation (EU) No 1176/2011**

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## EXECUTIVE SUMMARY

**Cyprus' robust economic recovery can help accelerate the correction of excessive macroeconomic imbalances and provide a window of opportunity to implement growth-enhancing reforms.** Macroeconomic imbalances are declining but remain significant in several areas. These include high levels of public, private and external debt, a large negative net international investment position and a high stock of non-performing loans. Unemployment is also declining but remains high, in a context of weak potential growth. Amid positive macroeconomic developments, a renewed reform momentum in key areas – e.g. the insolvency and foreclosure frameworks, the judicial system, the business environment, the public sector, education and the labour market – could help improve potential growth, reduce vulnerabilities and the risk of a slowdown, should the external environment and financial conditions become less supportive.<sup>(1)</sup>

**Cyprus is experiencing strong economic growth and the labour market is rapidly improving.** Real GDP growth was robust in 2017 at 3.8 % driven by domestic demand, in particular private consumption. Investment was mainly concentrated on construction linked to the tourism boom and the recovery of the real estate sector. Employment rate rose by 2.5 pps in 2017Q3 year on year, standing at around 71.5 %, while the unemployment rate decreased significantly to 10.5 %. Inflation started to turn positive albeit at low level. In 2018, economic growth is forecast to remain strong but decelerate to 3.2 %.

**Overall, Cyprus has made limited progress with implementing the 2017 country-specific recommendations.** After the government's adoption and implementation of an ambitious reform agenda during the economic adjustment

programme, the reform momentum has been more modest since 2016. Key public sector reforms are pending, notably those concerning public administration, local government and state-owned entities. Some measures have been taken or announced to improve the efficiency of the judicial system, but a more comprehensive reform is still at an early stage. Administrative measures have been taken to reduce the backlog in issuing title deeds. Yet, a structural solution to address the inadequacies of the property transaction system is still lacking. Progress on reducing non-performing loans and effectively implementing the insolvency and foreclosure frameworks is also limited. While the privatisation plan remains largely on hold, the action plan for growth is gradually being implemented, focussing on improving the business environment and boosting strategic investments. Concrete steps were taken to increase the capacity of the public employment services, while only limited progress was made on education. Finally, key legislation establishing a National Health System was adopted in June 2017 and its implementation is under way.

Regarding progress in reaching the national targets under the Europe 2020 strategy, Cyprus has reached its objectives for R&D expenditure and is making progress in increasing the proportion of renewable energy. The rise in energy consumption, in line with the economic recovery, weighs on the capacity to reduce greenhouse gases emissions and meet the energy efficiency target. Cyprus over-achieved its targets on higher education attainment level and on reducing early school leaving. Some progress was made on increasing the employment rate, but targets on reducing poverty and social exclusion remain distant.

**Cyprus faces challenges with regard to a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights.** Strong economic growth has translated into improved employment outcomes and a declining proportion of people at risk of poverty, except among children. However, a growing gender employment gap, the high share of young people not in education, employment or training and an increasing number of early school leavers may weigh on current and future equality of opportunities.

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<sup>(1)</sup> This report assesses Cyprus' economy in the light of the European Commission's Annual Growth Survey published on 22 November 2017. In the survey, the Commission calls on Member States to implement reforms to make the European economy more productive, resilient and inclusive. In so doing, Member States should focus their efforts on the three elements of the virtuous triangle of economic policy — boosting investment, pursuing structural reforms and ensuring responsible fiscal policies. At the same time, the Commission published the Alert Mechanism Report (AMR) that initiated the seventh round of the macroeconomic imbalance procedure. The 2018 AMR concluded that an in-depth review should be undertaken for the Cypriot economy. The review is presented in this report.

The main findings of the in-depth review contained in this report, and the related policy challenges, are as follows:

- **Private debt continues to be among the highest in the EU.** The debt of non-financial corporations and households has decreased to around 250 % of GDP (excluding non-financial SPEs) in 2017Q3, primarily driven by households' debt reduction. Despite the robust recovery, repayment of debt has only marginally improved as contract enforcement remains weak and the use of the insolvency and foreclosure frameworks is limited.
- **Although still high, public debt is falling markedly.** Cyprus has significantly accelerated debt reduction, notably thanks to a prudent fiscal stance and active debt management operations. While risks related to high private debt levels in the economy remain significant, they are mitigated by the country's favourable fiscal position. Cyprus remains vulnerable to external shocks and changes in fiscal stance and economic outlook. Significant reliance on corporate income tax revenues and the presence of tax planning businesses exposes the country to changes in international tax systems.
- **The net international investment position (NIIP) remains very negative, but nearly two thirds are linked to SPEs.** The NIIP has decreased in recent years, but remains largely negative at 120.6 % of GDP in 2017Q3. Excluding the external debt of SPEs, the negative NIIP is smaller but still substantial at around 44 % of GDP. This highlights Cyprus' dependency on foreign financing sources and its vulnerability to shifts in international financial market sentiment. The widening current account deficit warrants monitoring.
- **The high level of non-performing loans (NPLs) remains the key vulnerability of the banking sector and affects credit supply.** NPLs decreased, albeit unevenly across banks, as a result of debt restructuring through write-offs and debt-to-asset swaps. Uncertainties remain over the sustainability of banks reduction strategies, as loan re-defaults and re-structuring remain high and banks' direct exposure to the property market increases. The limited use of the insolvency and foreclosure framework remains an obstacle to the reduction of NPLs. Banks still face impediments in enforcing their claims on defaulted borrowers and weak repayment discipline remains problematic. The lack of a secondary market for loans and a loan securitisation framework also hinders progress. Supervisory pressure has led banks to increase their risk provisioning in line with the euro area average. This has weighed on profitability and the ability to increase credit supply.
- **Banks are improving their fundamentals but still face challenges as regards performance.** In 2017, the emergency liquidity assistance was repaid and banks continued to accumulate large liquidity buffers. This behaviour is explained by banks' reliance on potentially volatile short-term deposits, notably from non-residents. The poor asset quality and the lack of inter-bank markets are hindering wholesale long-term funding and the build-up of loss absorption capacity. Banks' operational costs remain high. Improvements to the governance and administrative capacity of insurance and pension funds' supervision remain pending.
- **Inefficiencies in the justice system continue to affect contract enforcement and swift resolution of civil and commercial cases.** Cumbersome civil procedures and weak enforcement of court decisions weigh on banks' incentives to use the insolvency and foreclosure frameworks to reduce their stock of NPLs. A series of reforms have started to address the most critical problems in the justice system, in particular low digitalisation of courts and the lack of life-long training of judges.
- **The housing market is recovering.** Housing transactions have picked up and prices are recovering, particularly in the luxury segment. This may incentivise mortgage holders in difficulty to liquidate the underlying real estate collateral, which might in turn help to reduce private debt. The increased construction activity is supported mainly by self-financing and foreign investment. However, major obstacles to transferring and issuing property title deeds have not yet been resolved.

- **Potential growth is recovering but remains subdued.** Higher investment and employment are lifting potential growth, but it remains below the EU average. The main constraining factors are low productivity, modest growth-boosting investment, notably in innovation, difficulties to access finance, in particular for small businesses, and shortcomings in the business environment.

Other key structural issues analysed in this report and pointing to particular challenges for Cyprus' economy are the following:

- **The labour market is improving.** Employment is on the rise and unemployment is rapidly decreasing, even though it remains high among young people and the long-term unemployed. The capacity of the public employment services and activation measures are improving but are still sub-optimal. Outreach to young people not in employment, education or training is limited. Conditions of employment differ significantly between temporary and permanent contracts and between public and private sectors, pointing to segmentation of the labour market. The share of employees covered by collective bargaining is lower than the EU average.
- **The modernisation of the education sector has advanced albeit important challenges remain.** Poor educational achievements and skills mismatches continue to weigh on potential growth. Participation in vocational education and training is low and the reform of the teachers' evaluation system is still pending. Recent reforms on the appointment of teachers, curricula and plans to increase vocational education and training capacity are expected to improve the current situation.
- **Key steps to reform the healthcare sector have been taken and the focus is now on implementation.** Legislation establishing the new National Health System, providing for universal health coverage, was adopted. The new system aims at improving access to care, reduce high levels of out-of-pocket payments and increase efficiency of care delivery in the public sector. Until the system becomes fully functional in 2020, important implementation challenges and investment needs are expected.
- **Enforcement of environmental and climate regulations remains weak.** Recent investment has proved insufficient to achieve full compliance with environmental regulations, in particular in waste and water management. Cyprus still lacks effective tools to sustainably increase energy and resource efficiency. The energy sector reform has made some progress and could encourage growth in renewable energy. However, Cyprus remains heavily dependent on fossil fuels.
- **Some indicators suggest that Cypriot tax rules are used by companies engaged in aggressive tax planning.** Cyprus has taken steps to amend aspects of its tax system that may facilitate aggressive tax planning. However, the existence of specific tax rules (e.g. the corporate tax residency rules, the absence of withholding taxes on dividend, interest and royalty payments by Cyprus companies and potential risks associated with the design of notional interest regimes), combined with the lack of some anti-abuse rules, suggest that Cyprus' corporate income tax rules may still be used in tax avoidance structures.
- **Inefficiencies in the public sector impact on the business environment.** Planned reforms to modernise the public administration and improve its efficiency are pending. Some efforts are being made to expand e-government services and improve regulatory quality. Measures to simplify permits and licensing procedures, notably for strategic investments, have also been taken. According to relevant indicators, competition and qualitative assessment in public tenders could be further enhanced to strengthen efficiency and transparency in public procurement. The governance framework for state-owned entities remains uncondusive to adequate assessment of risks and performance improvements. This might facilitate the build-up of public contingent liabilities and hinder investment capacity in key utilities such as telecoms and energy. Perceived levels of corruption in the public sector are high, which could deter

investment. The authorities have announced measures to strengthen the anti-corruption framework.

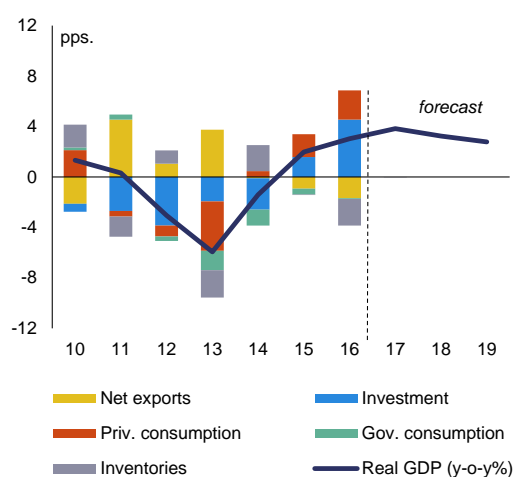


# 1. ECONOMIC SITUATION AND OUTLOOK

## GDP growth

**Cyprus' economy is in a vigorous upswing phase of the economic cycle, with real GDP expected to have grown by 3.8 % in 2017.** It is the third consecutive year of firm economic growth, confirming a sturdy recovery. For 2017 as a whole, the growth rate in Cyprus is estimated to have been among the highest in the euro area. It was driven by private consumption and exports of services, the latter mainly linked to the booming tourism (see Graph 1.1). For the first time in several years, public consumption posted a positive contribution.

Graph 1.1: Real GDP and contribution to growth



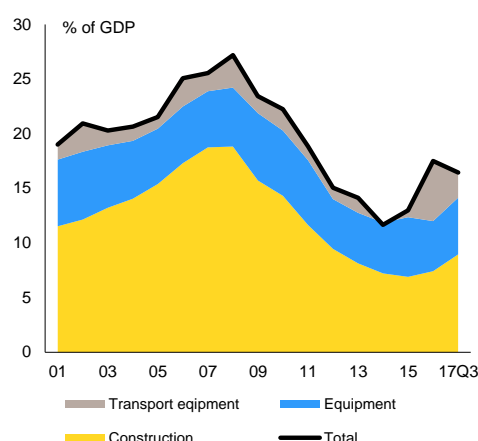
Source: European Commission

**Real private consumption is the main growth driver.** It is estimated to have increased by more than 3 % in 2017, driven by steadily rising household disposable income, solid employment and the first aggregate wage increases after a four-year drop. Consumer confidence is high, well above pre-crisis levels, signalling a continuation of the current strong consumption in the near term. Apart from these positive cyclical factors, Cypriot households continue to use accumulated wealth to finance consumption, as reflected by a negative savings rate.

**Investment is recovering, particularly in construction and equipment.** After contracting sharply during the crisis, investment started to recover in 2015, before increasing significantly in 2016 and levelling-off in 2017 (see Graph 1.2). In

2017<sup>(2)</sup>, gross fixed capital formation reached 16.4 % of GDP, coming closer to the EU average (20.0 %), from a low of 11.7 % in 2014. Investment was driven by construction, boosted by the tourism industry as well as the recovery of the residential real estate market, and shipping (which heavily influenced the equipment investment). Key indicators in the construction sector and plans for large tourism-related projects, amongst others, point to strong construction investment in the near future.

Graph 1.2: Investment (in current prices)



Source: Cystat

**Net exports in 2017 are expected to have positively contributed to growth.** Exports of services were strong, on the back of record numbers of tourists visiting Cyprus and a big increase in tourism revenues; exports of goods, after a sharp contraction in 2016, rebounded somewhat in 2017. Imports remained more moderate; if one excludes one-offs relating to ship registrations in 2016, they have risen in line with consumption and investment.

**The economic recovery is broad-based, fuelled by tourism.** Substantial gains were recorded in most sectors, except the financial sector, which remains heavily burdened with non-performing loans (NPLs). Tourism, booming for the second year in a row, had a positive impact on other sectors, particularly transport, trade, construction, food and accommodation. Business services, public administration, defence and education are

<sup>(2)</sup> Based on three quarters data.

also growing strongly. Meanwhile potential growth is improving on the back of recovering investment and increasing employment, but remains weak.

### Inflation

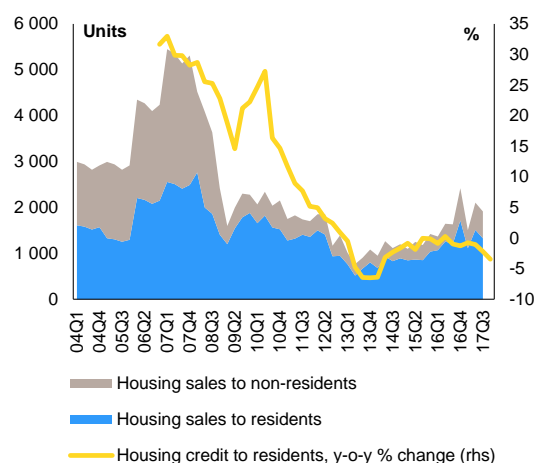
**Inflation based on the harmonised index of consumer prices (HICP) turned positive but remains modest.** After a few years of aggregate price declines, inflation in 2017 was positive at 0.7 %, driven mainly by rising energy prices in the first half of the year. Core inflation also turned marginally positive, as a result of rising prices for services. HICP inflation is expected to increase moderately in 2018-2019, driven by the economic recovery and anticipated wage rises.

### Housing market

**The residential real estate market has completed its downward adjustment and is in a modest recovery.** Housing sale contracts were up by double-digit percentage in 2017. A number of government incentives, such as lower property transfer fees, capital gains tax exemption, abolishing the immovable property tax, and a citizenship scheme based on property acquisition, have contributed to the recovery. Eurostat and Central Bank of Cyprus indicators show that house prices have started to rise since the end of 2016.

**Real estate acquisitions are funded mainly by savings and foreign investment** (see Graph 1.3). Domestic buyers funded property transactions mostly from their own savings. Foreign buyers, in particular from Russia, Asia and the Middle East, were responsible for fewer, but much more sizeable transactions, predominantly in cash. Mortgage interest rates have substantially come down initially as a result of directives issued by the Central Bank of Cyprus. Other historical factors included the European Central Bank (ECB) policy rates, and strong competition among banks for viable borrowers in the mortgage refinancing segment. However, banks in Cyprus remain very cautious when it comes to granting new mortgages (given the very high proportion of NPLs in their household credit portfolios, see Section 4.2).

Graph 1.3: **Housing sales by residency and housing credit to residents**



Source: Department of Lands and Surveys, European Central Bank, European Commission

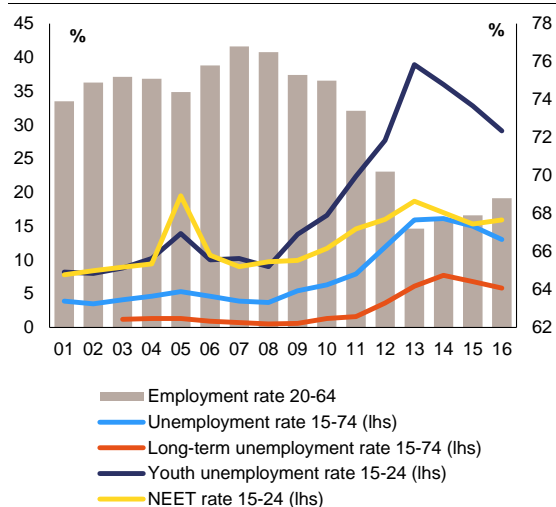
**The real estate supply side is responding to positive demand developments.** Construction activity has been on the rise since mid-2016 and this trend is expected to continue, as the number of building permits are increasing. Construction companies also face tough constraints when seeking to obtain bank credit for new projects, due to heavy corporate indebtedness in the sector and the prevalence of NPLs. Therefore, they fund most residential real estate projects by pre-sales.

### Labour market

**The labour market improves rapidly on the back of economic recovery.** The number of people employed is expected to increase at around 3 % in 2017, mainly in the services sectors and construction. Unemployment rate dropped to 10.5 % in 2017Q3, falling faster than expected on the basis of its pre-crisis relationship with economic growth (European Commission, 2017a, p. 25). However, unemployment remains particularly high among young people (25.1 % in 2017Q3, above the EU on average) and for long-term unemployed (4.3 % in 2017Q3 as against the EU average of 3.5 %). The employment rate increased and in 2017Q3 was only slightly below the EU average (71.5 %, as compared to 72.3 %, respectively), but still significantly below the pre-crisis level (76.8 % in 2007; see Graph 1.4). While headcount employment increased, the number of hours worked still lags behind. This is associated

with the rise in part-time work and employment on temporary contracts, both still above pre-crisis levels. Underemployment, which increased substantially as a consequence of the crisis, has subsided only marginally: in 2017Q3, 6.3 % of the labour force reported that they would like to work more hours (as against 7.4 % in 2016Q3).

Graph 1.4: Labour market situation



Source: Eurostat – Labour force survey

**Wage growth remained modest, even as the recovery gained strength.** Nominal wages had previously declined over a 4-year period, partly compensating for competitiveness losses accumulated since the early 2000s. In 2017, they are expected to have returned moderately positive, held back by labour market slack.<sup>(3)</sup> Collective agreements reached in all unionised sectors, covering about 30 % of private sector employees, provide for gradual wage increases and partial adjustment to the price index in the coming years.

### Social developments

**Social conditions are still challenging but have begun to improve as a result of the labour market recovery.** Gross household disposable income fell more steeply than GDP in 2010-2015, leading to a sharp rise in income inequality. Many young people are not in employment, education, or training (NEET). Income inequality receded to 4.9

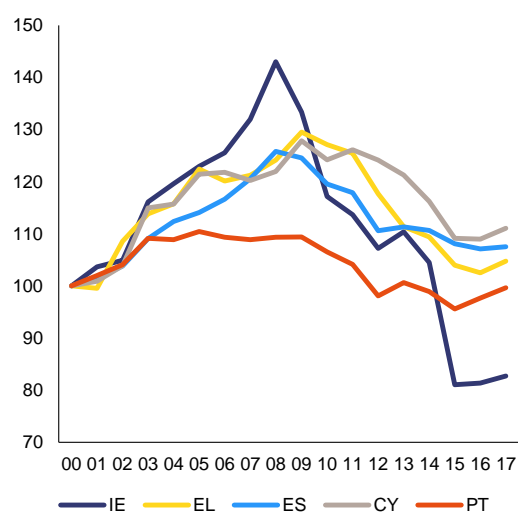
<sup>(3)</sup> The labour market slack is a sum of the persons available to work but not seeking work, those seeking work but not immediately available, and involuntarily part-time-employed (European Commission, 2017a).

% in 2016, slightly below the EU average (see Section 4.3.2). However, wealth inequality remains among the highest in the euro area. The Gini coefficient of net wealth (assets minus liabilities) was 0.72 in 2014<sup>(4)</sup>, reflecting a high proportion of indebted households.

### Competitiveness

**Real effective exchange rate (REER) developments may erode cost competitiveness gained during the crisis.** The REER has depreciated significantly in the crisis years, in line with the euro area trend (see Graph 1.5). With the euro appreciation against major currencies in 2017, the drop in REER is expected to have come to a halt. The Cypriot REER is expected to be reversing, particularly as wages start to rise and inflation is no longer negative, and the euro is projected to appreciate in 2018.

Graph 1.5: Real effective exchange rates



Source: AMECO

**Cyprus has continued to lose export market shares since 2010,** despite depreciating REER and downwards adjustment of the unit labour costs over several years. This suggests that structural factors, such as low business dynamism, are at play (see Section 4.4.2). The foreseen wage

<sup>(4)</sup> The Gini coefficient is a summary statistic of inequality. The closer the Gini is to 1, the more unequal is the distribution of income or wealth. If there is no inequality in a society, the indicator is equal to 0. If all national income or wealth is earned by one person alone, the Gini coefficient is equal to 1.

increases are expected to drive unit labour costs higher as of 2018.

**Total factor productivity remains weak.** After a long decline, total factor productivity has started to improve slightly in the past 3 years (see Graph 1.6). A substantial proportion of investment (around 30 % in 2017) is linked to the construction of dwellings, while the equipment category, accounting for around half of all investments, is partially driven by ship registrations (see Graph 1.2). This data points to potentially limited impacts on productivity.

### External position

**The current-account deficit, based on four-quarter rolling sum, is widening.** After increasing to 4.9 % in 2016, it widened further to 6.9 % in the third quarter of 2017 (on a four-quarter rolling sum basis). This was driven partly by recovering investment, which has high import content, and more generally by the consumption resuming after the crisis. As such, the widening may be temporary, but developments should be monitored carefully.

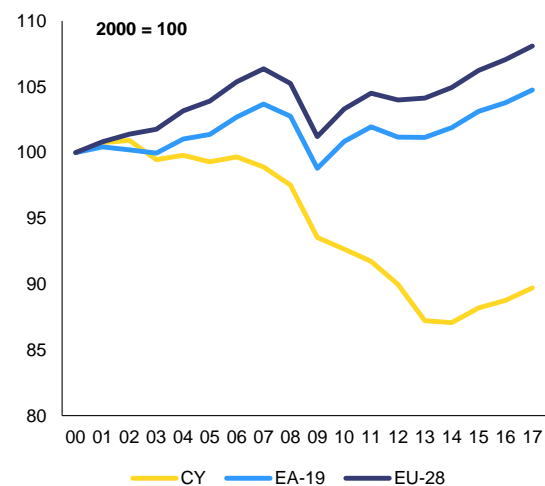
**The current-account deficit is largely influenced by special purpose entities (SPEs).**<sup>(5)</sup> The size and the current trend of the current account are driven to a very large extent by the activities of SPEs (see Box 1.1). When one excludes these, the current-account determined by the real sector was balanced in 2016, but turned negative in 2017 for

(5) Although no internationally agreed definition of SPEs exists, BPM6, ESA2010 and the fourth edition of the OECD's Benchmark Definition of Foreign Direct Investment (BD4) identify four distinctive features of SPEs, namely (a) legal entities incorporated by non-residents, (b) small footprint on the real economy and (c) balance sheets largely consisting of claims on and liabilities to non-residents. In the case of Cyprus, the major types of SPEs identified so far, can be classified in the following two broad categories:

- Financial companies
- Financing and holding companies, which channel funds within a global group on behalf of a non-resident parent company.
- Factoring/invoicing companies, which invoice the sales of a group with global operations on behalf of the parent.
- Non-financial companies (mainly ship-owning), which own non-financial assets that are usually financed through a loan from a non-resident bank or from their parent companies.

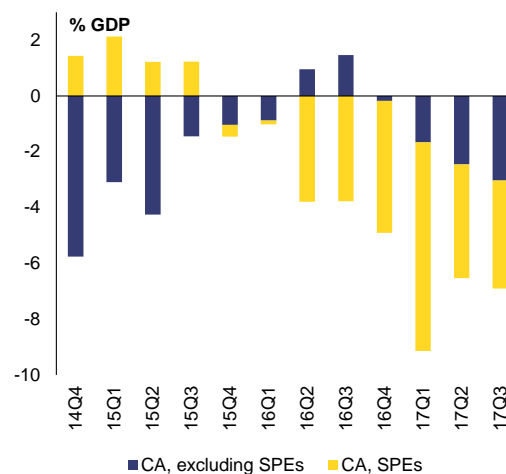
both the SPE sector and the real sector (on four quarter rolling basis) (see Graph 1.7).

Graph 1.6: Total factor productivity



Source: AMECO

Graph 1.7: Current account developments, SPEs and non-SPEs (based on 4 quarters rolling sum)



Source: Central Bank of Cyprus

**The net international investment position (NIIP) remains very negative, but nearly two thirds of it is attributable to the presence of SPEs.** As of 2017Q3, they determined a proportion of the negative NIIP equivalent to 76.4 % of GDP, while the total NIIP was equivalent to -120.6 % of GDP. This mitigates to a marked extent the risks stemming from the very large NIIP, as SPEs' links to the real economy are rather limited.

**The NIIP continued narrowing.** The NIIP contracted quite markedly, by 7pps, from the end of 2016 till the third quarter 2017. The correction of the NIIP since 2014 was driven by adjustments in the real sector, a positive sign, proving that the real Cypriot economy is becoming less reliant on foreign funds. Meanwhile the part of NIIP linked to the SPE sector has remained broadly stable and is expected to somewhat increase in the future. This indicates that the substantial negative overall NIIP is likely to persist in the medium term.

### Debt of non-financial private sector

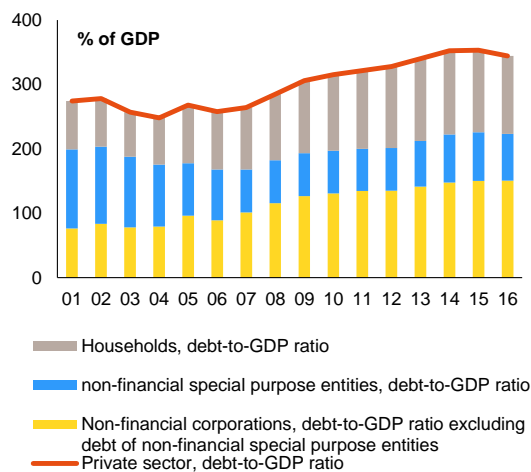
**While non-financial private sector debt is falling, it is still very high.** Private sector debt stood at 329 % of GDP in 2017Q3 — down from 345 % in 2016 (see Graph 1.8), but well above the macroeconomic imbalance procedure (MIP) threshold of 133%. Non-financial SPEs accounted for a substantial proportion of the accumulated private debt, at 79 % of GDP in 2017Q3. They have limited links to the real economy and their debt is funded mostly by foreign banks, which markedly diminishes the risks to the domestic economy. In nominal terms, household and non-financial corporate debt (including SPEs) has remained broadly stable since 2014 at EUR 62 billion. However, even when excluding SPEs, non-financial private sector debt remained very high, at 250 % of GDP, at 2017Q3 (see Section 4.2.2).

### Financial sector

**The high level of non-performing loans (NPLs) remains the key vulnerability of the banking sector.** NPLs in the banking sector started to fall, but are still very high, accounting for around half of the non-financial private sector loan portfolio. The proportion of NPLs in corporate and household loan portfolios have slightly declined to 52.7% in June 2017 (compared with 54.8% at end 2016), by EUR 1.4 billion. The most important NPL reduction has been in the sectors related to real estate and tourism activities, such as construction as well as accommodation and food services. NPLs fell on the back of loan restructuring in the form of cash repayments, debt-to-asset swaps and, to a lesser extent, loan write-offs. The recourse to debt-to-asset swaps led to an accumulation of real estate assets by banks,

increasing their exposure to the property market (see Section 4.2.1).

Graph 1.8: Private sector indebtedness



Source: Eurostat, Central Bank of Cyprus

**Risk provisioning improved substantially in 2017 and is now in line with the euro area average.** Supervisory pressure, notably through the single supervisory mechanism (SSM) supervisory review and evaluation processes (SREP), led to gradual improvements in the provisioning coverage of NPLs since 2014, i.e. from 31.7 % to 46.2 % as of June 2017 (see Graph 1.9 and Table 4.2.1). Provisioning is now comparable with the EU average and should reflect more accurately the real value of the real estate collateral. However, the improved average coverage masks differences across banks. As banks accelerate the cleaning-up of their balance sheets, further provisioning is likely to be necessary in order to maintain and, in some cases, improve coverage, where the valuation of collateral might not fully reflect market prices.

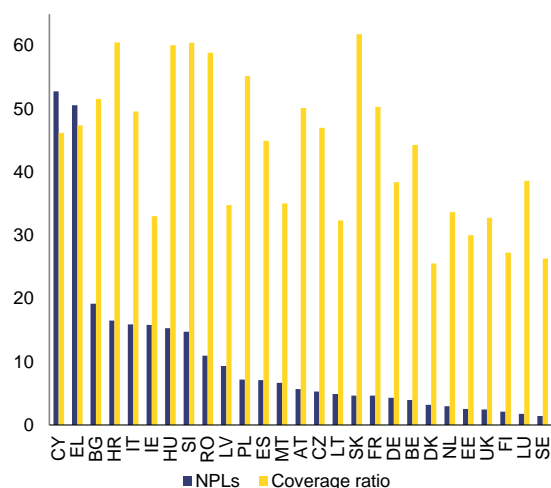
**Banks were loss making in the first nine months of 2017.** The results for the first nine months of 2017 show a hefty deterioration in the banks' profitability relative to the same period in 2016, as the net interest income declined by about EUR 158 million. In addition, the big increase in loan loss provisions announced by banks, notably by the Bank of Cyprus, led to a system-wide increase in provisions by more than EUR 850 million. It tipped financial results into deeply negative territory of about EUR 535 million in the first nine



months of 2017, relative to a profit of EUR 317 million in the same period of 2016. Overall, the banks' capacity to generate profits remains under pressure in a context of tighter interest margins and the need to work out the extremely high volume of NPLs.

**Banks are taking measures to reduce operating expenses.** Cypriot banks made progress in reducing numbers of branches and employees, but the number of customers and assets per branch or employee remains significantly lower than the euro area average.

Graph 1.9: Private sector NPLs and coverage ratios, June 2017



(1) Data for Portugal is not available.

Source: ECB consolidated banking data.

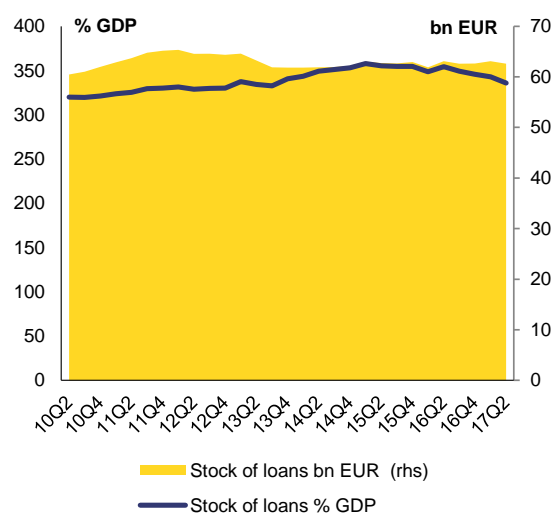
**The common equity tier 1 (CET 1) capital ratio of all banks declined to 15 % in September 2017, from 16 % a year before, and remains vulnerable to further loss recognition.** The overall solvency ratio fell by 0.6 pps to 16.3 % in September year on year. The CET 1 ratio is still higher than the EU average (around 13%), but this reflects the great uncertainty associated with the high ratio of impaired loans. While capital ratios did not decline in 2015 and 2016 despite negative financial results, the acceleration of the NPL workout has started to take a toll on banks' capital buffers. Banks that are more advanced in terms of balance-sheet clean-up have seen their CET 1 ratio fall well below average. If banks continue to increase their provisioning and recognise losses, maintaining current capitalisation is likely to prove challenging. Therefore, some of the largest banks

are planning to issue additional tier 1 or tier 2 capital in order to strengthen their capital buffers as a pre-requisite for achieving NPL reduction targets.

**Deleveraging appears to have come to a halt, but the clean-up of the balance sheets continues.**

As of November 2017, the stock of loans to domestic non-financial corporates (NFCs) and households remained relatively flat year on year. This masks underlying movements and efforts by banks to clean up their balance sheets. New lending picked up slightly, while unpaid interests on NPLs are capitalised, which increases the credit stock. On the other hand, banks' growing use of debt-to-asset swaps and debt write-offs in order to restructure their non-performing exposures, together with debt repayments, tends to reduce the stock of credit. Amid strong growth, the private sector debt to GDP continued declining (see Graph 1.10).

Graph 1.10: Private sector debt



Source: Eurostat

**New lending is gradually recovering.** The gross volume of new loans to domestic residents increased in the first half of 2017 to EUR 1.4 billion, from a very low base of EUR 890 million in the first half of 2016. The latest bank lending survey shows that credit standards for loans to businesses and households remained unchanged since end of 2014. Banks are increasingly venturing into new lending opportunities, given the large amount of liquidity on their balance sheets

and the pressing need to improve their financial results.

**Deposits increased in 2017 on the back of strengthened confidence.** Total deposits had increased by about EUR 240 million year-on-year (2.4 %) as of end November 2017. The highest annual growth rates were recorded for domestic and other euro area residents.

### Public finances

**Cyprus is expected to post sizeable budgetary surpluses in 2017-2019.** The Commission projects general government surpluses of above 1 % of GDP in 2017 and 2018 and close to 2 % in 2019. The primary surplus for 2017-2019 is expected to be among the highest in the EU, at 3.5 % of GDP in 2017 and just below 4 % of GDP in 2018 and 2019. Strong fiscal performance in 2017 is expected to have been driven by high revenue collection on the back of a favourable macroeconomic situation, positive developments in the labour market and the fact that the government concluded gas exploration contracts for 2017-2019. Revenue collection is expected to more than offset the impact of expansionary fiscal

measures of 2017, such as the abolition of the immovable property tax, termination of the temporary wage levy and the additional hiring of soldiers. The structural balance is forecast to be in surplus (0.4% of GDP) in 2017 and close to a balanced position in 2018 and 2019.

**There are risks associated with financing permanent expenditure increases from temporary revenue windfalls.** Public expenditure is projected to increase, albeit more slowly than revenue. However, the still-uncertain fiscal impact of health system reform, the absence of a mechanism to contain public payroll growth beyond 2018 and pressures for fiscal relaxation may pose further risks in the medium term.

**The debt ratio is expected to decline steadily and fall below 94 % of GDP in 2019.** The downward debt trajectory reflects expected high primary surpluses and favourable debt dynamics due to strong nominal growth. In the medium term, the high public debt remains subject to downside risks stemming from macroeconomic shocks, vulnerabilities in the financial system and gradual deterioration of the structural fiscal position (see Section 4.1.1).

**Box 1.1: The impact of special-purpose entities on statistics and the real economy**

**Special Purpose Entities (SPEs) are used to legally register and hold assets in Cyprus, including for risk insulation and tax planning purposes.** SPEs are legal entities registered and tax resident in Cyprus with few employees and/or no production, which are controlled by non-resident entities. They are mainly used by non-residents to channel funds to other non-residents, notably in the case of holding companies or intra-group financing operations. Companies can use SPEs to legally separate risk-bearing activities from other operations and valuable assets, for example at the request of their creditors. SPEs are also legal tools used to protect assets from bankruptcy proceedings, notably for economic agents originating from jurisdictions where contract enforcement is poor or characterised by high levels of corruption. Setting up an investment vehicle, a subsidiary or a shipping company in Cyprus currently allows benefitting from relatively low taxation and a local pool of specialised expertise.

**SPEs are also widely used to register ships in Cyprus.** Shipping activities usually take place offshore. Therefore, shipping companies have an interest in structuring these activities through SPEs in favourable tax regimes such as Cyprus (see Section 4.1.3).<sup>6</sup> Available data on non-financial SPEs (mostly linked to shipping activities) show that they had total liabilities of about EUR 18 billion at end-2016, or about 100% of Cyprus' GDP. Non-financial SPEs are significantly leveraged (debt to equity ratio of 3.7) and mostly funded from abroad (97% of outstanding loans).

**SPEs introduce a bias in Cyprus' economic statistics.** The economic transfer of transport equipment by non-financial entities owned by a resident of Cyprus has a large impact on external accounts, while its impact on the real domestic economy is limited to the leasing fee charged by these entities, which increases GDP. Under ESA2010, a vessel/aircraft is a Cypriot economic resident independently from the location of its activities if its economic owner is a resident of Cyprus. The gross financial assets and liabilities of financial SPEs offset each other, but considerably inflate the size of the financial accounts.

**Shipping-related transactions increase the volatility of investment, imports and exports statistics and have an impact on the GDP through the leasing services provided by ship-owning entities whose economic owners are residents of Cyprus.** The registration of a ship in Cyprus increases investment. This is however offset by a corresponding increase in imports of goods. Likewise, when a vessel is de-registered from Cyprus, this reduces investment, but increases exports. Neither registration nor de-registration affect GDP, but the size of some important transactions (some ships can be worth several hundred million euros) can distort the analysis of investment and external trade.

**The debt of ship-owning SPEs weighs on the net international investment position.** The capital-intensive nature of the shipping industry weighs significantly on the NIIP, as ship-owning SPEs have large financial liabilities towards foreign creditors, while they mostly hold tangible assets. Since the NIIP shows the financial position, and does not include real assets, the inclusion of ship-owning SPEs worsens significantly the NIIP. However, the impact risks for the real domestic economy are limited, as non-financial SPEs are currently overwhelmingly funded by foreign financial institutions or other related non-resident entities and own assets located outside Cyprus.

**The significance of the large and negative NIIP is reduced when excluding SPEs.** The NIIP stood at minus EUR 22.5 billion (127.8 % of GDP) in 2016. As of end-2016, the net external debt of non-financial SPEs reached EUR 11.3 billion, or 62.5 % of the NIIP. According to the Central Bank of Cyprus, the NIIP corrected from the impact of non-financial SPEs' own movable equipment was -71 % of GDP in 2015 and -50.6 % of GDP in 2016. Furthermore, a large part of the external debt is composed of general government debt to the ESM and the IMF, which has a very long term maturity structure and therefore is not exposed to short term refinancing risk. Taking these factors into account, the "underlying" NIIP could be considered closer to the MIP threshold of -35% of GDP. However, it still highlights Cyprus' high reliance on external credit to finance its economy.

<sup>6</sup> Source: <http://www.investcyprus.org.cy/en/establishing-business-cyprus/tax--legal-framework/competitive-corporate-tax-system>



Table 1.1: Key economic and financial indicators - Cyprus

	2004-07	2008-12	2013-14	2015	2016	forecast		
						2017	2018	2019
Real GDP (y-o-y)	4,4	0,1	-3,7	2,0	3,0	3,8	3,2	2,8
Potential growth (y-o-y)	3,4	1,7	-2,1	-1,4	0,4	1,1	1,4	1,7
Private consumption (y-o-y)	6,3	0,5	-2,7	2,6	3,3	.	.	.
Public consumption (y-o-y)	3,6	2,7	-7,6	-2,8	-0,4	.	.	.
Gross fixed capital formation (y-o-y)	9,9	-8,6	-15,2	13,6	35,0	.	.	.
Exports of goods and services (y-o-y)	2,7	0,5	3,2	6,3	3,9	.	.	.
Imports of goods and services (y-o-y)	6,1	-0,9	-0,2	8,1	6,6	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	6,7	-1,1	-5,4	2,9	6,8	.	.	.
Inventories (y-o-y)	-0,3	0,4	-0,1	-0,1	-2,1	.	.	.
Net exports (y-o-y)	-2,0	0,5	1,8	-0,9	-1,7	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	1,3	0,6	-1,8	-1,1	0,0	0,5	0,5	0,6
Capital accumulation (y-o-y)	2,0	1,5	0,0	-0,1	0,5	0,7	0,8	0,9
Total factor productivity (y-o-y)	0,0	-0,3	-0,3	-0,3	-0,2	0,0	0,2	0,2
Output gap	3,6	0,3	-7,3	-3,6	-1,1	1,3	2,7	3,7
Unemployment rate	4,6	7,0	16,0	15,0	13,0	11,0	10,0	9,3
GDP deflator (y-o-y)	3,5	2,1	-1,3	-1,2	-0,9	1,2	1,1	1,6
Harmonised index of consumer prices (HICP, y-o-y)	2,1	2,7	0,1	-1,5	-1,2	0,7	1,2	1,3
Nominal compensation per employee (y-o-y)	3,7	2,7	-4,5	-1,2	-0,8	1,7	1,5	1,8
Labour productivity (real, person employed, y-o-y)	0,9	-0,1	0,2	0,5	-0,1	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2,8	2,7	-4,7	-1,7	-0,7	1,0	0,5	0,5
Real unit labour costs (y-o-y)	-0,7	0,7	-3,4	-0,5	0,2	-0,2	-0,5	-1,1
Real effective exchange rate (ULC, y-o-y)	1,1	0,6	-3,2	-6,1	-0,1	1,9	1,1	-1,2
Real effective exchange rate (HICP, y-o-y)	-0,1	-0,4	0,2	-6,5	0,7	0,3	1,4	.
Savings rate of households (net saving as percentage of net disposable income)	3,8	0,3	-13,5	-13,7	.	.	.	.
Private credit flow, consolidated (% of GDP)	23,7	17,5	-6,8	4,1	10,2	.	.	.
Private sector debt, consolidated (% of GDP)	259,7	311,3	346,3	353,5	344,6	.	.	.
of which household debt, consolidated (% of GDP)	87,2	116,3	128,9	127,7	121,2	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	172,5	195,0	217,4	225,8	223,4	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	.	8,9	36,4	34,7	33,8	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-11,7	0,5	11,0	7,0	1,6	1,5	0,9	0,4
Corporations, gross operating surplus (% of GDP)	23,8	20,3	22,2	21,6	20,8	20,7	20,9	21,5
Households, net lending (+) or net borrowing (-) (% of GDP)	-5,7	-4,9	-8,1	-8,7	-7,8	-8,5	-9,2	-9,8
Deflated house price index (y-o-y)	6,9	-4,7	-2,7	0,3	1,6	.	.	.
Residential investment (% of GDP)	10,9	8,2	4,1	4,2	4,6	.	.	.
Current account balance (% of GDP), balance of payments	.	-8,9	-4,6	-1,5	-4,9	-5,4	-6,2	-6,8
Trade balance (% of GDP), balance of payments	.	-6,0	1,9	0,8	-0,8	.	.	.
Terms of trade of goods and services (y-o-y)	0,5	-0,2	-0,3	-0,5	0,1	0,0	-0,2	0,0
Capital account balance (% of GDP)	.	0,3	1,1	0,3	0,2	.	.	.
Net international investment position (% of GDP)	.	-109,9	-142,9	-145,0	-127,8	.	.	.
Net marketable external debt (% of GDP) (1)	.	-84,2	-109,3	-136,1	-118,4	.	.	.
Gross marketable external debt (% of GDP) (1)	.	578,3	512,5	500,3	492,3	.	.	.
Export performance vs. advanced countries (% change over 5 years)	-13,5	-8,7	-13,7	-10,6	-5,7	.	.	.
Export market share, goods and services (y-o-y)	.	.	1,6	-1,5	4,7	.	.	.
Net FDI flows (% of GDP)	.	1,7	-4,8	47,4	-7,8	.	.	.
General government balance (% of GDP)	-0,9	-4,1	-6,9	-1,2	0,5	1,1	1,4	1,9
Structural budget balance (% of GDP)	.	-4,6	1,2	1,6	1,1	0,4	0,0	-0,1
General government gross debt (% of GDP)	59,8	60,1	105,0	107,5	107,1	103,0	98,3	93,9
Tax-to-GDP ratio (%)	32,2	32,4	32,5	33,1	33,3	34,0	33,9	34,2
Tax rate for a single person earning the average wage (%)	7,9	.	.	.	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	6,3	.	.	.	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares.

(2) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches. The aggregate NPL ratio, which covers all loan and advances, may be misleading for Cyprus due to the large exposures of domestic and foreign banks to central banks (representing 14% of gross loans) and other financial institutions (10% of gross loans). For Cyprus the NPL ratio for the private sector, comprising only exposures to non-financial corporations and households is more appropriate indicator (see Section 4.2).

**Source:** Eurostat and ECB as of 30 Jan 2018, where available; European Commission for forecast figures (Winter forecast 2018 for real GDP and HICP, Autumn forecast 2017 otherwise)

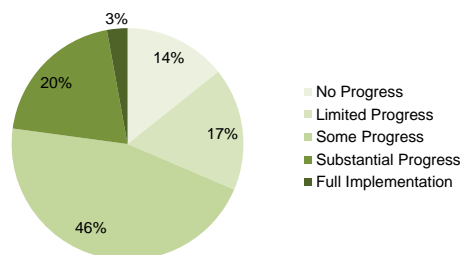
## 2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

**Progress with implementing the recommendations addressed to Cyprus in 2017<sup>(7)</sup> has to be seen in a longer perspective since the introduction of the European Semester in 2011.** Looking at the multi-annual assessment of the implementation of the CSRs since these were first adopted, 69 % of all CSRs addressed to Cyprus have recorded at least ‘some progress’. 31 % of these CSRs recorded ‘limited’ or ‘no progress’ (see Graph 2.1). Full implementation and substantial progress have been achieved in a wide range of reforms, in particular fiscal and financial ones supported by the 2013-2016 EU-IMF economic adjustment programme. These reforms address most of the CSRs made in 2011 and 2012. As regards CSRs made in 2016, these mostly cover persisting challenges, which are also reflected in the 2017 CSRs.

allowing for more efficient and targeted social benefits.

**The financial sector also underwent significant reforms**, including the modernisation of the supervisory framework. Insolvency and foreclosure frameworks were also modernised. Sector-specific obstacles to the establishment and **free provision of services** have been mostly removed. Measures were introduced to **promote renewable energy production** and diversify the energy mix. However, energy production is still heavily dependent on fossil fuels. Recommendations on the **labour market** have been implemented through a reform of wage indexation, measures addressing unemployment (notably youth and long-term) and policies to upgrade skills in the labour force.

Graph 2.1: Overall multiannual implementation of 2011-2017 CSRs to date



\* The overall assessment of the country-specific recommendations related to fiscal policy excludes compliance with the Stability and Growth Pact.

\*\* 2011-2012: Different CSR assessment categories

\*\*\*The multiannual CSR assessment looks at the implementation since CSRs were first adopted until February 2018 Country Report.

\*\*\*\*The multi-annual CSR assessment excludes the years when Cyprus was under an economic adjustment programme.

Source: European Commission

**The public financial management and budgetary framework was significantly strengthened** to ensure transparency and sustainability of public finances. **The pension system was reformed** to ensure its long-term sustainability. CSR on social benefits and the high ‘at risk of poverty’ rate among the elderly were addressed by the guaranteed minimum income

**Cyprus has made so far limited<sup>(8)</sup> progress in addressing the 2017 CSRs.** Reforms of the public administration, local government and state-owned entities remain pending, even though new rules on staff mobility were adopted. Some measures were taken or announced to improve the efficiency of the judicial system, but a comprehensive reform is still at an early stage. Administrative measures were taken to reduce the backlog in the issuing of title deeds, but no extensive solution has yet been proposed. Measures were announced to help accelerate the reduction of NPLs, in line with the euro area recommendation (EAR) 4, and to ensure the effective implementation of the insolvency and foreclosure frameworks, yet progress is still limited. Implementation of the action plan for growth advances, focussing on improving the business environment, in line with the EAR 1. The privatisation plan is largely on hold, while plans to open up the electricity market somewhat advance. Steps were made on increasing the capacity of the public employment services, in line with EAR 3, while on education reform only limited progress was achieved. Finally key legislation establishing a National Health System was adopted in June 2017 and implementation is underway.

<sup>(8)</sup> Information on progress and action taken to address the policy advice in each subpart of a CSR is presented in the overview table (see Annex A). This overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact. Source: European Commission.

<sup>(7)</sup> For the assessment of other reforms implemented in the past, see Section 4.

Table 2.1: Summary assessment of CSR implementation

2017 CSRs to Cyprus	Overall assessment of progress with the 2017 CSRs: Limited Progress
<p><b>CSR1:</b> <i>By the end of 2017, adopt key legislative reforms aiming to improve efficiency in the public sector, notably to the functioning of public administration, governance of State-owned entities and local governments. (MIP Relevant)</i></p>	<p><b>Limited progress*:</b></p> <ul style="list-style-type: none"> <li>• <b>Some progress</b> regarding the legislative reforms for the functioning of public administration.</li> <li>• <b>No progress</b> regarding the law on the governance of state-owned entities.</li> <li>• <b>No progress</b> regarding the reform of local governments.</li> </ul>
<p><b>CSR2:</b> <i>Increase the efficiency of the judicial system by modernising civil procedures, implementing appropriate information systems and increasing the specialisation of courts. Take additional measures to eliminate impediments to the full implementation of the insolvency and foreclosure frameworks, and to ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Limited progress</b> on increasing the efficiency of the judicial system, modernisation of civil procedures and on increasing the specialisation of courts.</li> <li>• <b>Limited progress</b> in eliminating impediments to the full implementation of the insolvency and foreclosure frameworks.</li> <li>• <b>Limited progress</b> on ensuring reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.</li> </ul>
<p><b>CSR3:</b> <i>Accelerate the reduction of non-performing loans by setting related quantitative and time-bound targets for banks and ensuring accurate valuation of collateral for provisioning purposes. Create the conditions for a functional secondary market for non-performing loans. Integrate and strengthen the supervision of insurance companies and pension funds. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Limited progress</b> on accelerating the reduction of non-performing loans by setting up a task force to develop national strategy and to evaluate comprehensive solutions including a new targeting framework.</li> <li>• <b>Limited progress</b> regarding the creation of the conditions for a functional secondary market for non-performing loans.</li> <li>• <b>Limited progress</b> on strengthening the supervision of insurance companies and pension funds.</li> </ul>
<p><b>CSR4:</b> <i>Accelerate the implementation of the action plan for growth, focusing in particular on fast-tracking strategic investments and improving access to finance, and, by the end of 2017, resume the implementation of the privatisation plan. Take decisive steps towards the ownership unbundling of the Electricity Authority of Cyprus and, in particular, proceed with the functional and accounting unbundling by the end of 2017. (MIP Relevant)</i></p>	<p><b>Limited progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Some progress</b> in accelerating the implementation of the action plan for growth focusing in particular on business environment, facilitating strategic investments and improving access to finance.</li> <li>• <b>Limited progress</b> regarding the implementation of the privatisation plan.</li> <li>• <b>Limited progress</b> regarding the ownership unbundling of the Electricity Authority of Cyprus.</li> </ul>
<p><b>CSR5:</b> <i>Speed up reforms aimed at increasing the capacity of public employment services and improving the quality of active labour market policies delivery. Complete the reform of the education system to improve its labour market relevance and performance, including teachers' evaluation. By the end of 2017, adopt legislation for a hospital reform and universal healthcare coverage. (MIP Relevant)</i></p>	<p><b>Some progress:</b></p> <ul style="list-style-type: none"> <li>• <b>Some progress</b> in increasing the capacity of the public employment services and improving the quality of active labour market policies.</li> <li>• <b>Limited progress</b> regarding the reform of the education system to improve its labour market relevance and performance.</li> <li>• <b>Substantial progress</b> regarding the adoption of the legislation for a hospital reform and universal healthcare coverage.</li> </ul>

\* This overall assessment of CSR1 does not include an assessment of compliance with the Stability and Growth Pact

**ESI Funds are pivotal in addressing key challenges to inclusive growth and convergence in Cyprus,** notably by the promotion and expansion of e-services and e-government, the support for women's and youth entrepreneurship, the enhancement of the energy efficiency, the

strengthening of links between vocational training and adult learning and the labour market needs. ESI Funds are also instrumental in promoting R&D in the private sector, for improving the links between research, development and innovation on one hand and industry on the other.

### Box 2.1: Tangible results delivered through EU support to structural change in Cyprus

**Cyprus is a beneficiary of European Structural and Investment Funds (ESI Funds) support and can receive up to EUR 917 million until 2020.** This represents around 1 % of GDP annually over the period 2014-2018 and 20% of public investment <sup>(1)</sup>. By 31 December 2017, an estimated EUR 330 million (36 % of the total) was allocated to projects on the ground. EU funding has paved the way for over 100 enterprises to be supported in introducing over 80 new products and over 250 enterprises are supported in the manufacturing sector. Approximately EUR 17 million has been contracted to investments to modernise and restructure the agro-food sector and promote young farmers entrepreneurship. Additional funds have been also allocated to boosting youth employment under the Youth Employment Initiative. Out of the EU financing, EUR 40 million is to be delivered via financial instruments i.e. twice the amount delivered in the 2007-2013 period.

**ESI Funds help address structural policy challenges and implement country-specific recommendations.** Actions financed cover, among others, boosting competitiveness and economic growth; promoting R&D in the private sector; strengthening links between R&D, innovation and industry; supporting women and youth entrepreneurship; promoting e-services and e-government; helping develop more sustainable economy; assisting Cyprus to meet EU standards, in particular as regards waste treatment and recycling; strengthening links between vocational training and the labour market and adult learning development.

**Various reforms were undertaken already as precondition for ESI Funds support.** Smart Specialisation Strategies for research and innovation were developed to focus efforts on product specialisation with strong market potential. A strategic policy framework was set up for digital strategy which will stimulate the ICT products and services and increase the development of ICT applications for e-government. The adoption of adequate water pricing policy, a river basin management plan and solid waste management plans will ensure efficient use of resources, promotion of sustainable investments as well as respect of the EU environmental acquis. Efforts are made to complete the outstanding ex-ante conditionality related in particular to re-use and recycling as soon as possible in order to avoid a possible suspension of interim payments.

**Cyprus is advancing the take up of the European Fund for Strategic Investments (EFSI).** As of December 2017, overall financing volume of operations approved under the EFSI for Cyprus amounted to EUR 45 million, which is expected to trigger total private and public investment of EUR 81 million. More specifically, 1 project under the Infrastructure and Innovation Window has been approved so far in the energy sector, amounting to EUR 35 million in EIB financing under the EFSI. This is expected to trigger nearly EUR 53 million in investments. Under the SME Window, 2 agreements with financial intermediaries have been approved so far. European Investment Fund financing enabled by the EFSI amounts to EUR 10 million, which is expected to mobilise more than EUR 28 million in total investment. About 125 smaller companies or start-ups will benefit from this support.

Funding under Horizon 2020, the Connecting Europe Facility and other directly managed EU funds is additional to the ESI Funds. By the end of 2017, Cyprus has signed agreements for EUR 51 million for projects under the Connecting Europe Facility.

<https://cohesiondata.ec.europa.eu/countries/CY>

(1) Public investment is defined as gross fixed capital formation + investment grants + national expenditure on agriculture and fisheries. (2) Before programmes are adopted, Member States are required to comply with a number of so-called ex-ante conditionalities, which aim at improving conditions for the majority of public investments areas.

**Box 2.2: Technical support for the implementation of structural reforms in Cyprus**

Cyprus is benefiting from technical support provided by the Commission's SRSS<sup>1</sup> to help implement structural reforms in various areas including public administration and justice, growth and the business environment, healthcare, education, public financial management and taxation.

**With SRSS support, the Cypriot authorities intend to improve the efficiency of the judicial system.** In this context, an in-depth functional review of the operations, processes and management of courts is ongoing. In addition, the reforms underway to improve the operations of the Law Office are being supported through a review of the latter's functions, processes, structures and management.

**The Cypriot authorities have drawn on SRSS support for the implementation of the Action Plan for Growth.** Assistance was provided for monitoring entrepreneurial activity, developing social entrepreneurship, and assessing and developing the non-credit cooperative sector. In addition, the SRSS has mobilised support for strengthening the administrative capacity for public investment management. In an effort to streamline the issuance of building permits and title deeds, the Cypriot authorities have, with technical support, reviewed the legislative framework for planning and construction. The authorities have also benefited from technical support to prepared reforms in the area of energy. This includes assistance for: revising the National Action Plan for Renewable Energy Sources; developing the forthcoming Integrated National Energy and Climate Plan; developing a national energy efficiency strategy, revising electricity tariffs; and assessing the potential of high-efficiency cogeneration of heat and power. In the area of environment, technical support has enabled the authorities to develop economic tools for the implementation of its Municipal Waste Management Plan.

**In the area of health, Cyprus has benefited from technical support on the design, financing and management of the National Health Insurance System,** reimbursement methods of outpatient laboratory tests, on capacity planning and health technology assessment and options for designing and negotiating agreements on outpatient pharmaceuticals.

**In the area of education, the SRSS assisted the authorities towards the development of an IT School Management System** and the improvement of the teachers' professional learning initiative. Also, the SRSS has been providing support for the introduction of performance based funding in higher education and the reorganisation of the school boards.

**In the area of public finance, the Cypriot authorities have made progress, using technical support, in bringing accounting practices in line with best international practices and international public-sector accounting standards.** In the area of revenue administration, technical support has focused on the integration of the Inland Revenue Department and VAT Services into a function-based, compliance strategy driven tax department. Support was also provided for the implementation of an information security risk assessment of the main IT tax systems, the preparation of the procurement procedure for a new tax IT system, and the development and implementation of a strategy for promoting TaxisNet, the online system for electronic submission of income tax returns. Additional support included training on VAT laws and regulations, revision of the audit manuals, and improvements of data collection and analysis through a survey on taxpayer compliance behaviour and satisfaction.

<sup>1</sup> The Structural Reform Support Service (SRSS) provides, in cooperation with the relevant Commission services, tailor-made technical support, which does not require co-financing and is provided at a Member State's request. The support addresses priorities identified in the context of the EU economic governance process (i.e., implementation of country-specific recommendations), but the scope of the SRSS support is wider as it can also cover reforms linked to other Commission priorities, or reforms undertaken at the initiative of Member States.



### 3. SUMMARY OF THE MAIN FINDINGS FROM THE MACROECONOMIC IMBALANCE PROCEDURE IN-DEPTH REVIEW

**The in-depth review for the Cyprus' economy is presented in this report.** In spring 2017, Cyprus was identified as having excessive macroeconomic imbalances, in particular relating to the very high share of non-performing loans, which burdens the financial sector and the high stock of private, public, and external debt weighing on the economy in the context of high unemployment and weak potential growth. The 2018 Alert Mechanism Report (European Commission, 2017d) concluded that a new in-depth review should be undertaken for Cyprus to assess developments relating to identified imbalances. Excessive government debt is discussed in Section 4.1.1, financial sector imbalances in Section 4.2.1, private indebtedness in Section 4.2.2 and external imbalances in Section 1. Investment is analysed in Section 4.4.1, given its links to private indebtedness and growth.<sup>(9)</sup>

#### 3.1 Imbalances and their gravity

**Non-financial private sector debt is high (albeit decreasing slowly) and remains far above the levels estimated by fundamental and prudential benchmarks** (see Section 4.2.1). It contracted from 353.5 % of GDP in 2015 to 344.6 % of GDP in 2016, as a result of deleveraging by households. The drop was driven by an absolute reduction in the stock of loans and 'passive deleveraging' (i.e. when nominal economic growth is faster than the accumulation of debt). Households' debt fell from 127.7 % of GDP to 121.2 %, mainly as a result of asset disposals and swaps as well as debt forgiveness and restructuring rather than actual repayment. NFCs indebtedness remained broadly unchanged at 223.3 % of GDP in 2016, among the highest in the EU, even when taking into consideration that non-financial SPEs account for over a third of the NFCs' debt stock. The high debt level contains growth and the scope for more investment from the non-financial private sector.

**Public debt has decreased significantly, but remains high, at around 99 % of GDP in 2017.** High public debt makes Cyprus vulnerable to

financial or economic shocks. However, the large proportion of long-term low-interest debt provided by external creditors during the economic adjustment programme, the current low sovereign bond yields and relatively low medium-term financing needs mitigate refinancing risks. Cyprus has significantly reduced debt thanks to robust fiscal performance and active debt management operations.

**Cyprus still has a large negative net international investment position (NIIP), combined with a current-account deficit.** The NIIP stood at -120.6% of GDP in 2017Q3. Excluding non-financial SPEs registered in Cyprus (see Section 1 and box 1.1), which distort the liability position, the NIIP was about -44 % of GDP, and has been on a declining trend, suggesting that the non-SPE sector of the Cypriot economy is adjusting. The persistent current-account deficit, however, weighs on NIIP and reflects low domestic savings compounded by increased investment.

**Around half of the financial sector's loan book is currently non-performing.<sup>(10)</sup>** The deep recession triggered a surge in NPLs, which are still very high, fuelled by the high level of indebtedness and weak contract enforcement. The high stock of NPLs continues to raise concerns for financial stability, as it weighs on banks' profitability and limits their ability to generate capital and increase credit supply.

**The recovery of the housing market may help to reduce NPLs and household debt.** A large proportion of loans have real estate collateral. The long downward price adjustment discouraged mortgage holders and banks from selling their assets and may have incentivised strategic defaults. Guiso et al. (2013) show that willingness to default depends on and increases with both the absolute value and the value of mortgage in excess of current house price.<sup>(11)</sup> The recent increase in

<sup>(9)</sup> An asterisk indicates that the analysis in the section contributes to the in-depth review under the MIP.

<sup>(10)</sup> The text refers to the NPL ratio for the private sector, comprising only of exposures to non-financial corporations and households. See section 4.2.1.

<sup>(11)</sup> Alongside other factors, such as others having defaulted previously and the probability of becoming unemployed.

house prices and transactions is expected to help both creditors and debtors to dispose debt and liquidate the collateral underlying NPLs. However, difficulties in the issuing and transfer of title deeds remain and deter some prospective buyers.

**Potential growth is expected to increase somewhat over the medium term, helping to slowly unwind the accumulated stock imbalances.** Recovering investment, the return of discouraged workers to the labour force and declining unemployment are expected to raise growth potential and support total factor productivity. The latter is expected to start contributing positively in 2018 after a decade of negative contribution. At the same time, very high debt still weighs on growth, limiting the availability of credit and impeding the expansion of existing businesses and the start-up of new ones. Potential growth is estimated at 1-1.6 % in the medium term; closer to, though still below, the euro area average, and far below the historical levels for Cyprus. Furthermore, the composition of investment may not be very conducive to long-term growth and productivity (see Sections 1 and 4.4.2).

### 3.2 Evolution, prospects and policy responses

**Private sector deleveraging is progressing slowly, despite limited use of the new insolvency tools.** Private debt reduction has been supported by the better economic situation and more so by valuation effects (debt write-offs and debt-to-asset swaps). The insolvency framework has still been used only scarcely to date, due to obstacles to its effective application (i.e. inadequate court rules, capacity limitations, legal impediments) and inefficiencies in the judicial system.

**Supposing Cyprus maintains a prudent fiscal policy stance, government debt is projected to fall below 68% of GDP by 2028.** Medium-term fiscal sustainability risks are moderate, mainly due to the favourable fiscal position. To that end, a sound fiscal policy, in particular limiting public expenditure increases to medium-term potential growth, remains key. However, there are risks such as the lack of a mechanism to contain increases in the public wage bill beyond 2018 and the slow pace of reforms of the public administration and local governments. Cyprus could also better support potential growth by

shifting public expenditure towards more growth-enhancing projects in a fiscally neutral manner.

**The NIIP is on a downwards trend but is still largely negative.** It improved from -145 % of GDP in 2015 to -127.8 % of GDP in 2016 and further to -120.6% in the third quarter of 2017. The NIIP of non-financial SPEs, which have limited links to the real economy, accounted for a very large share of NIIP, at -76.4 % of GDP, while the contraction of overall NIIP was achieved by adjustment in the real sector. The general government long-term debt to international creditors accounts for a large part of the remaining position, which further mitigates risk. However, banks' external liabilities remain high, exposing the financial sector and the economy to shifts in investor and depositor confidence.

**The current-account deficit has widened.** Activities of SPEs heavily influence Cyprus' current account and influence its volatility, which complicates its timely monitoring. The current account deficit increased in 2016 to 4.9 % of GDP from 1.5 % in 2015, notably due to negative household savings (-3.1 % of GDP in 2016). In 2017, it has continued further widening (data up to third quarter, on a four quarter rolling basis) and is expected to remain in deficit in the medium term amid strong economic recovery. Cyprus would need a current-account balance close to zero to reduce its NIIP, excluding SPEs, to the MIP threshold of -35 % of GDP by 2026.

**The household savings rate remained negative.** It is estimated to have been negative for the fifth year in a row, suggesting that households have been running down their accumulated savings (assets) in order to repay debt and smooth consumption. The persistence of negative household savings in good times is worrisome. Other factors, such as a change of attitude towards savings after the 2013 bail-in, low interest rates and currently high out-of-pocket payments in health, might have caused Cypriot households to save less.

**Continued loan restructurings have reduced NPLs.** Banks have continued to restructure loans, prioritising measures such as debt-to-assets swaps and debt write-offs. Recently, the ratio of NPLs to gross loans started to fall, albeit slowly (see Section 4.2.1).



**Meanwhile policy measures have had a limited impact on debt reduction and NPLs.** Weak contract enforcement fosters debt repayment indiscipline, which continues to hamper private sector deleveraging. It stems from inefficiencies in the judicial system, limited use of the foreclosure and insolvency frameworks, and persistent information gaps regarding borrowers. Some progress was made in addressing the shortcomings in the system for issuing and transferring property title deeds, but significant policy gaps remain.

**A key challenge is to avoid the build-up of new financial sector imbalances in the short term.** Banks' profitability is expected to remain challenged by risk provisioning and impairments, while credit growth is likely to be constrained by a limited pool of eligible borrowers. Low investment returns in the banking sector combined with abundant liquidity might incentivise risk-taking. At the same time, the increasing recourse to debt-to-asset swaps leads banks to accumulate real estate assets on their balance sheet. This may pose challenges in the future as they will need to devote resources to managing the assets (see Section 4.2.1).

**The housing market is recovering, but regulatory inefficiencies remain.** House prices have bottomed out and property sales have picked up, but significant backlogs and delays continue to affect the issuing of title deeds. Major obstacles to the transfer of title deeds from sellers to final buyers have not been resolved. Housing supply is responding to the increased demand, but is obstructed by long delays in issuing building permits and restricted credit availability. The lack of a reliable and transparent property transactions system does not allow banks to monitor the proceeds of sales from indebted and non-performing developers.

**Still-low labour productivity might constrain long-term growth.** Productivity has broadly stagnated since 2008 and investments that improve it (i.e. those not linked to ship registrations or residential construction) remain relatively limited (see Section 4.4.1). In the medium term, emerging upward cost pressures could erode competitiveness if productivity does not improve. Moreover, the labour-market relevance and quality of young jobseekers' education remain a concern.

**Structural reforms to improve the business environment are gradually being implemented.**

The action plan for growth aims to improve the business environment, promote alternative financing sources and boost investment and employment in priority sectors, including tourism and shipping. In addition, the government intends to cut the regulatory burden by making procedures more efficient, developing digital public services and improving the quality of regulation. However, the privatisation plan, which was adopted to attract investment and foster efficiency in public utilities, has largely been put on hold.

### 3.3 Overall assessment

**Cyprus still faces significant challenges in the form of very high levels of NPLs burdening the financial sector, combined with large stocks of private, government and external debt.** The current-account deficit is not conducive to a sustainable correction of the NIIP. Government debt is on a downward path, but the prudent fiscal policy needs to be maintained if the projected pace of debt reduction is to materialise. In the private sector, debt and the NPL ratio remain high. The surge in NPLs has dried up credit supply and is weighing on investment and harming the growth potential of the economy. Private sector savings fell in 2016 and are expected to have remained weak in 2017, leading to a worsening of the savings-investment balance.

**The implementation of policy measures to address macroeconomic imbalances remains a challenge.** Only limited progress has been recorded regarding the implementation of measures addressing the macroeconomic imbalances (see Section 2 and Annex A). Measures taken to reduce NPLs, such as the revised insolvency framework and a strengthened supervisory and regulatory framework, still face obstacles to effective application. Other reforms regarding public administration, the justice system, title deeds and improvements to the business environment are on-going but at a slow pace, while privatisation plan has lost momentum.

Table 3.1 Macroeconomic Imbalance Procedure assessment matrix for Cyprus

This MIP Assessment Matrix summarises the main findings of the in-depth review in the country report. It focuses on imbalances and adjustment issues relevant for the MIP.			
	Gravity of the challenge	Evolution and prospects	Policy response
<i>Imbalances (unsustainable trends, vulnerabilities and associated risks)</i>			
<b>External Balance</b>	<p>The NIIP stood at -127.8% of GDP in 2016. The current account balance, based on 3-year average, stood at -3.6%. This falls short of what is required for a swift external rebalancing.</p> <p>The NIIP and the current account are biased by non-financial SPEs (see Box 1.1).</p> <p>The REER depreciated by 6.5% over three years, beyond the MIP threshold of -5%.</p> <p>Over the last 5 years Cyprus lost 3% of world export shares.</p>	<p>The NIIP kept contracting in 2017. The current account deficit, however, is not conducive to durable NIIP reduction. The current account deficit widened to 4.9% in 2016 and remained in deficit in 2017.</p> <p>The real effective exchange rate started appreciating in 2016 and continued in 2017, eroding cost competitiveness. Unit labour costs fell in 2016 but the downwards adjustment seems to have paused in 2017.</p> <p>Domestic savings are low due to negative savings of households. This increases the gap between savings and investment.</p>	<p>Tourism exports have been stimulated by structural reforms aimed at extending the tourism season and improving connectivity, but less has been done in other areas.</p> <p>Authorities try to control wage growth. A new wage indexation mechanism (CoLA) for the private sector has been agreed by social partners for 2018-2020 based on 50% of inflation once a year. In the public sector the same mechanism applies permanently, in addition to the existing collective agreement until 2018.</p>
<b>Private debt</b>	<p>Private debt in Cyprus stood at 344.6% of GDP in 2016, among the highest level in the EU.</p> <p>A large proportion of debt stock is non-performing, despite the economic recovery, due to poor contract enforcement and inefficient implementation of the foreclosure and insolvency frameworks.</p>	<p>Deleveraging continues at a slow pace, with trend continuing in 2017 as a result of declining debt stock, strong real growth and inflation.</p> <p>The capitalisation of unpaid interest on the large stock of NPLs inflates the debt stock.</p> <p>The use of insolvency procedures remains limited. Recovery of property prices and more active real estate market may help to reduce debt.</p>	<p>Debt-to-asset swaps have been used as a deleveraging tool, as inefficiencies in the insolvency service and the judicial system deter the use of the new insolvency tools. Banks have increased debt write offs.</p> <p>Reforms aiming to improve the protection of property rights (notably regarding title deeds) are being adopted at a slow pace.</p> <p>Rules of Court for insolvency have been partly updated, while amendments to civil procedure have been proposed to better enforce contracts and court decisions.</p>
<b>Public debt</b>	<p>The Government debt-to-GDP ratio was high, at around 99 % in 2017, exposing the country to changes in financial or economic conditions that may increase financing costs.</p> <p>However, large share of long-term low-interest debt provided by external creditors during the economic adjustment programme mitigates risks to some extent.</p>	<p>The debt-to-GDP ratio peaked in 2015 and is projected to gradually decline below 94% and 68% of GDP in 2019 and 2028, respectively.</p> <p>Cyprus' sovereign credit rating has improved significantly since mid-2013, but remains at least one notch below investment grade.</p> <p>Yields on the longest term marketable debt (8-year) have declined substantially: from 3.5% at the end of 2016 to 1.5% in January 2018.</p> <p>The tax base is concentrated on a few components, in particular on corporate income tax and VAT, and the immovable property tax was abolished. This might pose risks to the long-term sustainability of tax revenue.</p>	<p>Active debt-management policy has allowed containing refinancing risk, smoothing-out the debt repayment schedule in the medium-term and quicker reduction of debt.</p>

(Continued on the next page)

Table (continued)

<b>Financial Sector</b>	<p>At around 45% of the total loan stock, non-performing loans (NPLs) in the Cypriot banking sector remain among the highest in the euro area.</p> <p>Banks have a strong exposure to the property market. A large proportion of loans are collateralised, while banks increasingly take over real estate collateral as part of NPL resolution efforts.</p> <p>Banks' weak underlying profitability and sustained provisioning needs are negatively affecting capitalisation.</p>	<p>The ratio of non-performing loans kept declining slowly in 2017, to 52.7% for households and non-financial corporations loans at end-June 2017 from 54.8% at end 2016.</p> <p>The high level of collateralised lending and relatively benign estimates of expected losses on collateralised loans have kept provisions at levels below the EU average, although there has been some catching up.</p> <p>Capacity to build up further capital buffers is still hampered by low profitability and high NPL risks. The flow of credit to the economy is still limited.</p>	<p>More information has been made available to creditors through the credit and company registry but the quality and breadth of available information can be enhanced.</p> <p>Targets for loan restructuring and early arrears management have been set but it had been difficult for banks to meet them.</p> <p>There are still impediments to the implementation of the reformed foreclosure framework.</p> <p>Legislation allowing the sale of non-performing loans was enacted but some provisions are considered overly restrictive.</p> <p>Provisioning requirements have been enhanced. Provisions improved and are now in line with the euro area averages.</p>
<i>Adjustment issues</i>			
<b>Potential growth</b>	<p>Potential growth is estimated at around 1-1.6% in the medium term, while higher rates would be needed to permit the economy to rapidly grow out of debt.</p>	<p>Potential growth was revised up in line with increasing investment and improving labour market. The investment to GDP ratio markedly increased, although a fair share of investment is linked to construction and ship registrations. Productivity growth remains weak.</p>	<p>An action plan for growth is in place to improve the business environment and help develop key sectors of the economy, but has only been partially implemented.</p> <p>A privatisation plan was adopted to attract investment, increase competition and reduce prices in network industries, but its implementation has stalled.</p>
<b>Unemployment</b>	<p>Unemployment was high at 11.3 % in 2017. The 3-year average was 13.1%, still above the MIP threshold. Youth and long term unemployment are also high but already within the threshold.</p> <p>The activity rate has reached 73.4% in 2016, 0.2 p.p. lower than in 2013 but within the MIP threshold</p>	<p>Unemployment has markedly shrunk in 2017 on the back of economic recovery, to 10.5% in 2017Q3. Youth and long-term unemployment also contracted, albeit still high at respectively 25.1% and 4.3% in 2017Q3.</p> <p>The capacity of the public employment services to provide quality services to the unemployed, reach out to NEETs, and help reduce welfare dependence remains sub-optimal. Participation in Vocational and Education Training remains low and the relevance and quality of young entrants in the labour market remains a concern.</p> <p>Activity rate is increasing alongside economic recovery.</p>	<p>The reform of the public employment services has been delayed and the impact of ALMPs implemented is still to be evaluated.</p> <p>Measures are being taken to enhance vocational training and the quality of higher education, but the implementation is slow.</p>
<b>Conclusions from IDR analysis</b>			
<ul style="list-style-type: none"> <li>• Cyprus faces important imbalances in the form of a weak financial sector, combined with large stocks of private, public, and external debt. The high ratio of non-performing loans in the domestic banking system constrains deleveraging and banks' profitability, reducing the amount of credit that can be channelled to the economy.</li> <li>• Private sector deleveraging and the reduction of the non-performing loans continue to be hampered by poor contract enforcement, inefficiencies in the judicial system, obstacles to the use of foreclosure and insolvency legislation and insufficient information on borrowers. Delays in reforming the system of issuance and transfer of title deeds continue, posing problems in the context of a large proportion of collateralised loan stocks. The Cypriot current account deficit is larger than what is required to bring down the NIIP to more manageable levels, reflecting very low domestic savings amid recovering investment.</li> <li>• Measures have been taken to review the insolvency legislation, improve the credit and companies' registries, enhance the efficiency of the judiciary, and allow for the sale of non-performing loans. However, efforts are still needed to improve available information on borrowers, to identify and remove obstacles to the use of the foreclosure and insolvency framework, to improve contract enforcement, to ensure well defined property rights, and to help banks resume a healthy flow of credit to the economy. Ensuring fiscal discipline is also crucial for debt-reduction. Measures are still needed to foster efficiency and competition in network industries and to reduce labour market frictions.</li> </ul>			
<p>(*) The first column summarises 'gravity' issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the 'evolution and prospects' of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment issue. The final three paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.</p>			

Source: European Commission

## 4. REFORM PRIORITIES

### 4.1. PUBLIC FINANCES AND TAXATION

#### 4.1.1. PUBLIC DEBT AND RISKS TO FISCAL SUSTAINABILITY\* <sup>(12)</sup>

**General government debt came down significantly in 2017 but remains high.** After rising sharply in the years following the financial crisis, it peaked at 107.5 % of GDP in 2015, about 62 percentage points (pps) above its 2008 trough. Owing to strong economic growth, fiscal performance and an early debt repayment in November 2017, it fell below 100% of GDP in 2017. The Commission's autumn 2017 forecast projects that it will fall to below 94 % of GDP in 2019 (about 14 pps above the EU average) <sup>(13)</sup>, on the back of sizeable fiscal primary surpluses combined with strong nominal growth.

**Cyprus does not appear to face immediate risks of fiscal stress, owing to its favourable fiscal position.** <sup>(14)</sup> This is mainly thanks to the improvement of the general government fiscal balance and primary balance, low gross financing needs and relatively low short-term general government debt. These more than offset the still-sizeable public debt. However, short-term risks on the macro-financial side remain significant. According to the S0 indicator breakdown, several factors remain sources of vulnerability. These include households' negative net saving rate, the large negative NIIP, the current-account deficit and the high private sector debt, a significant proportion of which is short-term. <sup>(15)</sup> This is partly mitigated by, in particular, the slope of the sovereign bond yield curve and improved cost competitiveness. The

vulnerabilities relating to NPLs are addressed separately below.

**Given its initial high public debt stock, Cyprus faces medium fiscal sustainability risks in the medium term.** <sup>(16)</sup> Debt sustainability analysis shows that, under normal economic conditions with no fiscal policy change (baseline scenario), the general government debt-to-GDP ratio would fall to around 68 % by 2028, still above the critical 60 % threshold (see Graph 4.1.1). The projected significant decrease of around 26 pps in 2020-2028 would be driven by persistent primary surpluses and (to a lesser extent) by a negative interest-rate/growth differential. In public debt projections taking into account potential shocks to nominal growth, fiscal stance and interest rates in alternative scenarios and sensitivity tests, debt-to-GDP does not exceed the critical 90 % threshold and does not rise over the projection period. The S1 medium-term sustainability indicator is assessed as pointing to medium (almost low) risk (European Commission, 2018a).

**Risks relating to the debt structure are low and investor confidence has improved.** In mid-2017, the average maturities of total public debt and marketable debt were 7.6 and 4.8 years, respectively. <sup>(17)</sup> The latter, relatively short period, was partly driven by the fact that the last foreign bond issuances targeted 7-year, rather than longer, maturity bonds. A large proportion of debt (79 % in 2016) is held by non-resident creditors. <sup>(18)</sup> This is largely because much of the borrowing is from official sources, in particular in the context of the macro-financial assistance programme. Although Cyprus' sovereign credit rating remains one notch below investment grade, <sup>(19)</sup> excluding its bonds

<sup>(12)</sup> An asterisk indicates that the analysis in the section contributes to the in-depth review under the MIP (see Section 3 for a summary of main findings).

<sup>(13)</sup> This does not take into account the outturn data for 2017.

<sup>(14)</sup> Short-term fiscal stress is measured by the S0 indicator, an early-detection indicator designed on the basis of past crises to highlight short-term (1-year horizon) fiscal risks stemming from the macro-financial or the fiscal side of the economy. According to the Commission's autumn 2017 forecast, the S0 indicator for Cyprus stood slightly below the critical threshold, but its macro-financial and competitiveness sub-index exceeded the critical value (European Commission, 2018a).

<sup>(15)</sup> The NIIP, the private sector debt and the current-account deficit are affected by SPEs (see Section 1).

<sup>(16)</sup> The assessment of medium-term sustainability challenges relies on the joint use of debt sustainability analysis (for a 10-year period) and the S1 medium-term sustainability indicator.

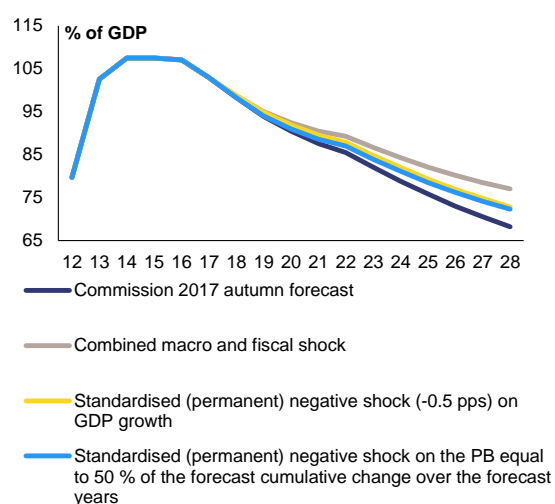
<sup>(17)</sup> Source: <http://www.mof.gov.cy/mof/pdmo/pdmo.nsf/All/B473D276A2304DD2C2257C6E003439D5?OpenDocument>

<sup>(18)</sup> Source: Eurostat.

<sup>(19)</sup> Although four rating agencies upgraded Cyprus' sovereign rating in 2017, its most favourable rating, by S&P, remains one notch below investment grade (see European Commission, 2017b, Section 6). In December 2017, DBRS changed the outlook to positive from stable.

from ECB refinancing and asset purchase programmes, investor confidence has improved significantly. In particular, sovereign yield spread (versus German bond) on the longest-term (8-year) marketable debt has declined substantially: from 3.5 % at the end of 2016 to 1.5 % in January 2018.

Graph 4.1.1: Public debt projections



Source: European Commission

**Government guarantees have declined, but there are risks associated with state-owned enterprises (SOEs).** Guarantees dropped significantly, to around 9 % of GDP, at the end of 2016, down from 15.1 % the previous year<sup>(20)</sup>, but still remain somewhat above the EU average. Although the risk of guarantees being called is limited due to the low proportion of state-guaranteed loans being made up of NPLs (representing less than 0.6 % of GDP), the lack of comprehensive and public information on the state's exposure to SOEs, in particular through their long-term liabilities relating to pensions, makes it difficult to assess Cyprus' fiscal risks.

**Contingent risks remain in the banking sector, notably in the short term,** mainly due to a high ratio of NPLs. They are more significant in the short term, since safety nets in the form of increasing capital requirements, bail-in and national and supranational resolution funds are still being put in place.<sup>(21)</sup> According to the

<sup>(20)</sup> This excludes guarantees on general government debt.

<sup>(21)</sup> As set out in the new Capital Requirement Regulation and Directive IV, the Bank Recovery and Resolution Directive and Single Resolution Mechanism Regulation.

Commission's systemic model of banking originated losses (Symbol), Cyprus is the Member State most exposed to short-term fiscal risks in a severe stress scenario of a repeat of the recent financial crisis.<sup>(22)</sup> On the basis of the current level of NPLs and conservative loss assumptions, a recapitalisation of Cyprus' systemic banks by public funds to 8 % and 10.5 % of their risk-weighted assets could increase sovereign debt by 4.1 % and 7.6 % of GDP, respectively, in the short term. However, the country's exposure to the banking sector is seen as decreasing to below 1 % of GDP by 2028, given that the safety nets will have been fully phased in and assuming that the effect of NPLs will become negligible in the long term.

**The setting-up of a sovereign wealth fund (SWF) could improve public debt sustainability in the long term.** The House of Representatives is still discussing the bill laying out the governance structure of the SWF and the draft legislation governing SWF inflows and outflows. Adoption of the legislation would contribute to ensure sustainable use of revenue from the exploitation of hydrocarbon reserves and to improve public debt sustainability outlook.

#### 4.1.2. FISCAL FRAMEWORK AND POLICY\*

**The reformed budgetary framework, currently being implemented, plays a key role in ensuring sustainable public finances.** The 2014 Fiscal Responsibility and Budget System Law (FRBSL) establishes a comprehensive and transparent legal framework for the entire general government, in line with EU requirements. Importantly, the FRBSL links ministries' strategic objectives and government policy priorities with the annual budget and medium-term budgetary planning, including expenditure ceilings and key performance indicators for each policy. It also governs the management and evaluation of public investment and the monitoring of fiscal risks

<sup>(22)</sup> Symbol simulates the short- and medium-term fiscal impact of a financial crisis similar to the 2008 crisis. The short-term simulation is run on the basis of December 2016 data for the first quarter of 2018. Symbol estimates the public bailout required to keep the systemic banks open and sufficiently capitalised after applying the safety net tools. The improvement in Symbol results for Cyprus as compared to the previous year is due to, amongst others, enlarging the sample of covered banks.



stemming from guarantees, payment arrears and SOEs. The budgetary framework is expected to be fully implemented in 2018.

**The reform of public financial management will take several years.** Current efforts are focused on the selection and evaluation of investment projects. Administrative capacity is being improved in the key institutions involved in investment projects, including public-private partnerships, in particular through specific guidance, training programmes and the acquisition of suitable IT management systems. Budget-data reporting from local authorities and SOEs is also improving, although the data are not sufficiently homogenised to ensure comparability and full assessment of fiscal positions.

**Solutions to ensure long-term fiscal sustainability of the public sector wage bill are lacking.** The containment of the public sector wage bill has been a significant factor in fiscal consolidation in Cyprus.<sup>(23)</sup> To instil more flexibility in workforce management, a bill adopted in May 2017 facilitates staff mobility between the public service and SOEs. However, the current collective agreement (covering also SOEs) limiting the growth of public sector compensation to nominal economic growth expires in 2018.

**Budgetary regulations were slightly amended to comply with the Budgetary Frameworks Directive** by improving the transparency of public finances. In particular, the amendment to the Budget Law requires comprehensive publication of tax expenditures as part of the annual budgetary documentation. Also, the publication on contingent liabilities was considerably improved recently, in particular as regards information on NPLs in the general government sector and state participation in the capital of corporations.

**The medium-term budgetary framework<sup>(24)</sup> effectively strengthens the transparency and predictability of the budgetary process.** Published and rolled over for a year each spring, it

<sup>(23)</sup> This results mainly from a reduction in the number of public sector employees through natural attrition and the freezing of wages in the broader public sector in 2012-2016.

<sup>(24)</sup> In Cyprus, referred to as the medium-term strategic framework for fiscal policy.

includes medium-term macroeconomic and budgetary forecasts, and expenditure ceilings for the following 3 years. The first framework was issued in 2014, covering the period of 2015-2017. The appropriations in the annual budgets in 2015-2018 should therefore be in line with the expenditure ceilings in the frameworks. As there are only small differences for certain years (below 0.3 % of GDP)<sup>(25)</sup>, the frameworks can be assessed to have improved the budgetary process in terms of transparency and predictability.

#### 4.1.3. TAXATION AND TAX ADMINISTRATION\*

**Value added tax (VAT) and corporate income tax (CIT) are major sources of revenue in Cyprus, with CIT revenue subject to potential decreases.** As percentages of GDP (9.2 % and 5.8 % respectively in 2016), VAT and CIT revenues are above the EU average (7 % and 2.6 %), although the effective CIT rate (13.1 %, 2016) is below the EU average (20.9 %).<sup>(26)</sup> The discrepancy between the higher revenue and the lower rate can be explained by a larger aggregate tax base at a lower statutory tax rate and the presence of businesses engaging in tax planning.<sup>(27)</sup> As a result, Cyprus appears exposed to CIT revenue decreases due to potential changes in the international corporate tax framework eliminating incentives for tax planning. The VAT gap (7.4 % of theoretical VAT liability in 2015) is below the EU average (12.8 %), indicating lower revenue losses due to non-compliance (Center for Social and Economic Research, 2017). Graph 4.1.2 shows the tax structure in Cyprus as compared to that of the EU and selected Member States for 2015.

**The tax burden on labour is low and consumption and environmental tax revenues are high, making Cyprus' tax structure relatively growth- and environment-friendly.** As

<sup>(25)</sup> The expenditure ceilings in the framework do not include expenditure on loans and interest payments, while the appropriations in the budget law do. These differences have been taken into account in this analysis.

<sup>(26)</sup> Source: [https://ec.europa.eu/taxation\\_customs/business/economic-analysis-taxation/data-taxation\\_en](https://ec.europa.eu/taxation_customs/business/economic-analysis-taxation/data-taxation_en).

<sup>(27)</sup> Aggressive tax planning allows businesses to reduce tax liabilities through debt shifting, strategic location of intellectual property rights and intangible assets, and/or (mis)use of transfer pricing.

a percentage of GDP, revenues from labour taxes are low compared with the EU average (11.3 %, as against 19.3 % in 2015). Taxes on labour are set to increase in the future due to legislated rises in social contributions in relation to the pension system in the period to 2039 (European Commission 2017c) and the introduction of compulsory health insurance contributions to finance the recently adopted national health service (see Section 4.3.2). However, labour tax revenue is not expected to catch up fully with the EU average. This is mainly due to the significantly lower revenue from personal income tax as a result of a threshold for untaxable income that is one of the highest in the EU. On the other hand, revenues from consumption and environmental taxes (12.9 % and 3 % of GDP respectively in 2015) are above the EU averages (11.1 % and 2.4 %). Vehicle taxation in Cyprus is also linked to carbon dioxide emissions.

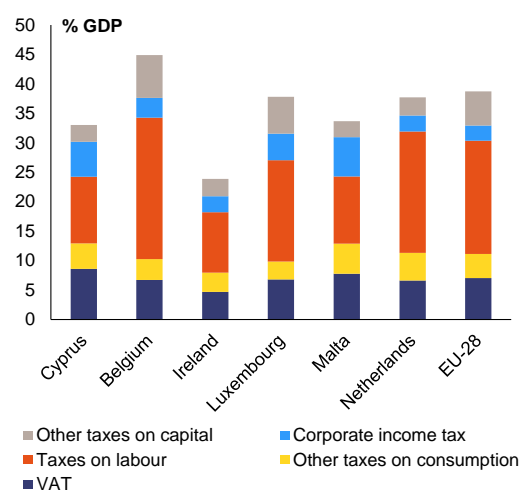
**Tax revenues are currently supported by temporary tax buoyancy effects, which could generate risks if used to finance long-term expenditure.** Commission analysis of CIT and VAT in Cyprus points to significant tax buoyancy effects, leading to revenue windfalls in the current economic cycle.<sup>(28)</sup> This is because real revenues from CIT and VAT increase faster than their tax bases (i.e. final consumption expenditure and gross operating surpluses) along the business cycle. There is also evidence, but to a lesser extent, of tax buoyancy effects in the case of the personal income tax revenues. The use of the additional revenue stemming from tax buoyancy effects should be monitored carefully, to avoid risks associated with using temporary revenue to finance increases in long-term expenditure. Given the high public debt stock and low potential growth in Cyprus, the additional revenue could be used to reduce public debt further or support growth-enhancing investment.

**Cyprus' tax base has narrowed and become more dependent on specific components.** The

<sup>(28)</sup> Tax buoyancy effects represent the deviation of short-term elasticities from long-term elasticities (usually close to one) as a result of changes in tax rates, tax collection or tax efficiency ratios. In the long term, tax revenues are expected to move closely in line with tax bases. Based on the Commission's assessment of tax buoyancy in Cyprus, the additional annual revenues from the VAT and CIT stemming from buoyancy effects are estimated at above 0.5 % of GDP in 2017.

Commission's analysis of the tax structure shows that the tax base is concentrated on a few drivers, in particular CIT and VAT. It was narrowed in 2017, when the immovable property tax was abolished, despite being widely considered one of the most growth-friendly sources of tax revenue.

Graph 4.1.2: Tax structure in 2015



(1) The countries were selected on the basis of legal and economic indicators of aggressive tax planning.

(2) 'Other taxes on capital' include immovable property tax revenues.

Source: European Commission

**The tax and benefits system has become more effective in addressing income inequality, but wealth inequality remains high.** The redistributive effects of the tax and benefits system in respect of revenue have grown almost twofold since the crisis (in 2009-2016), but remain slightly below the EU average. The system performs relatively well (better than the EU on average) in reducing the number of people at risk of poverty. However, the abolition of the immovable property tax undermined efforts to reduce wealth inequality, which was among the highest in the euro area in 2014 (see Section 1).<sup>(29)</sup>

**Some indicators continue to suggest that Cyprus' CIT rules are used by companies engaged in aggressive tax planning.** A study shows that Cyprus' high inward and outward foreign direct investment stocks can be only partly

<sup>(29)</sup> Given the absence of recurrent property tax, inheritance and gift tax and net wealth tax in Cyprus, the redistributive effect of the tax and benefit system concerning wealth is assessed to be very low.

explained by real economic activity in the country (Institute for Advanced Studies, 2018). Furthermore, the high levels of dividend and interest payments as percentage of GDP continue to suggest that its tax rules are used by companies that engage in aggressive tax planning.<sup>(30)</sup> As explained above, CIT revenue as a percentage of GDP in Cyprus (5.8 %) was much higher than the EU average (2.6 %) in 2016. The absence of withholding taxes on dividend, interest and royalty payments by Cyprus-based companies may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction.<sup>(31)</sup> This absence, together with the corporate tax residency rules, may continue to facilitate aggressive tax planning.<sup>(32)</sup> Notional interest deduction regimes, while helping to reduce the debt equity bias, can also be used for tax avoidance purposes if not properly safeguarded. Therefore, there is a need to closely monitor the effectiveness of anti-avoidance rules in this regime.

**Cyprus has taken measures to amend aspects of its tax system that were facilitating aggressive tax planning.** The Code of Conduct on Business Taxation Group has approved amendments to align the patent box scheme<sup>(33)</sup> with international developments and the modified nexus approach,<sup>(34)</sup> and the closure of the old patent box. The latter is subject to a grandfathering clause until June 2021. The new amendments will make a stronger link between the intellectual property

rights that can benefit and the R&D that created them. While economic evidence of the effectiveness of patent boxes as a means of encouraging R&D remains limited (CPB, 2014), they may be used as a tax competition tool (Alstadsæter et. al., 2017, pp. 131-177). A circular amending the rules on the tax treatment of financing companies from 1 July 2017 provides additional guidance on substance and transfer pricing requirements in line with OECD guidelines. Finally, in November 2017, the tax authorities launched a public consultation on the transposition into national law of the two EU Directives on Anti-Tax Avoidance (ATADs). The transposition should take place by the end of 2018 and 2019.<sup>(35)</sup> The extent to which the new measures and the transposition of ATADs will limit the scope for aggressive tax planning and the impact on the CIT revenue in the medium term is still to be assessed.

**After progress in previous years, revenue administration reforms have slowed down.** The single tax registration process has been completed for both direct and indirect taxes, which now share common procedures. Measures to step up the fight against tax evasion are under way, notably on social contributions for previously undeclared work (see Box 4.3.2). The tax procedure code has been drafted and some chapters are expected to be adopted in 2018. However, progress on implementing the integrated tax administration system (ITAS) is slow. The merger of the VAT service and the Inland Revenue department into a single department has not been completed yet, although the Large Taxpayer Office now carries out joint audits. ITAS implementation requires the full deployment of the new tax IT system, which will take several years. In the meantime, the current online system is being upgraded to improve tax administration (e.g. allowing for online VAT, tax income and debt payments).

<sup>(30)</sup> The inward and outward foreign direct investment stocks were 1 048% and 1 029% of GDP respectively in 2016, among the highest in the EU. In 2016, the flows of dividends paid and received amounted to 19.8 % and 11.4 % of GDP respectively, and the flows of interests paid and received to 3.3% and 2.3% of GDP respectively, all of those among the highest in the EU.

<sup>(31)</sup> There is a withholding tax on royalties if the intellectual property rights are used locally. For more information on the interaction between withholding tax and aggressive tax planning structures, see ZEW 2016.

<sup>(32)</sup> A company is resident if its management and control is exercised in Cyprus. A company may be incorporated in Cyprus but not regarded as resident there if its management and control is exercised abroad.

As regards corporate tax residency, following recommendations from the Global Forum on Tax Transparency, Cyprus introduced in 2012 local tax reporting of companies that are incorporated in Cyprus but non-resident.

<sup>(33)</sup> A tax scheme that offers a substantially reduced rate of CIT on the income derived from patents. In Cyprus, the rate was 2.5%.

<sup>(34)</sup> The nexus approach allows a taxpayer to benefit from patent box arrangements only to the extent that it can show that the taxpayer incurred related expenditure.

<sup>(35)</sup> These entail rules for interest limitation, controlled foreign companies, and general anti-avoidance (to take effect as from 2019); exit taxation (from 2020); and hybrid mismatch (from 2020-2022).

See [https://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en) and [http://europa.eu/rapid/press-release\\_IP-17-1433\\_en.htm](http://europa.eu/rapid/press-release_IP-17-1433_en.htm).



## 4.2. FINANCIAL SECTOR

### 4.2.1. ASSET QUALITY IN THE BANKING SECTOR \*

#### Financial developments

**The Cypriot economy is predominantly financed by the banking sector.** Loans from monetary and financial institutions (MFIs) to NFCs represented about 115 % of GDP in 2016, about three times higher than the EU average. Funding via equity markets, debt issuance and venture capital remains very marginal due to the small size and unsophisticated nature of Cyprus' capital markets. In 2017, credit conditions improved gradually for all types of client, including SMEs, in terms of both availability and cost. New bank lending picked up, albeit from a very low base (see Section 1), but remains insufficient to meet demand. Additional initiatives have been taken to develop access to finance (see Section 4.2.4).

**Poor asset quality and low interest margins continue to exert downward pressure on banks' profits.** Banks had to set aside additional provisioning in 2017, resulting in banks recording losses in the first nine months of 2017 (See Section 1). Net interest margins continue to decline as a result of lower interest income and still relatively high interest rates offered on deposits. At the same time, the three largest banks made good progress on restructuring their operations to reduce operating costs, but benchmark indicators point to them still being oversized. Banks may seek higher-yielding investments to use their ample liquidity and this is an important risk for the future.

**Banks face challenges in issuing funding instruments with longer maturities.** They are almost entirely reliant on short-term deposits to fund their lending operations. There is no inter-bank market in Cyprus, as banks currently hold excess liquidity at the ECB. Owing to their precarious asset quality, banks have not yet succeeded in raising medium- or long-term funding on wholesale capital markets. However, longer-term funding sources may be needed in future to diversify their funding structure and meet future regulatory requirements. Indeed, long-term subordinated debt issuance will be necessary in order to meet requirements on loss-absorption capacity, such as the minimum requirement for own funds and eligible liabilities, which is meant to complement the bail-in mechanism under the

Bank Recovery and Resolution Directive and the total loss absorption capacity set by the Financial Stability Board. As a consequence, the conditions under which funding will be raised hinge significantly on banks' ability to improve their asset quality.

#### Improving asset quality

**The stock and ratio of private sector NPLs have declined.** Excluding loans to financial institutions and the government sector, <sup>(36)</sup> the ratio of private sector NPLs has declined to 52.7 % in June 2017, which is still very high. The reduction was mostly a result of contraction in the stock of NPLs on the part of NFCs, which had fallen by approximately 16 % in June 2017 on a year-on-year basis. These developments came at a time when provisioning coverage ratios increased substantially as a result of supervisory action, from 41.3 % of gross NPLs at end-2016 to 46.2 % in June 2017, above the euro area average of 44.7 %. Despite these improvements, which also address the EAR 4, the stock of NPLs in absolute terms remains higher than its June 2013 level of EUR 21 billion.

Table 4.2.1: **Financial soundness indicators for domestic and foreign banks"**

(%)	2012	2013	2014	2015	2016	2017Q2
Non-performing debt	18,7	36,2	35,6	34,7	33,8	31,4
Non-performing loans (1)	-	-	38,6	36,3	35,4	33,4
from foreign banks	-	-	17,1	26,6	26,5	24,8
to NFCs and households (1)	-	-	54,6	55,1	54,8	52,7
to NFCs	-	-	57,2	55,3	55,0	50,9
to households	-	-	52,1	55,0	54,7	54,5
Coverage ratio	46,7	31,0	31,7	37,2	41,3	46,2
Loan to deposit ratio (2)	119,3	152,3	152,1	152,0	120,5	120,0
Tier 1 ratio	6,3	12,3	14,6	16,0	16,4	15,5
Capital adequacy ratio	7,3	13,5	15,3	16,6	16,8	16,4
Return on equity (3)	-100,8	-37,9	-7,1	-7,7	1,7	-
Return on assets (3)	-3,6	-2,9	-0,6	-0,6	-0,3	-

(1) Due to the sizeable exposures of banks to central banks and other financial institutions, the aggregate non-performing loan (NPL) ratio differs substantially from the NPL ratio for the private sector alone, comprising only of loans to NFCs and households.

(2) ECB aggregated balance sheet: loans excluding to government and MFIs / deposits excluding from government and MFIs.

(3) For comparability, only annual values are presented.

**Source:** ECB consolidated banking data

<sup>36</sup> The aggregate NPL ratio, which covers all loan and advances, may be misleading for Cyprus due to the large exposures of domestic and foreign banks to central banks (representing 14% of gross loans) and other financial institutions (10% of gross loans). For this reason, the text refers to the NPL ratio for the private sector, comprising only of exposures to non-financial corporations and households.

**The most notable improvements in asset quality have been in the sectors directly related to real estate and tourism.** In the construction sector, the largest sector in Cyprus in terms of outstanding loans, the NPL ratio dropped from 72 % in September 2016 to 64 % in September 2017 (see Table 4.2.2). The NPL ratio for the accommodation and food services sector was 35 % in September 2017, down from 53 % a year earlier (see Section 4.5.4). A similar improvement was seen in the real estate activities sector, where the ratio dropped from 54 % to 40 %, reflecting improving sales and prices. The NPL reduction in these three sectors alone contributed to almost three quarters of the aggregate reduction in NPLs over the year.

Table 4.2.2: **NPL and coverage ratios across main sectors of economic activity**

	NPL (% of loans)		Coverage (% of NPL)	
	2016Q3	2017Q3	2016Q3	2017Q3
<b>Construction</b>	72%	64%	39%	50%
<b>Wholesale &amp; retail trade</b>	46%	49%	45%	60%
<b>Real estate activities</b>	54%	40%	41%	48%
<b>Accommodation &amp; food services</b>	53%	35%	31%	42%
<b>Manufacturing</b>	50%	51%	42%	52%

Source: Central Bank of Cyprus

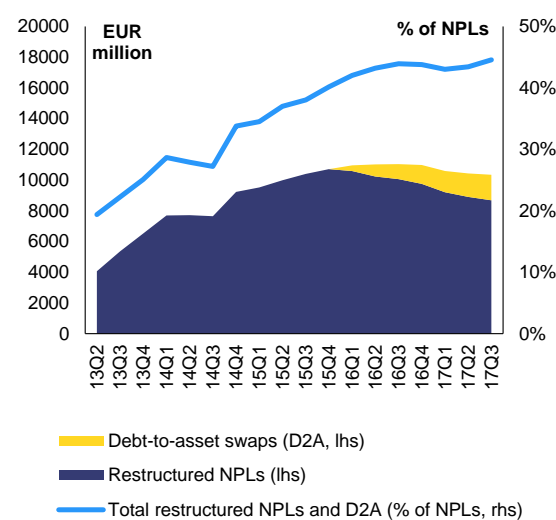
**Debt restructuring and debt-to-asset swaps remain the principal drivers of the reduction in NPLs.** Loan restructuring has slowed down, even when debt-to-asset swaps<sup>(37)</sup> are counted as restructuring solutions (see Graph 4.2.1). Banks' performance in meeting the loan restructuring targets set by the Central Bank of Cyprus remains uneven and deteriorated in the first quarter of 2017. Nearly half the reduction in the stock of NPLs from September 2016 to September 2017 was due to successful loan restructuring, cash repayments or debt-to-asset swaps. Another third was due to loan write-offs, in particular as part of restructuring efforts.

**The sustainability of loan restructuring solutions continues to be a concern.** New NPLs amounted to EUR 195 million a month on average between September 2016 and September 2017, and 52% were loans that had previously been restructured. Given the heavy reliance on loan restructuring as an NPL resolution strategy, the sustainability of these solutions is a key concern.

<sup>(37)</sup> In a debt-to-asset swap, part or all of the outstanding value of a loan is written off in exchange for an asset, usually the property underpinning the loan.

Over 11 % of all restructured loans had defaulted again as of September 2017. The ratio for the first 'vintages' of loan restructuring 2013-2014 is more than double this, indicating that these loans may require further restructuring. Nearly a quarter of all restructured NPLs have been restructured at least twice, which may conceal the true extent of re-defaults. Granular data show that re-restructuring is more common with solutions that convert present or past-due liabilities into future liabilities, this account for nearly half the volume of all restructured loans. In a bid to improve results, major banks have decided to outsource NPL resolution activities to third-party debt servicers, with experience in loan restructuring in other European markets. Hellenic Bank took first steps in this direction by selling EUR 145 million portfolio on NPLs to the Norwegian pan-European debt specialist in early 2018.

Graph 4.2.1: **Development of restructured loans**



Source: Central Bank of Cyprus

**Recourse to debt-to-asset swaps is leading banks to assume increasing direct real estate exposures.** Although this is expected to be contained by exposure limits, the large volume of real estate assets on banks' balance sheets might eventually increase the risk of fire sales or oversupply in the housing market, which could in turn affect collateral values. More importantly, in the absence of an effective, cost-efficient framework for selling properties, banks' ability to manage these assets effectively in the long run is questionable. This may exert more downward

pressure on their already weak profitability prospects.

#### 4.2.2. PRIVATE INDEBTEDNESS AND SAVINGS \*

**Private sector indebtedness is far above the levels estimated by fundamental and prudential benchmarks** (see Section 1 on actual debt levels). Household debt in 2016 was 16 % of GDP above what fundamentals suggest. For NFCs the gap reached 56 % the same year, even after subtracting the debt of non-financial SPEs (Graph 4.2.2). Moreover, the risks attached to the current level of debt can be highlighted by comparing non-financial private sector debt with a ‘prudential benchmark’ estimating the value of debt above which a banking crisis is more likely. <sup>(38)</sup> The debt stock exceeded the prudential threshold by 80 % of GDP in 2016 in the case of households and by 75 % in the case of NFCs, when subtracting the debt of non-financial SPEs.

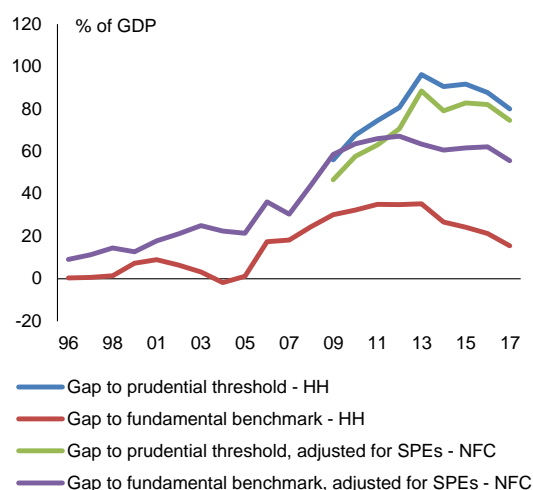
**Economic growth and loan valuation effects were major factors contributing to the recent reduction in the private indebtedness ratio** (see Graph 4.2.3). The stock of loans from MFIs to resident NFCs and households declined by 28 pps of GDP in 2016 and by another 10 pps in the first two quarters of 2017. <sup>(39)</sup> This reduction is largely attributable to GDP growth, which explains roughly a third of the decline in the ‘corporate loans to GDP’ ratio and roughly half in the case of household loans. The remainder is mostly due to debt write-offs and debt-to-asset swaps, i.e. valuation effects. Banks prefer to use debt-to-asset swaps and to hold real estate assets on their balance sheets, rather than realising potential losses from selling the collateral at prices that are still low (see Section 1). The difficulty of foreclosing properties is another obstacle to resolving NPLs more directly. Private sector

<sup>(38)</sup> Fundamental-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 high, minimising the probability of missed crisis and that of false alerts. See also European Commission (2017), “Benchmarks for the assessment of private debt”, Note for the Economic Policy Committee

<sup>(39)</sup> Given the high reliance on banking loans from the domestic banking system, developments in the stock of loans from the domestic banking system provide an early indication of developments in the scoreboard indicator.

deleveraging via actual debt repayment has been modest since 2014.

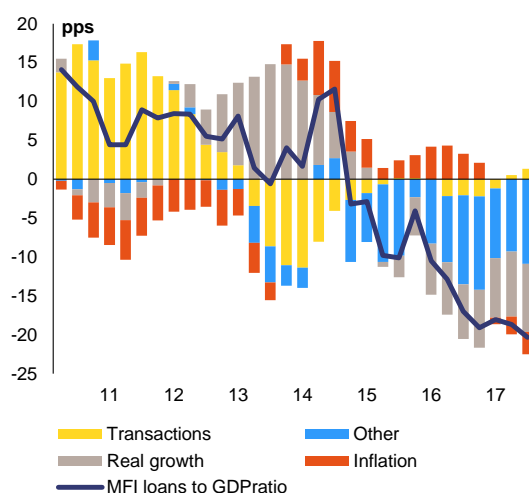
Graph 4.2.2: Private sector debt gap compared with prudential and fundamentals-based benchmarks



For NFCs, the gaps to benchmarks are adjusted for the impact of non-financial SPEs

Source: European Commission

Graph 4.2.3: MFI loans to domestic residents, annual changes

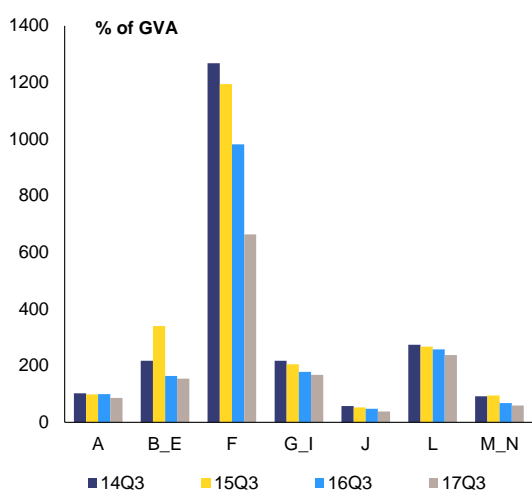


Source: Central Bank of Cyprus, Eurostat and European Commission

**Leverage is still high across most business sectors. Most sectors deleveraged in 2016 and the**

first half of 2017, but many — in particular construction, real estate activities, trade, transport and accommodation, and industry — remain highly indebted (see Graph 4.2.4). The rapid recovery of the construction sector improved the situation substantially in 2017 and this is expected to continue, as construction of residential and tourism-oriented projects supports the short- to medium-term growth outlook (see Section 1).

Graph 4.2.4: **Ratio of loans to gross value added across sectors of economic activity**



(1) A: Agriculture, forestry and fishing;  
 B\_E: Industry (except construction);  
 F: Construction;  
 G\_I: Wholesale and retail trade, transport, accommodation and food service activities;  
 J: Information and communication;  
 L: Real estate activities;  
 M\_N: Professional, scientific and technical activities; administrative and support service activities.

Source: Eurostat

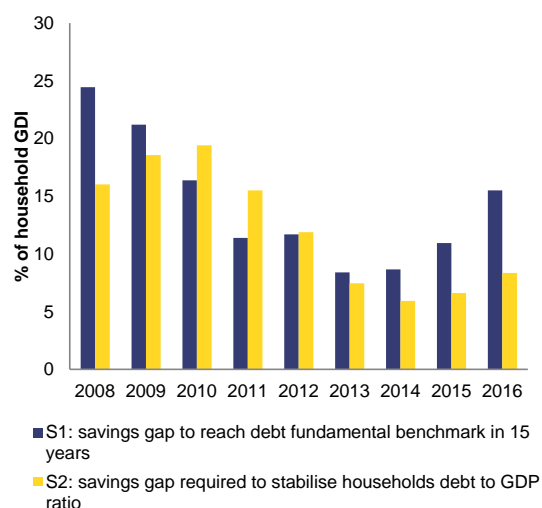
**Debt sustainability indicators highlight a considerable gap in households' savings.** Households' negative savings rate prevents them from reducing their debt to sustainable levels. To illustrate this, two long-term sustainability indicators were estimated. Debt sustainability indicators correspond to the permanent adjustment in the savings rate to (i) reach the fundamental benchmark for debt within 15 years (S1) and (ii) ensure that net financial liabilities are eventually reimbursed (S2).<sup>(40)</sup> As of 2016, the extra annual savings required to comply with both indicators are considerable, amounting respectively to 15.5 %

<sup>(40)</sup> See also European Commission (2017), "Benchmarks for the assessment of private debt", Note for the Economic Policy Committee.

and 8.3 % of gross disposable income (see Graph 4.2.5).

**Use of the new corporate and personal insolvency processes remains limited.** Rules of court for corporate insolvency have not been updated, which hampers the effectiveness of the insolvency framework. Banks do not make full use of the new tools, which offer sustainable restructuring solutions to clients with in sufficient repayment capacity. Insolvent borrowers and other stakeholders appear not to be fully aware of the possibilities offered by the insolvency and pre-insolvency mechanisms. Banks' participation in insolvency proceedings in the framework of loan restructuring remains limited.

Graph 4.2.5: **Cypriot households savings gap**



Source: European Commission

**Some impediments to the effective application of the insolvency framework have been identified.** A working group of relevant stakeholders (Central Bank, ministries) was set up to review the implementation and performance of the Insolvency and Foreclosure frameworks to ensure that it supports its objectives and principles. However, the group meets only occasionally and does not plan to release recommendations before the end of 2018.

**Use of the foreclosure framework remains marginal.** Foreclosure auctions under the new legislation started in June 2016, but have proved rather unsuccessful as the majority did not attract

satisfactory bids. Most foreclosure notices and auctions concern plots of lands, as these are considered less socially sensitive than primary residences. Banks have so far used foreclosure mainly to improve repayment discipline via a signalling effect, rather than as a means of collecting outstanding debts. Some key deficiencies of the foreclosure legislation have been identified, such as a high reserve price for the first auction (currently 80 % of the book value), the difficulty of serving foreclosure notices and a lack of clarity as regards guarantors' obligations. The foreclosure law does not ensure that the framework applies to cases affected by a court ruling based on the previous legislation.

**The reform of the system for transferring title deeds is still pending.** A substantial number of property buyers have yet to receive their title deed, despite having paid the full purchase price. The adoption of a law on legacy cases (for property sales up to the end of 2014) created some momentum. As of end September 2017, a total of 14 628 applications had been received in relation to such cases; in response, 6 683 title deeds were issued, which led to almost 3 000 transfers of titles. This progress is due, in particular, to sustained efforts by the Department of Land and Surveys, including website information, training and an instruction manual sent to all relevant staff. Pending a final ruling as to the constitutionality of the law, the authorities will continue to apply it, although amendments are under consideration.

**A reliable new system for the transfer of future title deeds has yet to be designed.** There is general agreement that the system should ensure that buyers who pay the full purchase price get their titles quickly and are prevented from refusing them (e.g. to avoid paying overdue taxes). Progress is slow on this issue due to its political sensitivity, but the authorities remain committed to designing a reliable legal framework in the coming months.

**There is a considerable backlog of new title deeds awaiting issue.** At the current rate, it would take about 7 years to address it (about 28 000 deeds were pending as of September 2017) (see Section 4.4.2). However, the Ministry of Interior has announced measures to streamline procedures, in particular through technical assistance from the Commission. Measures have been taken to facilitate the issuing and transfer of title deeds in

the event of relatively minor breaches of planning conditions. The main bottleneck as regards issuing deeds appears to be municipalities' uneven ability to fulfil their obligations, in particular as regards issuing the requisite certificates of approval.

#### 4.2.3. OTHER FINANCIAL ISSUES \*

##### Financial regulation

**In recent years, the authorities have ensured a good degree of compliance with the implementation of the EU supervisory framework and regulatory reform.** Most recently, a regulation on loan impairment and provisioning paved the way for the upcoming international financial reporting standard (IFRS) 9 rules, under which forward-looking losses can also be addressed.<sup>(41)</sup> Banks with sizeable legacy issues and those that rely heavily on loan restructuring are likely to face higher additional provisioning charges. However, the relatively strong underlying economic conditions are likely to serve as an offsetting factor. In 2017, the SSM and the local supervisor required additional provisioning buffers to be built, partly to offset the additional provisioning needs under IFRS 9.

**A secondary market for NPLs has yet to emerge.** No significant sale of NPLs has taken place since the sale of loans law was adopted in 2015. The lack of a secondary market for NPLs is due in particular to potential loan buyers' requirements, including data protection and establishment conditions. In addition, there are doubts as to the efficiency of the tools available to NPL purchasers to ensure loan repayments. To date, very limited use has been made of the foreclosure framework created in 2015, due to provisions making it easy for borrowers to stall or stop the process, and the burden of creditors' procedural requirements, in particular as regards notifying the debtor. The securitisation law would allow banks to manage their balance sheet more actively, but it is still awaiting adoption. Much like the foreclosure and loan sales frameworks, the draft law requires the originator to engage with the

<sup>(41)</sup> IFRS 9 will be the new accounting standard for financial instruments, replacing IAS 39 from 1 January 2018. It will have a significant impact on banks, especially in impairment methodology, as the focus on expected credit losses will require banks to recognise their losses earlier.



borrower before his or her loan is put into the securitisation pool.

### Pensions and insurance

**The merger of the pension fund and insurance supervisors is still pending.** The legal framework for a common independent supervisory body is awaiting parliamentary approval. In particular, it aims to ensure that transferred staff retains their rights and career prospects. A working group was set up to explore reform of the very fragmented provident pension fund system. Currently, each economic sector has its own rules concerning contributions and investment policy. The Ministry of Finance aims to create a universal pillar 2 system for both the public and private sectors, with harmonised contribution rates and private management of the accumulated funds.

#### 4.2.4. ACCESS TO FINANCE

**Access to finance has improved but remains a key issue, notably for small businesses.** According to the SAFE survey, access to finance is the most important concern for 16% of Cypriot SMEs (EU average: 7%) (European Commission/European Central Bank, 2017). Although modest improvements have been made, banks' collateral requirements remain major obstacles to SMEs' access to finance. Other obstacles include the lack of dedicated instruments to help small businesses with their costs. Although small and micro companies benefit from more diverse sources of external finance than larger firms, businesses' access to, and the availability of, alternative sources of finance such as venture capital, equity funding and crowdfunding are quite poor. A recent European Investment Bank (EIB) study has identified substantial financing gaps for SMEs and in the field of energy (European Investment Bank, 2017). In order to help implement the findings of the study, technical support will be provided by the Commission, via its Structural Reform Support Service.

**Financial support measures are based mainly on grants and access to alternative financing remains marginal.** A general lack of experience and awareness of equity financing continues to be a major obstacle to this alternative to bank financing. Supply of equity financing covers only a

fraction of identified demand (European Investment Bank, 2017). Also, there is no clear regulatory framework on microfinance. The small size of the market does not facilitate participation in equity mechanisms under H2020/Innofin and COSME. The EIB continues to direct funds through its multi-beneficiary intermediated lending facility. The Cyprus Entrepreneurship Fund (CYPEF) has supported both working capital and investment loans to SMEs. Results in 2016 were promising, thanks to greater participation by financing intermediaries.

**Some new financial support measures for SMEs were introduced in 2017, but their impact is yet to be seen.** In May 2017, the government signed a cooperation agreement with the European Bank for Reconstruction and Development (EBRD) on the implementation of the 'advice for small businesses' facility, financed through the European Structural and Investment Funds (ESIFs). The EBRD will provide SMEs with assistance, advice and training so as to increase the success rate of credit applications. Cyprus is contemplating the creation of an inter-ministerial coordination committee to improve SMEs' access to EU funds.

## 4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

### 4.3.1. LABOUR MARKET

**Labour market is improving, but the situation of young people remains precarious.** The robust recovery resulted in growing number of jobs, a steady increase of the employment rate (from 69 % in 2016Q3 to 71.5 % in 2017Q3) and a rapid drop in the unemployment rate (from 13.2 % in 2016Q3 to 10.5 % in 2017Q3). However, the youth unemployment rate is high (25.1 % in 2017Q3) and many young people are not in employment, education, or training (NEET rate 16 % in 2016 for 15-24 years old see Box 4.3.1). While decreasing, long-term and very long-term unemployment rates are also above the EU averages.

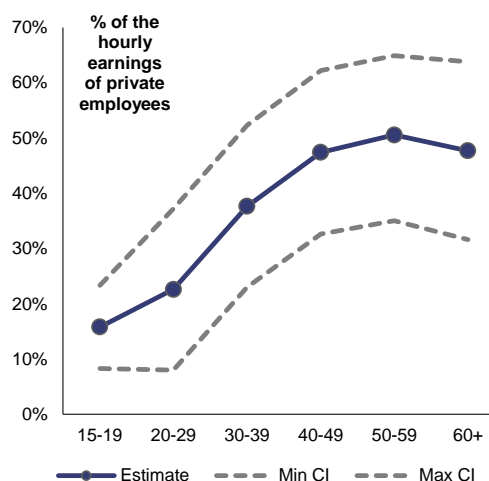
**Wage developments have turned moderately positive after several years of decline.** This provides grounds for an improvement of the real gross disposable household income. In the short term, despite a recent pick-up, the labour market slack (estimated at 10 % in 2017Q3) and the slowdown in productivity growth may still put downward pressure on wages.

**Although union density rate is higher in Cyprus than in other member states, the share of employees covered by collective bargaining is lower than the EU average.** Most of bargaining takes place at sector or company level. Social partners agreed on a new way of indexing the cost of living allowance (COLA) in the private sector for the period 2018-2020. The agreement foresees that wages will be indexed annually corresponding to half the level of inflation. In addition, wages will not be indexed when negative economic growth is recorded at the end of second and third quarters of the previous year. In the broader public sector, the same wage indexation mechanism applies on a permanent basis. This mechanism comes in addition to the existing collective agreement with the broader public sector until 2018, which caps the payroll growth to the nominal GDP growth.

**Conditions of employment differ between private and public sectors.** Public sector workers enjoy more stable employment and higher wages, on average 36% more than in the private sector.

<sup>(42)</sup> This wage gap, clearly correlated with age, was the highest in the EU (see Graph 4.3.1).

Graph 4.3.1: Adjusted wage gap between public and private employees by age group



Calculations based on the microdata from the Structure of Earnings Survey, 2010 and 2014

Source: European Commission

**Temporary employment started to decrease but it remains fairly high.** On the back of the improving labour market more workers moved from temporary to permanent employment and more new employees received a permanent contract. As a result, the proportion of temporary employees fell to 14.2 % in 2016 from 15.8 % in 2015 (see Graph 4.3.2), which was still 3.1 pps above the pre-crisis level and the EU average. Almost all temporary employees (93 %) work on such contracts because they could not find a permanent one (the EU average is 59%). The prevalence of temporary employment is linked to the importance of tourism in the economy. Temporary employment is associated with lower wages than permanent employment. In 2014, permanent employees earned on average 14 % more than temporary employees (see Graph 4.3.2). <sup>(43)</sup> The gap was slightly wider in 2010.

<sup>(42)</sup> The Commission's estimations are based on the microdata of the Structure of Earnings Survey. The adjusted wage gap is calculated based on an Ordinary Least Squares (OLS) regression analysis using a human capital earnings equation (so called "Mincer" equation). The regression estimates the average impact on wages of being employed in the public sector, while adjusting for age, gender, educational attainment, sector of employment, occupation, type of contract and working hour regime.

<sup>(43)</sup> Ibid.

**Box 4.3.1: Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 principles and rights to benefit citizens in the EU. In light of the legacy of the crisis and changes in our societies driven by population ageing, digitalisation and new ways of working, the Pillar serves as a compass for a renewed process of convergence towards better working and living conditions.

CYPRUS		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	To watch
	Gender employment gap	To watch
	Income quintile ratio (S80/S20)	On average
	At risk of poverty or social exclusion (in %)	To watch
	Youth NEET (% of total population aged 15-24)	Critical situation
Dynamic labour markets and fair working conditions	Employment rate (% population aged 20-64)	On average
	Unemployment rate (% population aged 15-74)	Weak but improving
	GDHI per capita growth	Critical situation
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	On average
	Children aged less than 3 years in formal childcare	To watch
	Self-reported unmet need for medical care	Better than average
	Individuals' level of digital skills	Weak but improving

Member States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situations"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2018, COM(2017)674 final.

has been important in fighting poverty. It is a significant step forward towards ensuring "minimum income protection".

(1) The Social Scoreboard is composed of 14 headline indicators, of which 12 are currently used to compare Member States' performance. The indicators "participants in active labour market policies per 100 persons wanting to work" and "compensation of employees per hour worked (in EUR)" are not used due to reservations by Member States. Possible alternatives will be discussed in the relevant Committees. GDHI: gross disposable household income.

**Cyprus faces challenges with regard to a number of indicators of the Social Scoreboard (1) supporting the European Pillar of Social Rights.** Those include the level of gross disposable household income, the gender employment gap and the coverage of formal childcare for children aged less than 3 years. The risk of poverty or social exclusion is still relatively high, but has been declining. While the unmet demand for medical care is low, there are high out-of-pocket payments for medical costs..

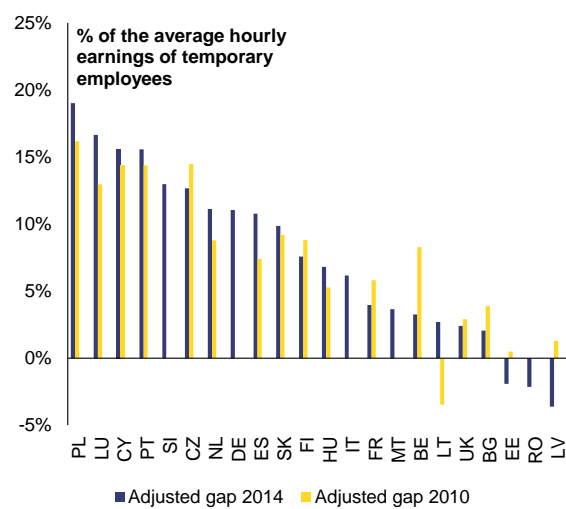
**Despite a decline in unemployment, the labour market situation of young people remains problematic.** The share of young people who are not in employment, education nor training (NEETs) continues to increase. This, together with increasing incidence of early school leaving may weigh on current and future equality of opportunities.

**In 2014, Cyprus introduced a Guaranteed Minimum Income (GMI) scheme.** The GMI provides targeted benefits to cover the basic needs and is defined in reference to a minimum consumption basket of different household types. The scheme is designed to incentivise work, as beneficiaries who are able to work must register with the public employment services and be willing to participate in active labour market programmes. The introduction of the GMI scheme



**Participation in active labour market policies (ALMPs) is increasing but remains lower than in most other EU Member States.** In 2015, there were 9.2 participants for every 100 people willing to work, which represents an increase from 2013 (5.6 participants) but it is significantly less than the EU average (23.7).

Graph 4.3.2: **Adjusted wage gap between permanent and temporary employees (% of the average hourly earnings of temporary employees)**



Calculations based on the microdata from the Structure of Earnings Survey, 2010 and 2014

Source: European Commission

**Cyprus has invested in the administrative capacity of the public employment service but, its effectiveness still remains a challenge.** In October 2017, a call for 30 additional PES counsellors was published, with a view of being recruited the first half of 2018, albeit, on a short-term contract (24 months). The long-term sustainability and quality of services, in particular in areas that are lagging behind (e.g. customer segmentation, personalised guidance and activation) and the provision of services to employers, remain a challenge. Additional

initiatives include peer support projects from other PES in the EU and an IT platform for use by both employers and job-seekers to better match labour market demand and supply. Cooperation with the private employment services has also been developed. However, the provision of services to both employers and job-seekers is still sub-optimal.

**New ALMPs schemes were launched.** They target young people, long-term unemployed and other vulnerable groups, including recipients of the guaranteed minimum income (GMI), in line with the euro area recommendation (EAR) 3. Around 5000 unemployed people benefited in 2017. However, activation results were mixed: ALMPs targeting young people were more successful than those targeting vulnerable groups. Meanwhile, measures were taken to improve the ALMPs. A monitoring and evaluation tool for reporting the output and results of the ALMPs became operational in December 2017.

**The proportion of young people (15-24 years) not in employment, education, or training (NEET) remains one of the highest in the EU.** In 2016, it grew to 16 % (from 15.3 % in 2015), still significantly above the EU average of 11.6 %. The NEET rate for young people with tertiary education was 4.8 %, compared to EU average of 0.9 % (see Graph 4.3.3). Contributing factors include lack of jobs for university graduates (two in five graduates work in jobs below their qualifications), low enrolment in VET and possibly undeclared work. The authorities try to address the situation through targeted counselling in schools and youth entrepreneurship schemes. Youth Guarantee monitoring led to estimates that only (23 %) of the NEET population was enrolled in relevant schemes in 2016. This is mainly due to the limited capacity of the Public Employment Services.

### Box 4.3.2: Policy highlights: Undeclared Work

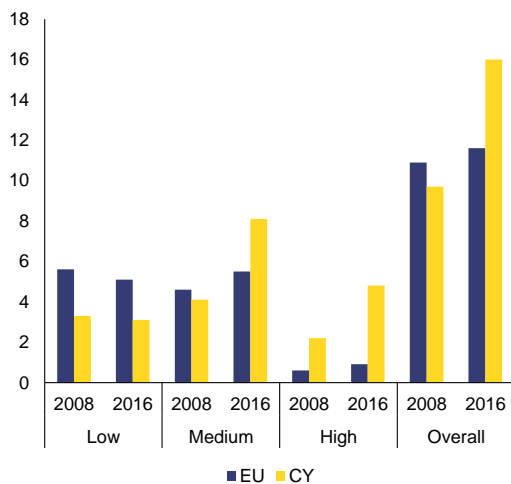
The informal sector has been estimated to be over 25% of the Cypriot economy (OECD, 2015), one among the largest in the EU. Since the financial crisis, the Republic of Cyprus has intensified attempts to combat undeclared work by increasing deterrents (e.g. more regular inspections, more and heftier fines).

The new legislation on Undeclared Work was enacted on 2 June 2017, introducing heavy fines and giving more legislative power to inspectors. It also improves processes by requiring pro-rata registration of employees before recruitment. In accordance with the transitional provisions of the Law, for three months from its entry into force employers could register any undeclared employees without having to pay any overdue contributions or risking a fine. This resulted in some 3 000 new registrations during the grace period.

Furthermore, the reform unifies all inspectorates into one unit within the Ministry of Labour. It also provides enhanced powers for the inspectorate, including inspection of safeguards contained in 28 laws. Closer cooperation and use of expertise of the Tax and Police departments is provided in the context of the reform and can be requested, when deemed necessary.

Overall, the new approach forms multi-disciplinary cooperation at local, regional and national level in order to tackle undeclared work in Cyprus. According to the latest national figures, based on targeted inspections, the size of the informal sector is down to 16.16%. Some challenges remain however on the quality the new unified operations and the use of the new IT system functionality.

Graph 4.3.3: NEET rate (15-24 years old) by educational attainment, 2008-2016



Labour Force Survey  
Source: Eurostat

### Education and skills

#### Spending on education is relatively high, but it is not reflected into high educational outcomes.

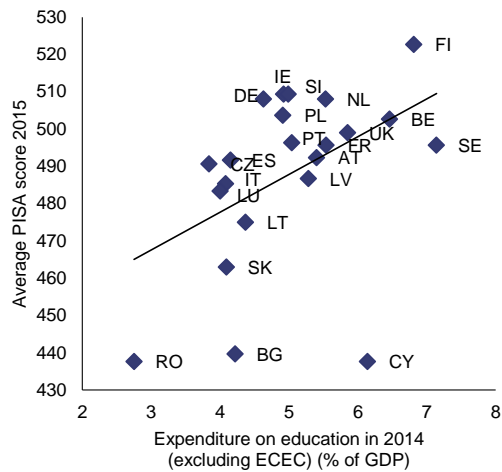
Public expenditure on education was 5.7 % of GDP in 2015, as compared with the EU average of 4.9 %. In primary and secondary education, Cyprus' spending per student is among the highest in the EU. However, Cypriot 15-year-olds ranked second from last across the EU in the most recent (2015) PISA survey measuring skills in science,

mathematics and reading. Low performance affects all socioeconomic groups. In science, Cyprus has one of the EU's highest proportion of low achievers among students from the bottom socioeconomic quartile and the highest proportion in the top quartile (OECD, 2016). Low performance in reading skills is a concern overall (35.6%), but male students perform considerably worse than female students, resulting in the widest gender gap in the EU (22 pps).

#### A new system for teacher appointments based on competitive exams was launched in 2017.

A shorter time-lapse between graduation and appointment is intended to increase the attractiveness and quality of the teaching profession and thus lead to better educational outcomes in line with EAR 3. Significant efforts have been made to upscale teachers ongoing training through a new 'professional learning' framework. Although participation levels varied significantly between primary and secondary schools during the pilot phase, these are expected to go up with the implementation of the framework at all school levels. The reform of the teacher evaluation system, which has not changed over 40 years, has not advanced. An action plan to improve student performance in particular on science, technology, engineering and maths (STEM), will be implemented in the next school year (2018/19). The entry age for primary education will be raised to 6 years (from current 5 years and 8 months currently) to improve school success rates.

Graph 4.3.4: **Expenditure on Education (% of GDP) compared to PISA results, 2015**



PISA average scores are based on the average score in science, mathematics and reading.  
**Source:** OECD, Eurostat

**The rate of early school leaving (ESL) remains below the EU average, but it rose significantly in 2016** (by 2.4 pps in 2016 to 7.6 %). The problem affects boys: 11.4 % of boys left school early in 2016, compared to 4.3 % of girls. Also, the early school leaving rate of 18.2 % for students with a migrant background contrasts sharply with that of 4.6 % for native-born students. To prevent school failure, the ‘actions for social and school inclusion’ programme, which supports disadvantaged students at all levels of education, has been extended to 96 schools and now covers 15 % of the student population (Pandeia news, 2017).

**Participation in vocational education and training (VET) remains far below the EU average, despite favourable employment prospects for VET graduates.** The proportion of upper secondary students (ISCED 3) in VET in Cyprus increased slightly in 2015 to 15.6 %, but remains far below the EU average of 47.3 %. Participation levels are expected to increase in the coming years with the creation of new technical schools. The employment rate for VET graduates has risen by 17.1 pps since 2014 and stands at 72 %, which is still below the EU average (75 %) but slightly above the total employment rate for Cyprus (71 %). Measures to ensure skills relevance in the VET sector include tracking graduates on

placement schemes, and cooperation with industry on curriculum development.

**Tertiary educational attainment remains high but its labour market relevance is low.** At 53.4 %, the overall rate of tertiary attainment is one of the highest in the EU and has far surpassed the national target of 46 %, but for the foreign-born students the figure is only 37.3 % (all data for 2016). While the employment level for recent tertiary graduates has risen since 2015 at 76.4 %, it remains below the EU average of 82.8 %. The skills mismatch in tertiary education (ISCED 5 or 6) remains one of the highest in the EU (41.2 %) (European Commission, 2017a). To establish closer links to the labour market new legislation has been tabled to facilitate the commercialisation of public universities' research results. The first graduates of the University of Cyprus Medical School (established in 2013) and of the Maritime Academy (2015) will enter the labour market in 2019.

**Adult participation in learning remains low, impacting on the skills level.** In 2016, the respective figure was 6.9 %, below the EU average of 10.8 % and down from 7.5 % in 2015. The participation of the low-skilled workers in adult learning is among the lowest in the EU (1.5 %). Remedial actions to implement the Council Recommendation on upskilling pathways (European Commission, 2016) includes the setting-up of a validation system for informal and non-formal education, the development of additional professional standards and strengthening the capacity of post-secondary VET schools and second chance schools for upskilling and retraining. The national qualification framework was cross-referenced to the European Qualifications Framework in 2017. Challenges remain in relation to the integration and efficiency of adult learning governance structures, and the systematic training of adult education trainers.

**The level of digital skills is below the EU average.** 50 % of Cypriots have basic digital skills, as compared with the EU average of 57 %. Cyprus also has one of the highest proportions of people who have never used the internet (26 %), while the rate of people with advanced ICT skills and

development is one of the lowest in the EU<sup>(44)</sup> (European Commission, 2017b). This poses a challenge for labour-market needs in an area of growing demand. In response to those challenges, since 2017 training and certification in the European Computer Driving Licence (ECDL) training and certification is being offered free of charge to all secondary students and some vulnerable groups from 2017 (Government of Cyprus, 2017).

#### 4.3.2. SOCIAL POLICIES

##### **Poverty and social exclusion are improving.**

This could be attributed to the roll out of social and activation measures (GMI and labour market activation schemes for vulnerable groups), in line with EAR 3, and to the improved economic and labour market conditions. More than one in four Cypriots (27.7 %) was at risk of poverty or social exclusion (AROPE) in 2016. This represents a decrease of 1.2 pps from the year before but the rate remains 4.2 pps above the EU average. Absolute poverty decreased, with the incidence of severe material deprivation falling from 15.4 % in 2015 to 13.6 % in 2016. However, relative (monetary) poverty remained close to its highest point (16.1 % compared to the EU average: 17.3 %). The relative poverty of older people (aged 65+ and 75+) is much lower than in 2008. According to analysis carried out for the upcoming Pension adequacy report, this can be attributed to the maturation of the pension system, the statistical effect of the economic crisis pushing down the incomes of non-pensioners and the anti-poverty effect of non-contributory policies supporting low-income pensioners. However, the wide gender gap as regards pensions (49%) is also a matter of concern. This may be linked to a significant gender gap of 5.7 years in the duration of working life (EU average of 4.9 years) and to the past significant gender pay gap, which narrowed over the years and now stands around the EU average.

**The social safety net has been strengthened by the new guaranteed minimum income (GMI) scheme.** The reform aimed to prevent abuses, improve targeting and strengthen incentives for

reintegration in the labour market, while ending administrative fragmentation and keeping the social budget envelope unchanged. Most of those aims have been reached and over two-thirds of public social assistance spending is now channelled through GMI. By September 2017, the scheme had reached about 28 000 households (approx. 48 000 people, up from approx. 14 000 covered by the previous public assistance system). Calculations show that GMI has a greater impact on extremely poor people than public assistance alone. GMI recipients who are able to work are obliged to register with the PES. Targeted ALMPs launched in October 2017 are aimed at activating around 2500 GMI recipients. A comprehensive assessment of GMI remains pending.

##### **The risk of poverty or social exclusion for people with disabilities has come down but remains high.**

In 2016, it fell from 38.1 % to 35.5 %, partly thanks to additional funding from the European Social Fund for in-house services and schemes for labour market activation. A unified system for the certification of disabilities has been put in place. Changes in the legislation on disability benefits – aimed at boosting the benefits in kind and improving the services – have been delayed. In December 2017, the government approved the new National Disability Action Plan 2018 – 2020.

##### **The unemployment protection is suboptimal.**

Between 2008 and 2016, the coverage of unemployment benefits for the short-term unemployed dropped by 9 pps., down to 21 %.<sup>(45)</sup> This is well below the EU average. In addition, the unemployment protection is not available to the self-employed. There is also no compulsory insurance for self-employed against accidents at work and occupational injuries.

##### **Increases in income inequality since the crisis are starting to reverse, but wealth inequality remains high.**

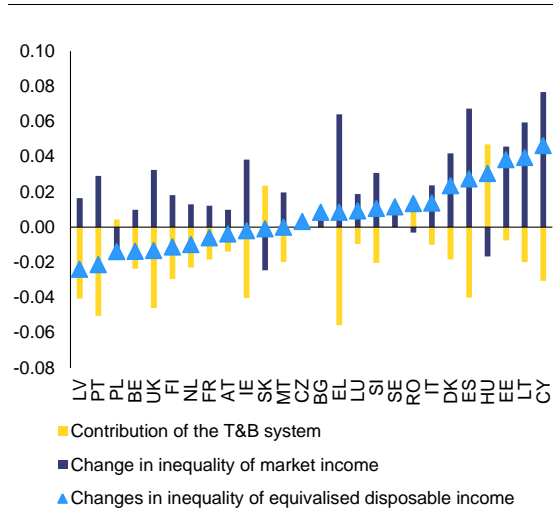
The impact of the crisis on household income led to a sharp increase in income inequality. The increase between 2008 and 2015 can be explained by an increase in inequality in market income (household income before taxes

<sup>(44)</sup> Measured by the aggregated score of IT specialists and science, technology, engineering, and math (STEM) graduates.

<sup>(45)</sup> According to the benchmarking exercise in the area of unemployment benefits and ALMP, conducted within the EMCO Committee. See the draft European Commission (2017i) for details.

and social transfers), which resulted from the precarious labour market situation during the crisis (see Graph 4.3.5). Changes to enhance the redistributive effect of the benefits system have mitigated this effect only partially. Wealth inequality increased to 0.72 Gini points in 2014, one of the highest levels in the euro area. It is largely driven by a high share of indebted households, as a result of negative equity in housing assets.

Graph 4.3.5: Change in income inequality and its components, 2008-2015



(1) Countries are ranked by increasing order of the change in overall income inequality between 2008 and 2015, as measured by the Gini coefficient of the equivalised (corrected for household composition) disposable household income. (2) The contribution of the tax and benefit system is calculated as the difference of the change in inequality of the disposable household income between 2008 and 2015 and the change in inequality of market income (including private pensions) between 2008 and 2015.

Source: Eurostat

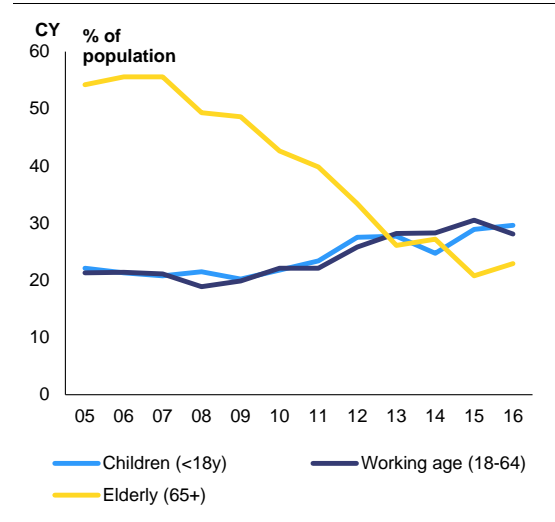
**Cyprus has seen a strong increase in child poverty since the crisis.** The AROPE rate among children rose steadily from 20.2 % in 2009 to 29.6 % in 2016. The increase has been greatest for the children of parents with low skills (from 14.9 % in 2010 to 46.0 % in 2015); for the children of high-skilled parents the risk rose from 5.3 % to 6.1 % over the same period). The GMI includes measures to combat child poverty such as extra allowance for children and single parents. In addition, the Child Benefit Law was modified in 2017 to increase the eligible income threshold by EUR 5 000 for every additional child after the first two.

**Enrolling children in formal childcare remains a challenge.** The proportion of children under 3 years of age in formal childcare (20.8 %) is low compared with the EU average (30.3 %). Parental leave is currently unpaid. However, paid paternity leave of 15 days was introduced in July 2017.

### Health Care

**Health spending in Cyprus is among the lowest in the EU and comes mainly from out-of-pocket payments.** In 2015, Cyprus spent EUR 1,592 per person on health care, well below the EU average of EUR 2,797. Total health spending was 6.8 % of GDP in 2015, of which only 42.6 % came from

Graph 4.3.6: At risk-of-poverty or social exclusion rate, age groups



(1) The European Union Statistics on Income and Living Conditions (EU-SILC)  
 (2) AROPE: At-risk-of-poverty or social exclusion rate (% of total population). People who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

Source: Eurostat

public expenditure (7.1 % of the government budget); both proportions were among the lowest in the EU (see Graph 4.3.7). Meanwhile, out-of-pocket healthcare expenditure amounted to EUR 606 per inhabitant – the highest level for the surveyed EU Member States, once adjusted for purchasing power standard. This reflects the lack of universal coverage and the fragmentation of healthcare provision between the public and the largely unregulated private sector, resulting in unequal access and inefficient use of resources.

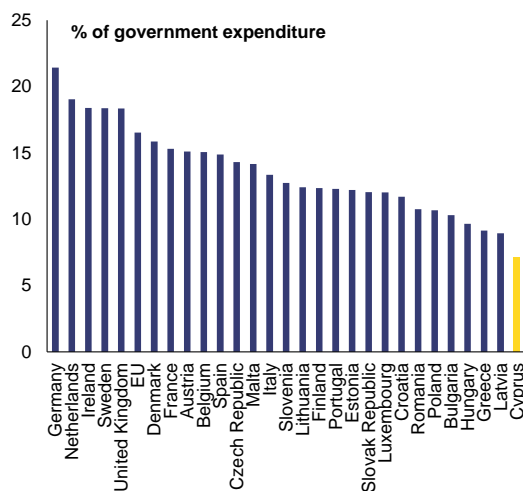


The legislation for establishing a universal national health insurance system (NHIS) was adopted and is being implemented. In June 2017, the House of Representatives adopted two bills establishing a universal health insurance system by 2020 and providing for gradual financial and administrative autonomy for the public hospitals. The NHIS aims to reduce out-of-pocket costs significantly and ensure universal healthcare coverage and sustainable public health care expenditure. A study is being conducted to assess the NHIS' economic impact. Implementation of the reform entails investment in public health providers (human capital, health technologies, hardware, and new IT system). Further financing opportunities, in particular involving EU funds might be explored.

to financial reasons (4.6 % of surveyed Cypriots reported that needs were unmet due to costs).

**The authorities have made efforts to improve the planning in the health sector and to ensure that current resources are adequately used.** In 2015, the number of nurses per 1000 inhabitants (5.2) was well below the EU average and the ratio of 1.5 nurses for every doctor was among the lowest in the EU. The relative availability of advanced medical equipment is very high compared with other EU countries but those resources are mainly concentrated in the private sector. In both sectors, allocative inefficiencies result from underuse of these high-cost medical technologies.

Graph 4.3.7: Share of healthcare in public expenditure



Source: OECD Health Statistics; Eurostat Database; WHO Global Health Expenditure Database.

**Primary health care (PHC) will be the backbone of the system.** Under the NHIS a formal referral is foreseen from primary to specialised and hospital care, for both private and government hospitals and outpatient departments. This entails restructuring of public PHC by clustering small healthcare facilities, extending opening hours, standardising procedures and improving coordination of care.

**Meanwhile, around a quarter of the population - among the highest proportion in the EU - is not covered by the public system.** The incidence of reporting unmet medical need, though lower than the EU average, was attributed almost entirely

**The levels of long-term care (LTC) <sup>(46)</sup> provided is low.** Public spending on LTC is among the lowest in the EU (0.3 % of GDP, as compared with the EU average of 1.6 %). The acceleration of the population ageing poses a further challenge. At present, there are regular medical visits to remote areas offered to the elderly and other vulnerable groups. The new NHIS system will involve actions for long-term care, including outpatient services, which are currently been provided mostly by private enterprises. The ALMP schemes to train unemployed people to provide LTC have been successful. There are also plans to establish community centres, co-financed by the European Social Fund, to offer in house LTC.

<sup>(46)</sup> Long-term care includes health, personal, and support services, aiming at helping people to remain at home and live as independently as possible.

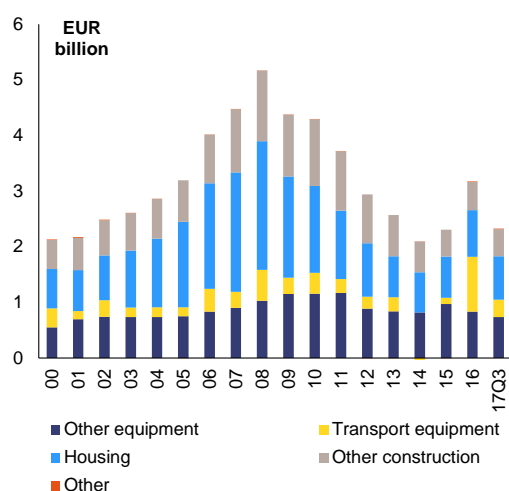


## 4.4. INVESTMENT

### 4.4.1. INVESTMENT SITUATION\*

**Investment in Cyprus is driven by the expansion of construction and ship registrations** (see Graph 4.4.1). The recovery of the residential real estate market (see Section 1), capacity constraints in hotels and the development of new tourism products, such as yachting and entertainment (see Section 4.5.4) have led to a substantial expansion of construction activities. Investment in equipment has also been strong, but partly driven by ship registration, since Cyprus has one of the largest ship registers in the world. The shipping sector's overall contribution to GDP and employment is small.

Graph 4.4.1: Investment by category (2000-2016)



Source: Cystat

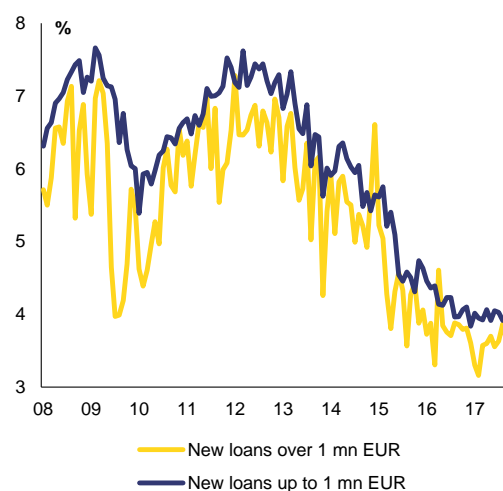
**The composition of investment is not expected to boost productivity in a durable way.** The investment trend does not appear to markedly contribute to the diversification of the economy and may fall short of Cyprus' smart specialisation strategy.<sup>(47)</sup> While the construction industry currently exhibits the highest productivity in Cyprus, this may not hold in the long run. The very limited level of investment in R&I (see Section 4.5.1) suggests that productivity may

<sup>(47)</sup> The Commission's smart specialisation strategies set out ex-ante conditions for each Member State's use, in the 2014-2020 programming period, of ESIF resources to enhance R&I in areas where it has a competitive advantage. For Cyprus, these are energy, tourism, the structured environment/construction industry, transport/marine, agriculture/food industry and health.

remain structurally low, which might hamper competitiveness in the future.

**Limited access to finance and the need to reduce debt still restrain private sector investment.** Bank credit supply remains very limited, while alternative modes of financing are underdeveloped. In addition, NFCs remain heavily indebted and are struggling to repay outstanding loans (see Section 4.2). Therefore, private sector investment has been financed mainly through FDI and self-financing. Survey indicators suggest that credit demand, though weak, exceeds supply (see Section 4.2). On the other hand, while banks remain very selective as regards project financing, funding conditions are gradually improving (see Graph 4.4.2).

Graph 4.4.2: Interest rates on loans to NFCs



Source: Central Bank of Cyprus

### 4.4.2. BUSINESS ENVIRONMENT\*

**The quality of the business environment is improving slowly**, in line with the EAR 1. Cyprus moved up 13 places in the 2017 ranking of the *Doing Business* report (World Bank, 2017a) and improved its ranking in the World Economic Forum's global competitiveness index (World Economic Forum, 2017), moving up 19 places to 64<sup>th</sup>. However, it still lags behind most EU countries in both survey-based rankings. Implementation of the action plan for growth led to some progress in the areas of strategic investments, tourism, entrepreneurship and better regulation.

However, other important reforms have stalled, in particular the granting of licenses authorising investment projects.

**On entrepreneurship, Cyprus is performing in line with the EU average.** Early-stage entrepreneurial activity in Cyprus was the third highest in the EU in 2016 (European Commission, 2017f), but the proportion of ‘high-growth’ companies<sup>(48)</sup> is relatively low. Implementation of the national policy statement on entrepreneurship identified a series of actions in five broad areas (entrepreneurial culture, business environment, innovation, access to finance and access to markets), of which 50 % were completed by September 2017. This includes streamlining company registration procedures, creating an online administrative platform for businesses, simplifying social security contributions and establishing a regulatory framework for university spin-offs. Efforts were made to improve digital entrepreneurship by setting up a working group to promote digital skills, innovation and creativity in elementary and secondary education.

**Heavy regulation in some professional services is restricting competition.** This applies in particular to lawyers, patent agents and real estate agents. There are persistent high barriers to entry to those activities, such as reserve of activities and residency requirements, as well as requirements for establishing a practice, such as legal form and, in some cases, shareholding requirements. In addition to serving consumers’ interests, more competition in services would support growth and jobs.

**The issuing of building permits and planning licences remains cumbersome** (see Section 4.2.2). The issuing of building permits is characterised by time-consuming formalities (World Bank, 2017a). Despite authorisation and notification schemes to check for technical and professional capacity in the construction sector, there are no simplified procedures for permit issuance.

**Implementation of the privatisation plan is basically at a standstill.** In 2017, the privatisation

unit was dismantled and decrees on the privatisation of the Cyprus Telecom Authority (CyTA) and the Cyprus Stock Exchange were cancelled. Only minor privatisation projects remain active, although a draft bill was proposed to re-launch CyTA privatisation. An agreement to sell CYTA Hellas, the Greek subsidiary of CYTA, was recently reached. The lack of major progress on privatisation exposes the state to the build-up of contingent liabilities in the medium term, due to the weakening competitiveness of public companies (see Section 4.1.1).

**Action is being taken to support growth-friendly policies, stimulate investment and promote the social economy.** To mobilise public resources to ensure consistent implementation of strategic policy priorities, Cyprus intends to create deputy ministries for growth and competitiveness and tourism, in addition to the one for shipping already established in 2017. Legislation on the new procedural and legal framework on strategic investments, including the setting-up of a fast-track mechanism, is due to be put in place in 2018. A ‘start-up visa’ programme allows talented entrepreneurs from non-EU countries to come to Cyprus to set up, operate and develop start-ups with high growth potential. Tax incentives were adopted to boost and promote entrepreneurship, in particular exempting investments from investors’ taxable income (up to 50 % of taxable income). Furthermore, the government has approved a bill in January 2018 in order to boost the socio-economic benefits from social enterprises.

**E-Commerce remains relatively under-developed in Cyprus.** The rates of individuals and NFCs making use of e-commerce are among the lowest in the EU, with 29 % and 12 % of survey respondents respectively having purchased online in 2016.<sup>(49)</sup> According to a recent study (Baker Tilly, 2016), the main obstacles to the growth of e-commerce are: (i) concerns over the security of transactions; (ii) legal issues; (iii) shipping costs; (iv) taxation, and (v) language and reliability issues. Cypriot businesses and consumers appear to face significant problems due to shipping conditions (high costs and difficult product returns).

<sup>(48)</sup> High-growth companies have average annualised growth in employee numbers of over 10 % a year over a three-year period, from a base of at least 10 employees.

<sup>(49)</sup> Source: Eurostat.

#### 4.4.3. PUBLIC ADMINISTRATION\*

**Efficiency in the public administration remains a challenge.** According to European Commission and World Economic Forum surveys (European Commission, 2015 and World Economic Forum, 2017), Cyprus ranks relatively low in comparison with other Member States for the efficiency of its public administration. Also, it is among the lowest rated Member States as regards executive capacity and accountability (Bertelsmann Institute, 2017).

**The reform of the public administration has not been completed yet.** To date, Cyprus has only taken measures to incentivise staff mobility and improve redeployment rules.

**Local government reform has stalled.** The local government reform bill is awaiting adoption by the House of Representatives. The reform is intended to streamline local public services, notably waste and water management and the issuing of building permits and certificates, which might lead to improvements in the issuing of title deeds. It also addresses gaps in local government financial reporting by establishing a common accounting and reporting framework.

**Efforts are being made to improve and broaden Cyprus' digital public services (e-government).** Cyprus ranks in the bottom half of Member States as regards e-government services (European Commission, 2017j). To improve the situation, it has enhanced its e-government governance and updated its national e-government interoperability framework (eGIF), which is a mandatory tender requirement for the design and implementation of e-government information systems/services. An awareness campaign was launched to inform citizens and businesses of the benefits of using ICT and the internet. 68 e-services have been developed in line with the 'once-only' principle and 30 more are expected to be made available in the course of 2018. As of 2017, there were around 38 000 users in the government gateway portal 'Ariadni', and over 300 000 in TAXISnet, the electronic income tax returns system.

**The justice system continues to face serious challenges as regards its efficiency.** In particular, this concerns very long proceedings in administrative, civil and commercial cases

(European Commission, 2018c),<sup>(50)</sup> leading to a persistently big backlog of pending cases. The problems stem mainly from complex and outdated procedural rules. They are compounded by a low level of digitalisation in courts, in particular for case management, the under-use of alternative dispute resolution mechanisms and a lack of formal life-long training for judges. Operational inefficiencies in the justice system hamper the implementation of the insolvency and foreclosure frameworks, and more generally deter investments, as they undermine the enforcement of contracts.

**Some reform initiatives are aimed at making the courts more efficient.** An amendment to the Courts of Justice Law places new limits on the right to appeal against interlocutory decisions during civil proceedings. This is expected to accelerate judicial procedures and reduce backlogs. A public tender was launched in 2017 to procure a court management information system. The authorities aim to have a fully operational e-justice system by the end of 2018. The Supreme Court intends to create a special section in charge of the life-long training for judges, to become fully operational in 2018.

**The planned creation of specialised courts could help to accelerate the resolution of pending cases.** The establishment of a commercial court is envisaged in 2018 and it will be responsible for cases involving amounts of over EUR 2 million. New rules of procedure should be drafted in 2018. It is also expected that a court of appeals will be created in 2018 to rule on civil, criminal and administrative cases at second instance. A bill has been submitted to the House of Representatives for the establishment of an administrative court of international protection, to deal mainly with asylum cases. This would leave the Administrative Court to deal with all other administrative cases. Also, a study is expected to contribute for the preparation of legal amendments in 2018 to facilitate the use of mediation.

**Steps have been taken to improve the quality of regulation.** A new impact assessment mechanism was put in place in 2017, ensuring more focused and thorough impact assessments of new

<sup>(50)</sup> Disposition time for first instance administrative law cases was 1 582 days in 2016, exceeding the already very long disposition time in 2015.

legislation. This includes an SME test, to assess the possible negative impact of new laws on SMEs and examine mitigating measures. Efforts have also been made to improve legal drafting and vetting. Civil servants undergo specialised training and guidelines have been issued for legal drafting and harmonising national legislation. The authorities also aim to lower administrative hurdles in strategic areas such as the tourism sector. These measures are aimed to improve the institutional environment, which is in line with the EAR 1.

**Anti-corruption measures have been put forward as high levels of perceived corruption risk undermining the business environment.** In a 2017 Eurobarometer survey (European Commission, 2017g), all companies surveyed considered that corruption is widespread in Cyprus (EU average: 67 %), 91 % agreed that corruption hampers business competition (EU average: 74 %) and 72 % pointed to patronage and nepotism as problems for their company when doing business in Cyprus (EU average: 38 %). Recurrent surveys also point to similar problems in dealing with the public administration (World Bank, 2017b and Transparency International, 2017). A draft law to protect whistle-blowers was submitted to the House of Representatives in May 2017 and a national anti-corruption strategy and action plan were published in December. The government is considering establishing a new independent anti-corruption agency. In the meantime, the Coordinating Body against Corruption remains without permanent staff or budget, and the House of Representatives is revising the asset declaration law after deeming it inadequate. A new website with information on public procedures and services has also been developed.

**Competition and qualitative assessment in public tenders could be further enhanced to strengthen the efficiency and transparency of public procurement.** In 2017, 42% of public procurement procedures involved only a single bidder, up from 38% in 2016. The proportion of procedures that did not feature a call for tender decreased from 38% in 2016 to 30% in 2017, but it remains one of the highest in the EU (European Commission, 2018b). Many business respondents (European Commission, 2017g) point to the abuse of negotiated and fast-track procedures, tailor-made specifications and conflicts of interest in the evaluation of bids. A recruitment freeze blocked

plans for a central pool of public procurement experts. Instead, the Treasury continues to provide guidance, standard templates and a helpdesk for local contracting authorities, in addition to participating, together with the Audit Office, in selected tender boards and evaluation committees. Cyprus is ranked among the EU countries with the highest number of contracts awarded exclusively on the basis of lowest price (93% of public contracts awarded in 2017) (European Commission, 2018b), contrary to best practice foreseeing the use of more comprehensive criteria.

**The framework for managing SOEs still poses certain risks.** There are no established common reporting standards, financial data are not centralised and benchmarked, and direct supervision is scattered among line ministries. There are no common standards for corporate governance. The lack of visibility and long-term strategy regarding SOEs may pose risks of contingent liabilities, as the state is their ultimate guarantor. A draft law on SOEs was submitted for discussion in the House of Representatives, but has not been adopted. It aims to improve SOEs' corporate governance and monitoring of their functioning. The adoption delays are holding up these improvements and the mitigation of SOE-related fiscal risks.

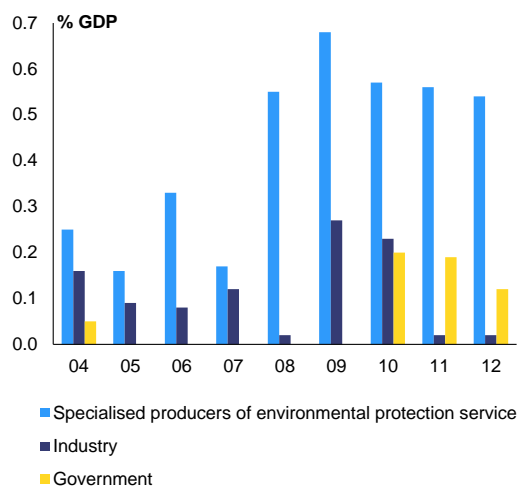
#### 4.4.4. GREEN INVESTMENT

**In the recent past, Cyprus' spending on environmental protection<sup>(51)</sup> has increased significantly.** Between 2004 and 2012, total environmental expenditure by the most important contributing sector, i.e. specialised providers of environmental protection services, grew by 139 %, reaching 1.7 % of GDP in 2012, <sup>(52)</sup> well above the EU average of 1.14 % (see Graph 4.4.3). Investments by this sector accounted for 0.5 % of GDP, three times the EU average (0.18 %). This high level of investment stems from the need to bring environmental protection standards into line with EU requirements, in particular as regards sewerage and waste management.

<sup>(51)</sup> Total spending by specialised providers of environmental protection services.

<sup>(52)</sup> Data not available after 2012.

Graph 4.4.3: Environmental investment



(1) Data on government spending in 2005-2009 are not available in the dataset.

(2) For statistical reasons the sectoral data cannot be aggregated.

Source: Eurostat

**At the same time, Cyprus' environmental performance is considerably below the EU average.** This indicates the need for additional investment. For instance, investment needs in water-collecting systems and treatment plants are

forecast to reach about EUR 750 million by 2026. (European Commission, 2017d)

**Framework conditions for investment in the renewable energy sector have improved but remain relatively constrained.** This has prevented Cyprus from exploiting its considerable potential in renewable energy generation, notably as regards solar power. Some progress was made in 2017, as Cyprus opened its electricity market to bilateral long-term contracts between producers and suppliers, allowing energy producers to negotiate the sale price of electricity directly with suppliers. However, the Electricity Authority of Cyprus (EAC) remains the only supplier to date. Following a court order, Cyprus abandoned its embargo on licensing new independent power producers, which might allow investment projects to develop. The reform of the electricity market, in particular the adoption of new trade and settlement rules, the gradual unbundling of EAC as well as recent decisions on the independence of the Transmission System Operator, might incentivise further investment in the coming years. Cyprus' plans to import natural liquefied gas by 2020 might create opportunities for new power generation facilities.

### Box 4.4.1: Investment challenges and reforms in Cyprus

#### Macroeconomic perspective

Investment in Cyprus has been recovering for the third year in a row since 2014, increasing to 16 % of GDP in 2017Q3, though still well below Cyprus' historical average. Private investment has been mostly funded by foreign sources and self-financing, as domestic credit remains tight. Public investment is constrained by the need to reduce public debt. The composition of investment reflects the recovery of the construction sector, and also stems from rising ship registrations and airplane imports. Public investment increased slightly, albeit remaining among the lowest in the EU in 2016. Low public investment might weaken the quality of basic public services, while low investment in R&D and infrastructure weighs on potential growth.

#### Assessment of barriers to investment and reform priorities:

Public administration/ Business environment	Regulatory/ administrative burden	Some progress	Financial Sector / Taxation	Taxation	No barrier to investment identified
	Public administration	CSR		Access to finance	CSR
	Public procurement /PPPs	Limited progress	R&D&I	Cooperation btw academia, research and business	Some progress
	Judicial system	CSR		Financing of R&D&I	No barrier to investment identified
	Insolvency framework	CSR	Sector specific regulation	Business services / Regulated professions	No barrier to investment identified
	Competition and regulatory framework	CSR		Retail	No barrier to investment identified
Labour market/ Education	EPL & framework for labour contracts	CSR		Construction	Limited progress
	Wages & wage setting	No barrier to investment identified		Digital Economy / Telecom	No barrier to investment identified
	Education	No barrier to investment identified		Energy	CSR
				Transport	No barrier to investment identified

**Legend:**

	No barrier to investment identified		Some progress
CSR	Investment barriers that are also subject to a CSR		Substantial progress
	No progress		Fully addressed
	Limited progress		

In addition to macroeconomic constraints, the overall business environment in Cyprus does not appear to facilitate investment, notably due to difficult access to finance and weak contract enforcement. An action plan for growth is being implemented gradually, which and mainly aims to improve the business environment, lighten the administrative burden for companies as well as and support growth and boost investment. Furthermore, a wide range of reforms have been adopted or are envisaged, in particular in the areas of the judicial system and labour legislation, albeit. Nevertheless, some barriers remain to be addressed in areas such as contract enforcement and judicial procedures.

#### Main barriers to investment and priority actions underway

1. Firms' access to finance remains wholly dependent on bank lending, which has recovered only slightly in 2017 (see Section 4.2.4). Banking sector vulnerabilities persist and capital markets remain underdeveloped, while Cypriot banks are not equipped to assess early-stage business risks and innovative projects. This results in significant constraints, particularly for small and medium-sized businesses SMEs. Access to alternative financing sources, such as venture capital and equity funding remains limited. More intensive use of the new insolvency and foreclosure frameworks, material progress with reforming the system of issuing and transferring title deeds, and modernising the legal procedures would support the resolution of NPLs and the deleveraging process.

2. The regulatory and administrative burden remains high and hampers business activities and investment decisions (see Section 4.4.3). Inefficiencies in the public administration and broad public sector, underdeveloped digital public services and a high level of perceived corruption all constitute barriers to investment. Additionally, low quality of regulations negatively weighs on competitiveness, although steps have been taken to address this (e.g. with the introduction of an "SME test"). Inadequate enforcement due to lengthy administrative and court proceedings weakens the effectiveness of Cyprus' legislation and overall legal certainty.



## 4.5. SECTORAL POLICIES

### 4.5.1. RESEARCH AND INNOVATION

**Cyprus remains a moderate innovator with a focus on higher added value activities.** In 2016, innovation performance declined by 12.7 % compared with that of the EU in 2010. (European Commission, 2017e) The relative strengths of the innovation system are the number of international scientific co-publications, the percentage of the population with tertiary education and increasing trademark applications. Relative weaknesses are limited public-private collaboration, difficulties in the private co-funding of public R&D expenditure, low R&D expenditure in the public sector and business investments. Cyprus' services-oriented economy, its small market size and geographical remoteness hinder the realisation of economies of scale. For this reason, the government focuses on higher-value niche production. (Eurostat, 2017)

**Public and private R&D expenditure levels are among the lowest in the EU.** In 2016, Cyprus reached its national target of 0.50 % of GDP for R&D expenditures, however both public and private expenditure remain well below the EU average. Public expenditure was 0.27 % of GDP in 2016, as compared with the EU average of 0.70 % (2015) and the R&D expenditure in the business sector was 0.17 % of GDP in 2016 (EU average: 1.31 % in 2015). The fact that multinational companies in Cyprus are mostly present in Cyprus for sales representation purposes and carry out their R&I activities elsewhere (headquarters and other countries) is a contributory factor (European Commission, 2017h). The government aims to improve the quality of R&I expenditure (rather than raising the R&D intensity target) in its implementation of the Smart Specialisation Strategy (S3) with grants targeting specific S3 identified areas.

**Increasing private R&I investment and the innovation capacity of the business sector remains a major challenge.** Firms' access to finance for innovative investment depends on bank lending, which has been significantly reduced in recent years. To remedy the situation, Cyprus provides public grants to innovative companies to support the development and marketing of innovative products and services, and to promote cooperation between stakeholders. Implementation of the schemes has been successful so far and it is expected to increase enterprises' R&I spending of

enterprises due to the 'own contribution' rule (usually around 30 % of a project's budget).

**Cyprus' R&I governance structure is being improved.** The Council of Ministers acts as the political decision-making body for R&I, while the National Council for Research and Innovation (NCRI) has been inactive since 2014. The government has announced its intention to create a Deputy Ministry for Growth, which will be responsible for R&I policy-making, including coordination of national stakeholders. (European Commission, 2017e) The establishment has been approved of a National Academy of Sciences, Letters and Arts (European Commission, 2017e) and a relevant Law was voted by the House of Representatives in November 2017 aiming, inter alia at providing policy-makers with scientific guidance.

**Cyprus participates actively in EU R&I programmes.** To date, it has been quite successful in targeting teaming actions in Horizon 2020, aiming to establish centres of excellence. The latest Horizon 2020 figures show that it participates in 328 projects with EU funding of over EUR 88 million. (European Commission, 2017e) The national 2016-2020 European Research Area (ERA) roadmap for Cyprus recommends even greater participation in Horizon 2020 and a stronger evaluation framework. This might provide scientific employment opportunities and enhance Cyprus' potential to become a node of scientific cooperation in the Mediterranean and Middle East. Cyprus intends to build on constructive partnerships between research institutions in these regions.

### 4.5.2. ENVIRONMENTAL POLICIES

**Poor waste management performance remains a major environmental concern.** Taking policy measures to achieve the 2020 targets under the Waste Framework Directive and meeting EU funding conditions remain a challenge. In the meantime, waste generation is increasing.

**Recycling rates are low and there is still a strong dependence on landfilling.** Cyprus landfills most of its municipal waste (75 %, as compared with the EU-average of 26 %). It missed the 2010 target for diverting biodegradable

municipal waste from landfills. The minimum permissible quantity for disposal was exceeded by 64 %. Recycling accounts for 17 %, including 4 % of composting, which is significantly below the EU average (45 %).

**Eliminating illegal landfilling and putting in place the necessary infrastructure for waste management remain a challenge.** There are no landfill taxes and limited incentives for producers to take responsibility for their waste. Extended Producer Responsibility or equivalent schemes cover only a few waste streams and do not cover the full costs of separate collection and recycling of the main waste streams. Incentive systems to favour prevention and participation in separate collection also appear to be limited. Cyprus' transition to circular economy is hampered by the lack of policies and investments encouraging a shift from landfilling and implementing separate collection. An additional challenge is to avoid creating overcapacity for the treatment of residual waste.

**Cyprus' main water management problem is the over-abstraction of groundwater, coupled with water scarcity.** The use of recycled water is promoted for irrigation and the recharging of aquifers – a good practice that can mitigate water scarcity under the right conditions. Cyprus has also put in place a new water pricing policy. The new regulations apply to all sectors. They transpose certain requirements under the Water Framework Directive, but it is still early to assess whether the new framework provides adequate incentives for the efficient use of water. Regarding waste waters, Cyprus forecasts in its National Implementation Programme that it will have the necessary capacity to reach full compliance with the Urban Waste Water Treatment Directive by 2026, i.e. significantly later than provided for in the Accession Treaty.

**Incompatible development activities endanger Cyprus' rich natural environment and biodiversity.** Cyprus is one of the countries with the largest Natura 2000 network coverage. However, in many cases infrastructure has developed in protected areas without the assessments required under European and national legislation. This hinders Natura 2000 projects and can lead to significant environmental damage, such as fragmentation or degradation of these areas and

significant threats to protected species. Safeguarding natural capital, especially under Natura 2000, and promoting green tourism remain a challenge.

#### 4.5.3. ENERGY AND CLIMATE POLICIES

**Cyprus appears on track to meet its greenhouse gas emissions target in 2020.** It adopted a low carbon development strategy in 2016 and aims to fulfil its commitments on greenhouse gas emissions by reducing its dependence on fossil fuels. This involves the promotion of renewable energy sources, energy efficiency and climate-friendly technologies. While Cyprus is still on its planned trajectory for increasing the share of renewables in final energy consumption, an acceleration of renewable energy supply is likely to be needed to meet the 2020 target. The economic recovery is leading to a sustained increase in sales of petroleum products, which might translate into rising energy consumption and, consequently, greenhouse gas emissions, and make it harder to reach the mitigation targets.

**The electricity market remains heavily dependent on imported oil products.** Electricity is mostly produced by the state-owned EAC, which relies on a set of plants using heavy fuel oil and gas oil. The production of electricity from renewable energy sources remains below EU 2020 targets, as capacity build-up was prevented by the freeze on new licences for independent power producers until early 2017. The opening-up of the electricity market is scheduled for mid-2019, while from September 2017, suppliers and generators may trade electricity using bilateral contracts. In December, ministerial decisions were taken to ensure that in the future the Transmission System Operator will have the capacity and the independency to operate the electricity market. The authorities have identified the desired structure for introduction of natural gas into the domestic electricity market by 2020. They intend to launch tenders for establishing the necessary infrastructure and the long-term importing of natural gas.

**Gas exploration in Cyprus' exclusive economic zone (EEZ) has resumed and will intensify.** Following the renewal of exploration licences for blocks 2, 3, 9 and 11 of the EEZ (ENI/KOGAS

and Total) until 2018, in April 2017 new licences for blocks 6, 8 and 10 were granted to well-known companies (ExxonMobil, Qatar Petroleum, Eni and Total). Exploration drilling resumed in June, indicating that the geological features of Cyprus' EEZ are similar to that of the large gas field in the neighbouring, Egyptian EEZ. This can be considered an encouraging sign for oil companies currently present in Cyprus, as it might indicate that more gas reserves are likely to be found. As negotiations on the commercialisation of the Aphrodite gas field continue, exploratory drillings took place in 2017 and more are expected in 2018, which should bring more clarity as to the extent of Cyprus' hydrocarbon reserves.

**Measures have not yet been taken to ensure continued compliance with the Industrial Emissions Directive once current derogations have expired.** The plants using heavy fuel oil to generate electricity must comply with the Directive, but are covered by derogations until the end of 2019, and in one case, until 2023. Plans to start importing liquefied natural gas by 2020, might facilitate compliance with the Directive.

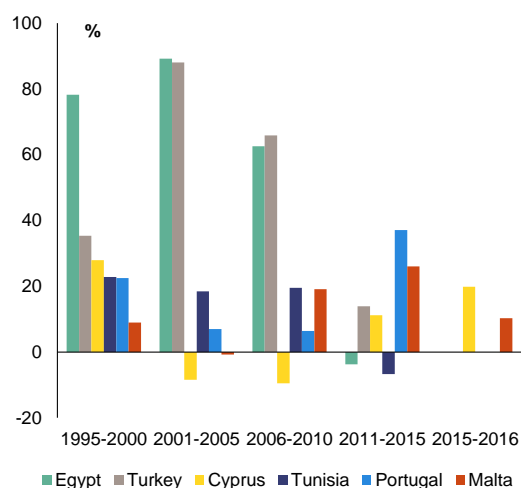
#### 4.5.4. TOURISM POLICY

**Cyprus is experiencing a tourism boom.** In 2016, the number of visiting tourists rose by 20 %, while tourism revenues increased by 13 % of GDP. In 2017, visits increased by another 15 % to an all-time record of 3.7 million tourists. Tourism revenues grew by 12 % y-o-y<sup>(53)</sup>. It is estimated that tourism accounted directly for 7 % of Cyprus' GDP and 7 % of jobs in 2016, while including indirect and induced effects, it accounted for over a fifth of GDP and 22 % of jobs (World Travel & Tourism Council, 2017).

**External factors are playing a major positive role in the current tourism boom.** While globally the tourism industry has been on the rise, Cyprus performance from 2000 up to 2015 was rather weak. The country lost its competitive advantage, as rising industry costs were not matched by improvements in quality, while most of its competitors, particularly Turkey, engaged in substantial upgrades of tourism facilities. As of 2010, terrorist attacks, as well as political and civil

unrest have severely harmed Cyprus' competitors in North Africa and the Middle East. This trend has intensified since 2015, diverting tourist flows, particularly from Europe, to safer destinations, and giving Cyprus a temporary competitive advantage.

Graph 4.5.1: Changes in number of tourist arrivals



Source: World Tourism Organisation

**Cyprus has also made efforts to attract tourists by improving air connectivity, advertising, and diversifying tourism products.** The 2015 bankruptcy of Cyprus Airways, the national carrier, incentivised competition in the air transport market. Traditional airlines increased their participation and low-cost operators entered the market. As part of the economic adjustment programme, Cyprus removed several restrictions on foreign operators, in particular as regards the number of airlines that can fly to Cyprus. Improved air access was combined with intensified, more targeted advertising. In parallel, tourism products diversified from the traditional 'sun and beach' to include nautical, rustic and sport tourism, 'experiences' such as cycling, diving, golf, wellness, wine tours, and conference hosting. This ongoing strategy has been successful, in particular by extending tourist arrivals during to the 'shoulder months' (March-May and October). Compared with European peers with a similar climate, Cyprus scores well in seasonality terms.

**The heavy reliance on two inbound markets is one of the main challenges, although efforts are being made to broaden the tourist base.** The UK remains the largest inbound market, accounting for

<sup>(53)</sup> Data up to October 2017.

about a third of all tourists, followed by Russia, currently accounting for about a quarter of all tourists. The few other long-established, but much smaller markets include Greece, Germany and Sweden (about 5% each). Efforts have been made to exploit other markets, resulting in more short-distance visitors, notably from Israel and Lebanon, with number of Israeli visitors growing particularly fast (76% in 2017) and becoming the third biggest inbound market. Thanks to new connections to European regional airports, substantial increase in 2017 was recorded in visits by German (52%), Swedes (19%), Polish (33%), Austrian (33%) and other tourists. Efforts to diversify the tourist base are expected to continue, with some progress made in providing visas, e.g. for Chinese and Iranian nationals.

**The challenges to further expansion of tourism stem from accommodation capacity and growing environmental impact.** The official accommodation sector reached full capacity in the peak months of 2016. The further increase in arrivals in 2017 suggests the active use of informal accommodation. Supply is responding to demand, and various hotel units were either under construction or renovation in 2017, which is expected to increase official bed capacity by 3%.

Further sizable projects are planned to start in 2018. However, the rapid hotel expansion and buoyant residential construction in prime tourist areas pose questions of environmental sustainability. This is particularly true with respect to air pollution, and water and waste management, which pose critical challenges (see Section 4.5.2). The overall sustainability of the tourism sector depends on the implementation of adequate environmental impact assessment in new investments.

**A new national tourism strategy is under consideration.** Following the public consultation on a study conducted by the external consultants, a proposal on National Tourism Strategy was submitted to the Council of Ministers, with the summary and the main elements of the new strategy. The strategy aims at making Cyprus a premium tourism destination, while emphasizing the sustainability aspects of tourism growth. The proposal was approved on 17<sup>th</sup> January 2018.

## ANNEX A

### OVERVIEW TABLE

Commitments	Summary assessment <sup>(54)</sup>
Country – specific recommendations (CSRs)	
<p><b>CSR 1:</b> Pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails remaining at its medium-term budgetary objective in 2018. Use windfall gains to accelerate the reduction of the general government debt ratio. By the end of 2017, adopt key legislative reforms aiming to improve efficiency in the public sector, in particular on the functioning of public administration governance of state-owned entities local governments. (MIP-relevant)</p>	<p>Cyprus has made <b>limited progress</b> in addressing CSR 1, in particular concerning the public administration reform, with the adoption of legislation facilitating staff mobility between the public administration and state-owned entities. No progress was made regarding the reforms of state-owned entities and local governments.</p> <p>The compliance assessment with the Stability and Growth Pact will be included in Spring when final data for 2017 will be available.</p>
<p>Pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails remaining at its medium-term budgetary objective in 2018.</p>	<p>The compliance assessment with the Stability and Growth Pact will be included in Spring when final data for 2017 will be available.</p>
<p>Use windfall gains to accelerate the reduction of the general government debt ratio.</p>	<p>The compliance assessment with the Stability and Growth Pact will be included in Spring when final data for</p>

<sup>(54)</sup> The following categories are used to assess progress in implementing the 2017 country-specific recommendations (CSRs):

**No progress:** The Member State has not credibly announced nor adopted any measures to address the CSR. This category covers a number of typical situations, to be interpreted on a case-by-case basis taking into account country-specific conditions. They include the following:

- no legal, administrative, or budgetary measures have been announced in the national reform programme, in any other official communication to the national Parliament/relevant parliamentary committees or the European Commission, publicly (e.g. in a press statement or on the government's website);
- no non-legislative acts have been presented by the governing or legislative body;
- the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures to be taken (unless the CSR explicitly asks for orientations or exploratory actions). However, it has not proposed any clearly-specified measure(s) to address the CSR.

**Limited progress:** The Member State has:

- announced certain measures but these address the CSR only to a limited extent; and/or
- presented legislative acts in the governing or legislative body but these have not been adopted yet and substantial further, non-legislative work is needed before the CSR is implemented;
- presented non-legislative acts, but has not followed these up with the implementation needed to address the CSR.

**Some progress:** The Member State has adopted measures:

- that partly address the CSR; and/or
- that address the CSR, but a fair amount of work is still needed to address the CSR fully as only a few of the measures have been implemented. For instance, a measure or measures have been adopted by the national Parliament or by ministerial decision, but no implementing decisions are in place.

**Substantial progress:** The Member State has adopted measures that go a long way towards addressing the CSR and most of them have been implemented.

**Full implementation:** The Member State has implemented all measures needed to address the CSR appropriately.

	2017 will be available.
<p>By the end of 2017, adopt key legislative reforms aiming to improve efficiency in the public sector, in particular on the functioning of public administration,</p> <p>(...) governance of state-owned entities</p> <p>(...) and local governments</p>	<p>There has been <b>some progress</b> regarding the improvement of the efficiency of the public sector with the adoption of legislation facilitating staff mobility between the public service and state-owned entities. Some measures were also undertaken promoting e-governance. However, key legislation remains to be adopted.</p> <p>There has been <b>no progress</b> with regard to the governance of state-owned entities. The draft law is still pending adoption by the House of Representatives.</p> <p>There has been <b>no progress</b> related to the reform of local governments. Relevant legislation is awaiting adoption by the House of Representatives.</p>
<p><b>CSR 2:</b> Increase the efficiency of the judicial system by modernising civil procedures, implementing appropriate information systems and increasing the specialisation of courts. Take additional measures to eliminate impediments to the full implementation of the insolvency and foreclosure frameworks, and to ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.</p>	<p>Cyprus has made <b>Limited Progress</b> in addressing CSR 2. Regarding the efficiency of the judicial system, some measures have been announced, but key reforms are at preliminary stage. Efforts are on-going on eliminating obstacles to fully implement the insolvency and foreclosure frameworks, but no significant progress was recorded. Administrative steps were taken to address the issuance of title deeds and transfer of immovable property rights, but more comprehensive measures remain to be adopted.</p>
<p>Increase the efficiency of the judicial system by modernising civil procedures, implementing appropriate information systems and increasing the specialisation of courts.</p>	<p><b>Limited Progress</b> in modernising the civil procedures. A legislation filtering appeals on interlocutory decisions is in place. However, a series of announced measures still remain to be implemented, such as setting up a management information system for the courts (e-justice system), establishing a specialised commercial court, amending the civil procedure law to strengthen the legal framework for the enforcement of</p>



	judgements, incentivising judicial mediation and creating a training department in the Supreme Court.
Take additional measures to eliminate impediments to the full implementation of the insolvency and foreclosure frameworks,	<b>Limited progress</b> in eliminating barriers to fully implement the insolvency and foreclosure frameworks. Rules of Court have been adopted for personal insolvency procedures, but the amendment of the bankruptcy rules on legal entities is still under preparation. An independent review of the insolvency and foreclosure frameworks, covering also staffing and IT requirements, is completed and the results are reviewed by the authorities.
(...) and to ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.	<b>Limited Progress</b> on ensuring reliable and swift systems for issuing title deeds and transferring of immovable property rights. Administrative simplification measures to facilitate the issuance of title deeds are on-going and a policy response related to the licencing and permitting procedures is under preparation based on findings of external experts. A draft law on the creation of a new system for the transfer of property rights is under preparation.
<b>CSR 3:</b> Accelerate the reduction of non-performing loans by setting related quantitative and time-bound targets for banks and ensuring accurate valuation of collateral for provisioning purposes. Create the conditions for a functional secondary market for non-performing loans. Integrate and strengthen the supervision of insurance companies and pension funds.	Cyprus has made <b>Limited Progress</b> in addressing CSR 3. Some measures were undertaken such as setting up a task force on non-performing loan in the Central Bank. Despite the small decline in non-performing loans, the level of stock is still very high.
Accelerate the reduction of non-performing loans by setting related quantitative and time-bound targets for banks and ensuring accurate valuation of collateral for provisioning purposes.	<b>Limited Progress</b> was made. The Central Bank of Cyprus in July 2017 set-up an NPL task force to develop a national strategy to reduce NPLs and the authorities are evaluating various options for a comprehensive solution to the NPL problem, including a new targeting framework creation.
Create the conditions for a functional secondary	<b>Limited Progress</b> was made by banks announcing the creation of joint

<p>market for non-performing loans.</p> <p>Integrate and strengthen the supervision of insurance companies and pension funds.</p>	<p>ventures with specialised foreign debt servicers to manage their NPL portfolios, which could facilitate NPL sales in the future. Recently Hellenic bank has sold a loan package of 145 mln euros. However, the legal framework for the securitisation of loans is still pending.</p> <p><b>Limited Progress</b> was made as relevant legislation is still under preparation.</p>
<p><b>CSR 4:</b> Accelerate the implementation of the action plan for growth, focusing in particular on fast-tracking strategic investments and improving access to finance, and, by the end of 2017, resume the implementation of the privatisation plan. Take decisive steps towards the ownership unbundling of the Electricity Authority of Cyprus and, in particular, proceed with the functional and accounting unbundling by the end of 2017.</p>	<p>Cyprus has made <b>Limited Progress</b> in addressing CSR 4. Limited progress was recorded in the implementation of the action plan for growth and no progress was made with regard to the privatisation plan.</p>
<p>Accelerate the implementation of the action plan for growth, focusing in particular on fast-tracking strategic investments and improving access to finance,</p>	<p><b>Some Progress</b> was made in implementing the action plan for growth. A series of measures stemming from the action plan are gradually being implemented. The legal framework to attract and facilitate large scale investments was submitted to the House of Representatives for adoption. Some initiatives were undertaken by the authorities to improve access to finance, but still remain at a preliminary stage.</p>
<p>(...) and, by the end of 2017, resume the implementation of the privatisation plan.</p>	<p><b>Limited Progress</b> has been achieved in pursuing the privatisation plan. Only the operations of the port of Limassol were transferred to a private consortium, while the privatisation of the port of Larnaca is under way. An agreement to sell the Greek subsidiary of CYTA was reached. A series of measures were announced but still are at preliminary stage.</p>
<p>Take decisive steps towards the ownership unbundling of the Electricity Authority of Cyprus and, in particular, proceed with the functional and accounting unbundling by the end of 2017.</p>	<p><b>Limited Progress.</b> Some new decisions were taken at ministerial level to ensure greater independence of the Transmission System Operator Cyprus, but many important steps still need to be</p>

	taken.
<b>CSR 5:</b> Speed up reforms aimed at increasing the capacity of public employment services and improving the quality of active labour market policies delivery. Complete the reform of the education system to improve its labour market relevance and performance, including teachers' evaluation. By the end of 2017, adopt legislation for a hospital reform and universal healthcare coverage.	There has been <b>some progress</b> overall in addressing CSR 5, in particular with the adoption of legislation establishing a universal National Health System.
Speed up reforms aimed at increasing the capacity of public employment services and improving the quality of active labour market policies delivery.	There has been <b>some progress</b> regarding the capacity of the public employment services with the initiation of the recruitment of additional counsellors, which will also facilitate the active labour market policies. A web platform to facilitate recruitment of personnel by employers was launched and a project for the use of private employment services by unemployed is being implemented.
Complete the reform of the education system to improve its labour market relevance and performance, including teachers' evaluation.	<b>Limited Progress.</b> Some measures are being implemented in relation to the vocational education training system. The new teacher appointing system is in place; however, no progress has been made regarding the evaluation system of teachers.
By the end of 2017, adopt legislation for a hospital reform and universal healthcare coverage.	<b>Substantial Progress.</b> The legislation for the creation of a national health system with universal coverage and the autonomisation of public hospitals was adopted. Secondary legislation and implementing steps are under way.
<b>Europe 2020 (national targets and progress)</b>	
<b>Target</b>	<b>Summary assessment</b>
Employment rate: 75 % - 77 % of the population aged 20-64 should be employed by 2020.	In 2016 the employment rate (20-64 years) increased to 68.7 % below the lower bound set in the national target. The employment rate is increasing, but remains below the pre-crisis period level, when Cyprus was already fulfilling its national target.

<p>Research and development target: Increase research and development expenditure to 0.5 % of GDP by 2020.</p>	<p>Cyprus has reached its national target with regard to R&amp;D intensity 0.5 % of GDP in 2016. Cyprus does not plan to further increase the annual expenditure on research, development and innovation until 2020, but rather to focus on the quality of spending.</p>
<p>Emissions in the sectors not covered by the EU ETS must decrease by 5 % in 2020 compared to 2005.</p>	<p>According to the latest national projections submitted to the Commission and taking into account existing measures, the target might be achieved by 2020.</p>
<p>Renewable energy target: 13 % of gross final energy consumption from renewable sources.</p>	<p>With a renewable energy share of 9.4 % in 2015 <sup>(55)</sup>, Cyprus is on track to reach the target for 2020. However, since the trajectory is not linear, the final target will need to be achieved by means of a stronger annual growth of the renewable energy share, in line with Cyprus's high potential in this area.</p>
<p>Energy efficiency target: absolute level of primary consumption of 2.2 Mtoe</p>	<p>Gross inland primary energy consumption was reduced during the recent economic recession, from 2.5 Mtoe in 2012 to 2.2 Mtoe in 2015. National data show that the energy consumption has recently started to pick-up in line with the sustained economic growth, which poses challenges in reaching the target without additional measures. Furthermore, over 90 % of Cyprus's energy consumption continues to be covered by imported oil and oil products.</p>
<p>Early school leaving target: Reduce the rate of early school leavers to 10 % by 2020.</p>	<p>Cyprus has already reached the Europe 2020 national target as regards early school leaving 7.6 % in 2016. However, in 2016 early school leaving rate grew by 2.4 pps compared to 2015. Among students with migrant background early school leaving is</p>

<sup>(55)</sup> Renewable energy shares for 2015 are approximations and not official data, reflecting the available data (04.10.2016). See Öko-Institut (2016).

	markedly higher at 18.2 %.
Tertiary education target: Increase participation in higher education to 46 %.	Cyprus surpassed its national target and it has one of the highest tertiary education attainment rates in the EU, 53.4 %, in 2016 as compared to 39.1 % EU average. However, unemployment of tertiary education graduates and skills mismatches continue to be a challenge.
Target for reducing the population at risk of poverty or social exclusion in number of persons: Reduce the number of people at risk of poverty or social inclusion by 27 000 persons or decrease to 19.3 % of the population. (base year 2008)	The number of people at risk of poverty or social exclusion had been increasing since 2008, reaching 27.8 % of the total population in 2013. In 2016 it increased to 27.7 % (corresponding to 10 000 less people at-risk-of-poverty or social exclusion than in 2015). Based on these figures, the national target for 2020 appears distant.

## ANNEX B

### MACROECONOMIC IMBALANCE PROCEDURE SCOREBOARD

Table B.1: The MIP scoreboard for Cyprus (AMR 2018)

			Thresholds	2011	2012	2013	2014	2015	2016
External imbalances and competitiveness	Current account balance, % of GDP	3 year average	-4%/6%	-7.7	-7.1	-5.0	-5.1	-3.6	-3.6
	Net international investment position	% of GDP	-35%	-129.9	-129.1	-138.7	-147.0	-145.0	-127.8
	Real effective exchange rate - 42 trading partners, HICP deflator	3 year % change	±5% (EA) ±11% (Non-EA)	-3.0	-5.9	-0.8	-1.7	-6.1	-6.5
	Export market share - % of world exports	5 year % change	-6%	-11.4e	-21.7e	-14.9	-23.8	-11.9	-3.0
	Nominal unit labour cost index (2010=100)	3 year % change	9% (EA) 12% (Non-EA)	9.4	3.2	-2.1	-7.6	-10.6	-6.2p
House price index (2015=100), deflated	1 year % change	6%	-4.5p	-5.3p	-4.1p	-1.3p	0.3bp	1.6	
Internal imbalances	Private sector credit flow, consolidated	% of GDP	14%	13.0	16.5	-13.3	-0.3	4.1	10.2p
	Private sector debt, consolidated	% of GDP	133%	321.6	328.1	340.1	352.5	353.5	344.6p
	General government gross debt	% of GDP	60%	65.7	79.7	102.6	107.5	107.5	107.1
	Unemployment rate	3 year average	10%	6.5	8.7	11.9	14.6	15.7	14.7
	Total financial sector liabilities, non-consolidated	1 year % change	16.5%	-6.1	6.3	-15.3	-3.7	11.1	0.7
Employment indicators	Activity rate - % of total population aged 15-64	3 year change in pp	-0.2 pp	-0.1	0.5b	0.0	0.8	0.4	-0.2
	Long-term unemployment rate - % of active population aged 15-74	3 year change in pp	0.5 pp	1.1	3.0	4.8	6.1	3.2	-0.3
	Youth unemployment rate - % of active population aged 15-24	3 year change in pp	2 pp	13.4	13.9	22.3	13.6	5.1	-9.8

Flags:b:Break in series. e:Estimated. p:Provisional.

1) This table provides data as published under the Alert Mechanism Report 2018, which reports data as of 24 Oct 2017. Please note that figures reported in this table may therefore differ from more recent data elsewhere in this document. 2) Figures highlighted are those falling outside the threshold established in the European Commission's Alert Mechanism Report.

Source: European Commission 2017, Statistical Annex to the Alert Mechanism Report 2018, SWD(2017) 661.



## ANNEX C

### STANDARD TABLES

Table C.1: **Financial market indicators**

	2012	2013	2014	2015	2016	2017
Total assets of the banking sector (% of GDP) <sup>(1)</sup>	657.4	497.7	517.7	513.0	477.6	425.1
Share of assets of the five largest banks (% of total assets)	62.6	64.1	63.4	67.5	65.7	-
Foreign ownership of banking system (% of total assets) <sup>(2)</sup>	30.1	33.9	35.2	19.2	21.6	19.7
Financial soundness indicators: <sup>(2)</sup>						
- non-performing loans (% of total loans) <sup>(3)</sup>	18.7	36.2	35.6	34.7	33.8	31.4
- capital adequacy ratio (%)	7.3	13.5	15.3	16.6	16.8	16.4
- return on equity (%) <sup>(4)</sup>	-100.8	-37.9	-7.1	-7.7	1.7	-8.5
Bank loans to the private sector (year-on-year % change) <sup>(1)</sup>	4.2	-9.4	-4.2	3.6	-8.3	3.8
Lending for house purchase (year-on-year % change) <sup>(1)</sup>	0.3	-6.8	-2.8	-3.0	-1.0	-0.6
Loan to deposit ratio <sup>(1)</sup>	119.3	152.3	152.1	152.0	120.5	114.1
Central Bank liquidity as % of liabilities	-	-	12.4	6.9	1.3	1.4
Private debt (% of GDP)	328.1	340.1	352.5	353.5	344.6	-
Gross external debt (% of GDP) <sup>(2)</sup> - public	-	-	-	-	-	-
- private	-	-	-	-	-	-
Long-term interest rate spread versus Bund (basis points)*	550.5	493.0	483.7	404.1	368.3	239.9
Credit default swap spreads for sovereign securities (5-year)*	1196.2	943.9	423.1	330.6	262.5	180.0

(1) Latest data Q3 2017. Includes not only banks but all monetary financial institutions excluding central banks.

(2) Latest data Q2 2017.

(3) As per ECB definition of gross non-performing debt instruments. The aggregate NPL ratio, which covers all loan and advances, may be misleading for Cyprus due to the large exposures of domestic and foreign banks to central banks (representing 14% of gross loans) and other financial institutions (10% of gross loans). For Cyprus the NPL ratio for the private sector, comprising only exposures to non-financial corporations and households is more appropriate indicator see Section 4.2.

(4) Quarterly values are not annualised.

\* Measured in basis points.

**Source:** European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators)

Table C.2: **Headline Social Scoreboard indicators**

	2012	2013	2014	2015	2016	2017 <sup>5</sup>
<b>Equal opportunities and access to the labour market</b>						
Early leavers from education and training (% of population aged 18-24)	11.4	9.1	6.8	5.2	7.6	:
Gender employment gap (pps)	11.3	10.4	7.7	8.3	9.7	9.9
Income inequality, measured as quintile share ratio (S80/S20)	4.7	4.9	5.4	5.2	4.9	:
At-risk-of-poverty or social exclusion rate <sup>1</sup> (AROPE)	27.1	27.8	27.4	28.9	27.7	:
Young people neither in employment nor in education and training (% of population aged 15-24)	16.0	18.7	17.0	15.3	16.0	:
<b>Dynamic labour markets and fair working conditions<sup>†</sup></b>						
Employment rate (20-64 years)	70.2	67.2	67.6	67.9	68.7	70.4
Unemployment rate <sup>2</sup> (15-74 years)	11.9	15.9	16.1	15.0	13.0	11.3
Gross disposable income of households in real terms per capita <sup>3</sup> (Index 2008=100)	:	:	77.0	76.9	:	:
<b>Public support / Social protection and inclusion</b>						
Impact of social transfers (excluding pensions) on poverty reduction <sup>4</sup>	37.4	37.0	41.5	36.2	35.6	:
Children aged less than 3 years in formal childcare	26.0	25.0	25.5	20.8	24.8	:
Self-reported unmet need for medical care	3.5	4.4	4.7	1.5	0.6	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	:	43.0	43.0	50.0

† The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance. The indicators "participants in active labour market policies per 100 persons wanting to work" and "compensation of employees per hour worked (in EUR)" are not used due to technical concerns by Member States. Possible alternatives will be discussed in the relevant Committees.

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).

(2) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.

(3) Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2018.

(4) Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).

(5) Average of first three quarters of 2017 for the employment rate and gender employment gap.

Source: Eurostat

Table C.3: Labour market and education indicators

Labour market indicators	2012	2013	2014	2015	2016	2017 <sup>5</sup>
Activity rate (15-64)	73.5	73.6	74.3	73.9	73.4	:
Employment in current job by duration						
<i>From 0 to 11 months</i>	15.7	15.7	18.5	18.1	19.7	:
<i>From 12 to 23 months</i>	10.1	8.5	7.6	9.5	9.7	:
<i>From 24 to 59 months</i>	19.1	17.9	15.7	14.9	13.7	:
<i>60 months or over</i>	55.1	57.9	58.2	57.5	56.9	:
Employment growth*						
(% change from previous year)	-3.2	-5.9	-1.8	1.5	3.1	3.3
Employment rate of women						
(% of female population aged 20-64)	64.8	62.2	63.9	64.0	64.1	65.7
Employment rate of men						
(% of male population aged 20-64)	76.1	72.6	71.6	72.3	73.8	75.6
Employment rate of older workers*						
(% of population aged 55-64)	50.7	49.6	46.9	48.5	52.2	54.5
Part-time employment*						
(% of total employment, aged 15-64)	9.7	11.9	13.5	13.0	13.4	12.4
Fixed-term employment*						
(% of employees with a fixed term contract, aged 15-64)	15.1	17.5	19.0	18.4	16.5	15.5
Transition rate from temporary to permanent employment (3-year average)	23.0	22.0	20.4	21.6	:	:
Long-term unemployment rate <sup>1</sup> (% of labour force)	3.6	6.1	7.7	6.8	5.8	4.8
Youth unemployment rate						
(% active population aged 15-24)	27.7	38.9	36.0	32.8	29.1	26.1
Gender gap in part-time employment	6.7	7.2	6.5	5.5	4.3	6.4
Gender pay gap <sup>2</sup> (in undadjusted form)	15.6	14.9	14.2	14.0	:	:
<b>Education and training indicators</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Adult participation in learning (% of people aged 25-64 participating in education and training)	7.7	7.2	7.1	7.5	6.9	:
Underachievement in education <sup>3</sup>	42.0	:	:	42.6	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	49.9	47.8	52.5	54.5	53.4	:
Variation in performance explained by students' socio-economic status <sup>4</sup>	:	:	:	9.5	:	:

\* Non-scoreboard indicator

(1) Long-term unemployed are people who have been unemployed for at least 12 months.

(2) Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included.

(3) PISA (OECD) results for low achievement in mathematics for 15 year-olds.

(4) Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.

(5) Average of first three quarters of 2017, unless for the youth unemployment rate (annual figure).

Source: Eurostat, OECD

Table C.4: Social inclusion and health indicators

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
<i>Sickness/healthcare</i>	4.5	4.5	4.4	4.7	:	:
<i>Disability</i>	0.7	0.7	0.7	0.7	:	:
<i>Old age and survivors</i>	11.1	12.0	11.8	11.7	:	:
<i>Family/children</i>	1.5	1.4	1.4	1.3	:	:
<i>Unemployment</i>	1.6	2.0	1.5	1.2	:	:
<i>Housing</i>	0.6	0.4	0.3	0.4	:	:
<i>Social exclusion n.e.c.</i>	1.2	1.1	1.1	1.3	:	:
<b>Total</b>	21.2	22.1	21.3	21.4	:	:
<i>of which: means-tested benefits</i>	2.9	2.7	2.6	2.8	:	:
General government expenditure by function (% of GDP, COFOG)						
<i>Social protection</i>	12.9	13.4	13.7	13.6	13.8	:
<i>Health</i>	3.0	3.1	2.6	2.6	2.6	:
<i>Education</i>	6.3	6.8	6.0	6.0	6.0	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	44.0	43.1	44.8	43.9	:	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	27.5	27.7	24.7	28.9	29.6	:
At-risk-of-poverty rate <sup>1</sup> (% of total population)	14.7	15.3	14.4	16.2	16.1	:
In-work at-risk-of-poverty rate (% of persons employed)	7.9	8.9	7.8	9.1	8.2	:
Severe material deprivation rate <sup>2</sup> (% of total population)	15.0	16.1	15.3	15.4	13.6	:
Severe housing deprivation rate <sup>3</sup> , by tenure status						
<i>Owner, with mortgage or loan</i>	0.0	1.1	1.5	0.0	2.0	:
<i>Tenant, rent at market price</i>	1.9	2.6	3.0	1.3	1.6	:
Proportion of people living in low work intensity households <sup>4</sup> (% of people aged 0-59)	6.5	7.9	9.7	10.9	10.6	:
Poverty thresholds, expressed in national currency at constant prices*	8958	8148	7363	7072	7301	:
Healthy life years (at the age of 65)						
<i>Females</i>	7.7	8.7	8.8	7.3	:	:
<i>Males</i>	8.8	9.5	10.4	8.4	:	:
Aggregate replacement ratio for pensions <sup>5</sup> (at the age of 65)	0.4	0.4	0.4	0.4	0.4	:
Connectivity dimension of the Digital Economy and Society Index (DESI) <sup>6</sup>	:	:	37.7	40.4	48.2	54.6
GINI coefficient before taxes and transfers*	42.9	43.8	44.8	47.4	47.1	:
GINI coefficient after taxes and transfers*	31.0	32.4	34.8	33.6	32.1	:

(1) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.

(2) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.

(3) Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.

(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.

(5) Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.

(6) Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.

Source: Eurostat, OECD

Table C.5: Product market performance and policy indicators

Performance Indicators	2010	2011	2012	2013	2014	2015	2016
Labour productivity (real, per person employed, year-on-year % change)							
Labour productivity in Industry	4.24	-10.75	-5.09	2.79	4.39	4.51	3.01
Labour productivity in Construction	-2.97	-1.47	-6.43	6.58	-0.54	-1.99	4.21
Labour productivity in Market Services	2.93	2.12	0.98	-0.49	-2.26	0.75	-0.95
Unit labour costs (ULC) (whole economy, year-on-year % change)							
ULC in Industry	3.42	12.59	11.61	-19.22	-1.19	-3.57	-3.84
ULC in Construction	4.65	2.89	3.10	-3.91	-3.25	0.97	-4.28
ULC in Market Services	1.53	1.47	0.80	-2.85	-0.83	-1.38	0.42
<b>Business Environment</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Time needed to enforce contracts <sup>(1)</sup> (days)	735.0	735.0	735.0	735.0	1100.0	1100.0	1100.0
Time needed to start a business <sup>(1)</sup> (days)	8.0	8.0	8.0	8.0	8.0	8.0	6.0
Outcome of applications by SMEs for bank loans <sup>(2)</sup>	na	0.70	na	1.41	1.34	1.76	0.76
<b>Research and innovation</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
R&D intensity	0.45	0.46	0.44	0.48	0.51	0.48	0.50
General government expenditure on education as % of GDP	6.70	6.50	6.10	6.50	5.70	5.70	na
Persons with tertiary education and/or employed in science and technology as % of total employment	42	45	47	48	50	49	49
Population having completed tertiary education <sup>(3)</sup>	32	34	35	35	36	36	38
Young people with upper secondary level education <sup>(4)</sup>	86	88	88	90	92	94	91
Trade balance of high technology products as % of GDP	-3.03	-1.40	-1.00	-0.23	-1.24	-0.25	na
<b>Product and service markets and competition</b>					<b>2003</b>	<b>2008</b>	<b>2013</b>
OECD product market regulation (PMR) <sup>(5)</sup> , overall					na	na	1.65
OECD PMR <sup>(5)</sup> , retail					na	na	1.67
OECD PMR <sup>(5)</sup> , professional services					na	na	3.11
OECD PMR <sup>(5)</sup> , network industries <sup>(6)</sup>					na	na	2.64

(1) The methodologies, including the assumptions, for this indicator are shown in detail here:

<http://www.doingbusiness.org/methodology>.

(2) Average of the answer to question Q7B\_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received most of it, two if only received a limited part of it, three if refused or rejected and treated as missing values if the application is still pending or don't know.

(3) Percentage population aged 15-64 having completed tertiary education.

(4) Percentage population aged 20-24 having attained at least upper secondary education.

(5) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: <http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm>

(6) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).

**Source:** European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans).

Table C.6: Green growth

Green growth performance		2011	2012	2013	2014	2015	2016
<b>Macroeconomic</b>							
Energy intensity	kgoe / €	0.14	0.13	0.12	0.13	0.13	0.13
Carbon intensity	kg / €	0.48	0.47	0.46	0.48	0.47	-
Resource intensity (reciprocal of resource productivity)	kg / €	1.17	0.89	0.68	0.69	0.65	0.70
Waste intensity	kg / €	-	0.11	-	0.12	-	-
Energy balance of trade	% GDP	-6.8	-7.5	-6.3	-5.9	-4.1	-3.5
Weighting of energy in HICP	%	8.73	9.42	9.53	9.33	8.35	7.46
Difference between energy price change and inflation	%	14.0	17.9	-7.0	-8.8	-17.5	-13.5
Real unit of energy cost	% of value added	10.7	12.6	11.8	11.6	-	-
Ratio of environmental taxes to labour taxes	ratio	0.24	0.23	0.26	0.28	0.26	-
Environmental taxes	% GDP	2.8	2.6	2.7	3.1	3.0	3.0
<b>Sectoral</b>							
Industry energy intensity	kgoe / €	0.17	0.16	0.18	0.22	0.19	0.19
Real unit energy cost for manufacturing industry excl. refining	% of value added	26.7	28.8	26.7	26.4	-	-
Share of energy-intensive industries in the economy	% GDP	4.15	3.73	3.67	3.56	3.75	-
Electricity prices for medium-sized industrial users	€ / kWh	0.19	0.23	0.20	0.18	0.14	0.12
Gas prices for medium-sized industrial users	€ / kWh	-	-	-	-	-	0.00
Public R&D for energy	% GDP	0.00	0.00	0.00	0.00	0.00	0.00
Public R&D for environmental protection	% GDP	0.00	0.00	0.00	0.00	0.00	0.00
Municipal waste recycling rate	%	12.6	13.6	14.6	16.8	17.9	17.2
Share of GHG emissions covered by ETS*	%	49.8	50.3	50.6	53.2	50.1	52.6
Transport energy intensity	kgoe / €	0.81	0.78	0.68	0.73	0.77	0.81
Transport carbon intensity	kg / €	1.73	1.67	1.47	1.58	1.68	-
<b>Security of energy supply</b>							
Energy import dependency	%	92.4	97.0	96.3	93.2	97.7	96.2
Aggregated supplier concentration index	HHI	0.0	0.0	0.0	0.0	0.0	-
Diversification of energy mix	HHI	0.91	0.90	0.88	0.88	0.87	0.87

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 prices)

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)

Carbon intensity: greenhouse gas emissions (in kg CO<sub>2</sub> equivalents) divided by GDP (in EUR)

Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)

Real unit energy cost: real energy costs as % of total value added for the economy

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2010 EUR)

Real unit energy costs for manufacturing industry excluding refining: real costs as % of value added for manufacturing sectors

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Electricity and gas prices for medium-sized industrial users: consumption band 500–20 000 MWh and 10 000–100 000 GJ; figures excl. VAT.

Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste

Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP

Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG emissions (excl land use, land use change and forestry) as reported by Member States to the European Environment Agency.

Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2010 EUR)

Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport sector

Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels

Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.

Diversification of the energy mix: Herfindahl index covering natural gas, total petrol products, nuclear heat, renewable energies and solid fuels

\* European Commission and European Environment Agency

**Source:** European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes and GDP); Eurostat (all other indicators)



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